Are the Rich Necessary?

Great Economic Arguments and How They Reflect Our Personal Values

Hunter Lewis

"Highly provocative and highly pleasurable."

The New York Times

Updated & Expanded Edition

Praise for the First Edition of *Are the Rich Necessary?*

"I salute Hunter Lewis for his original and stimulating book, which concerns itself with subjects of the greatest possible importance and relevance in today's unbalanced world. His ideas for helping the problems we face are radical, thought provoking and should be considered by as many people as possible."

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"Lewis presents a number of prescient arguments that seek to answer the title question and others, exposing in the process alternate approaches to solving everyday economic problems. . . . [He] is skilled at boiling down arguments to their most concise, and his sharp analysis employs highly accessible prose."

—*Publishers Weekly*

"Carefully weighing the pros and cons of big-think economic issues . . . Lewis . . . offers some big ideas of his own."

—Justin Ewers, *U.S. News & World Report*

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"Lewis sees great promise in expanding the non-profit sector . . . to bring the various economic factions together."

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"Creative."

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"Hunter Lewis . . . argues both sides of such questions as 'Are there alternatives to the profit system?' and 'Can government protect us from the excesses of the profit system?' . . . [then] sets forth his own argument on the best way to ease poverty and create economic cooperation, which he says is key to building lasting societal wealth."

—Anne W. Howard,
The Chronicle of Philanthropy

"Provocative."

—Mike Schneider, Bloomberg Television

"Prompts the reader to question his or her assumptions."

—Kathryn Fuller, Chair of the Board,
Ford Foundation

"[Lewis] . . . break[s] complex subjects down into understandable language."

—David Maurer, *Charlottesville* (VA) *Daily Progress*

"The 'rich question' is the issue on which economics was founded."

—Mark Thornton, LewRockwell.com

"Pits the likes of Al Sharpton against Milton Friedman. Fair fight."

—Jesse Eisinger, *Conde Nast Portfolio*

"Excellent . . . Lewis has an ingenious idea . . . that he hopes will elicit agreement from the proponents of the major value perspectives."

—David Gordon, *The Mises Review*

"Lewis presents a number of prescient arguments that seek to answer the title question and others, exposing in the process alternate approaches to solving everyday economic problems. . . . [He] is skilled at boiling down arguments to their most concise, and his sharp analysis employs highly accessible prose."

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UPDATED AND EXPANDED EDITION

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A Note on This Edition

ARE THE RICH NECESSARY? has been updated and expanded in this initial softcover edition. In particular, material has been added to cover the world financial crisis of 2008, although that crisis was already anticipated by comments in the original 2007 hardcover edition. In addition, material from *Rich's* companion volume, *How Much Money Does an Economy Need?*, has now been included within *Rich*.

Part One

The Central Economic Problem

1

Why Are We Still So Poor?

If you put $10 in a bank account and earn 3% interest, the money will double every twenty-five years. Even after a long lifetime, you might have only $30 or $40 dollars. "No way to get rich," you are thinking.

But humanity goes on. Imagine that the bank account kept on doubling every quarter century for 1,000 years. The original $10 would then have grown to a sum worth over two times the world's total wealth today.

Compounding money over long periods of time produces fantastic results. So why has humanity not done better? The reason is simple. Throughout human history, capital has been created, capital has been destroyed, over and over. Compounding has hardly had a chance to start, much less reach the magic of multiplying large numbers.

There are a variety of reasons for this: natural disasters such as disease and weather-related famine, war, and other human follies. But there has also been almost complete intellectual confusion about how to organize ourselves to end poverty and deprivation.

We also know, through simple intuition, that it is not enough to find the right answer. We must agree on the answer. Societies do not become rich simply by preserving and growing their capital. They become rich by cooperating. The more cooperation, the more potential to preserve, invest, and grow capital. There is an irony in this. We need to cooperate. But, almost at once, we start to argue about how we might best go about cooperating.

2

The Appeal of Science

One way to try to overcome this initial obstacle, the difficulty in deciding how best to go about cooperating, is to see if we can develop economics into a science. A scientific approach would separate truth from error and help us reach agreement.

But can economics be a science? Is wealth creation like building an engine or a bridge, something that will follow formal rules, as soon as we discover the rules? Or is wealth creation more like raising children, a task for which there are no formal rules, at least no rules that fit every occasion and every child?

If the economic problem is a scientific one, it can be solved. If a non-scientific one, it can only be managed, not solved. In the latter case, we will have to rely on our judgment, in particular we will have to rely on value judgments.

Economist Milton Friedman thought that economics could be a science. He spoke for many of his colleagues in the 1950s when he wrote that "Economics is, or can be, an 'objective' science, in precisely the same sense as any of the physical sciences."[1]

Unfortunately, there are important reasons why a scientific approach to economics may not work. To begin with, the ultimate subject matter in economics is human behavior, and human beings are notoriously unpredictable. Today we want this, tomorrow we want the opposite, and there may not be much "rhyme or reason" about it.

Our unpredictability is only one problem. There is another major one. If we watch an apple fall from a tree, our watching has no effect on the apple. But if we watch people, the lessons we learn may change our behavior or even the behavior of the people we are watching.

Here's an example. Assume that people study stock market history and decide that stocks are the best and the safest place to put their money. What will they do then?

Naturally they will buy more and more stocks. But, by doing so together, they will raise prices dramatically, and this will make the stocks more and more risky. Eventually, almost all the potential buyers will already have bought, so that people who must sell (such as retirees) will have no one left to whom to sell. At that point, prices will collapse, leaving millions of investors poor and bewildered.

This is not a hypothetical example. Something similar happened in the great American stock market crashes of 1929, 1973, and 2000. The lesson here is clear: just when we all decide that something in economics is "true," it may cease to be true.

3

Economic Arguments

WHETHER WE LIKE it or not, economics is unlikely to become a science, in the same sense that physics or chemistry are sciences. But that does not mean that there are no economic answers. We must find them and we do.

In the first place, we develop guide rules based on our life experiences. Sometimes these guide rules are highly contextual, even paradoxical, as in the motto, "Moderation in all things, even in moderation."

We also form ideals, and try to temper those ideals with common sense. We change our stance as the times change. Above all, we argue.

Many economics textbooks downplay arguments. They do not want to leave an impression that nothing is settled, that the entire field is in a state of chaos. This is understandable. As noted earlier, we cannot create wealth without cooperating. And we cannot cooperate if we are always fighting over who is right.

Nevertheless, it may be better to acknowledge forthrightly that economics is, now and always, an intellectual, moral, and material battlefield. On the positive side, this means that economics, properly presented, is rarely dull, because there is nothing more exciting than entering a battlefield.

In any case, the remainder of this book will present a series of fundamental economic arguments. These arguments are fundamental in the sense that they underlie many other, perhaps most other economic quarrels. For example, the question "Are the rich necessary?" underlies many of the most contentious issues about how the government should intervene (or not intervene) in the economy.

In presenting these fundamental economic arguments, the author of this book has tried to avoid taking sides. Only the reader can judge the success of this effort to stand back from the economic battlefield, and the verdict is not likely to be kind. But, in every case, both sides of the argument are covered, first one side, then the other. To borrow super-lawyer Robert Strauss's quip, the object has been to "teach it flat and teach it round" and then let the reader choose.

As the book progresses through the arguments, some of the debating points may appeal to our emotions, some to logic, some to "common sense," which usually reflects our practical experience. Some may be simple, others complex. If a point of view is complex, it may get more space.

Unequal space for contesting points of view may strike some readers as a betrayal of the author's intention to try to avoid taking sides. Should not the "equal time" doctrine applied to commercial broadcasts of political debates in the US also apply here? But, in this case, we are not dealing with candidate A versus candidate B. We are dealing with ideas, some simple, some complex. A rigid, Procrustean, one-size-fits-all approach will not help us to understand them. In any case, simple (and brief) ideas are often more persuasive than complex (and wordy) ones.

The order in which arguments are presented may also trouble some readers. Is it favoritism to present an argument first? Or, conversely, last? As a general rule, the side with simpler arguments has been presented first.

It goes without saying that the author of this book does have his own ideas like anyone else. Some of these ideas are laid out in the last chapter. In particular, I would like to expand the part of the economy that is neither "private" (owned by individuals) nor "public" (owned or controlled by government). That is, I would like to expand the charitable or nonprofit sector, something that could easily be accomplished by changes in the tax code. My hope is that this approach would help reduce the bitter quarrels that continually rage over the degree of government control of the economy.

But, as stated above, the principal purpose of this book is not to propagate a particular set of ideas. It is instead to present a variety of conflicting economic ideals, ideas, and arguments, so that the reader can better understand the issues, and then decide for himself or herself.

So many of the choices that voters in a democracy face require at least some knowledge of economics, yet it is not easy to get the issues in clear focus. I hope that this book helps at least some voters to clarify their own thinking. Voters should also understand that the way the government, representing us, responds to these issues will directly affect their jobs, raises, promotions, and, in general, all their economic opportunities.

One final point should be made before embarking on the arguments. People tend to be very passionate, if not about economics, then about some of the issues surrounding economics, issues such as whether the rich should pay more in taxes. It is easy, in the midst of all the passion, to conclude that one's opponents are selfish, evil, or perhaps just "dumb."

I have found many an economic idea to be, if not "dumb," then at least illogical or impractical. But, even so, more often than not I have found myself sympathizing with the ideals that underlie it. Indeed, I believe that if we take the trouble to look beneath the surface of clashing economic ideas, we will generally find some ideals on all sides that are inspiring, and others that are at least worthy of respect.

Part Two

The Rich

4

Are the Rich Necessary?—No

On one level, this might seem to be a foolish question. Large-scale human societies have never been run on a truly share-and-share-alike basis. Even the Russian Communists, who espoused such principles, completely failed to live up to them. If the rich have always been with us, they probably always will be with us, so why concern ourselves further?

In fact, however, the role of the rich is and should be hotly debated. People referred to as “egalitarians” or “equalitarians” (we shall use the latter term) want to get rid of them, or at least reduce the extremes of wealth and poverty. If we cannot eliminate the rich entirely, they say, can we not at least tax the rich to help the poor?

The equalitarian case against the rich may be summarized as a series of arguments:

Argument 1: The rich are essentially parasites.

A student working as a summer farmhand explains:

> I had been on the baler all day, the usual ten hours. . . . The Nevada sun was hot, and the work was dusty. As usual, Mr. Phelps [the farm owner] had been cruising around, checking on us from his air-conditioned, white Lincoln Continental. We were sweating for just over minimum wage. He wasn't working, but he was making the profits. It . . . didn't . . . look fair . . . to me.[2]

Argument 2: Wealth causes poverty; without rich people there would be no poor people.

Political commentator George Will thinks this argument absurd: "People are not hungry in Bombay [now Mumbai] because people are well-fed in Boston."[3]

But Argument 2 cannot be dismissed so readily. The fact remains that if the top one percent of American earners gave away half their net income after tax to charity, and those funds went directly to the American poor, poverty as defined by the government would be eliminated. It is true that these same funds spread globally would barely dent the problem. There is an especially acute moral dilemma sorting out national versus international claims, since the global poor have so much less than the American poor. But the observation that desperately poor people need more money, and that others are awash in money, is indisputable.

Argument 3: The problem is not simply that very rich people do not share adequately with the poor.

The larger problem is that the rich steal from or exploit the poor, that, as Proudhon said, "property is theft."[4]

The book of Isaiah in the Bible tells us that "The spoil of the poor is in your houses; what mean ye that ye crush my people, And grind the face of the poor? Saith the LORD, God of hosts."[5]

Each generation rediscovers this idea anew. As heiress Abby Rockefeller, a great-grandchild of John D. Rockefeller, Sr., has written:

> That riches and poverty were interwoven, that one fed on the other, that the many suffered because of the few; that good and bad fortune were inextricably linked—this was new for me. It was compelling.[6]

The notion that rich people and their corporate agents grind poor people into the ground, exploit them, steal from them, deny them decent living standards or healthcare, or otherwise abuse them, may be articulated at the national as well as the personal level. Monsignor Alfonso Lopez Trujillo, Secretary General of the Latin American Bishops' Conference, has written that "the United States and Canada are rich because the peoples of Latin America are poor. They have built their wealth on top of us."[7]

Julius Nyerere, long-time president of Tanzania and respected leader of the "Third World" during the US–Soviet Cold War, suggested that the economically advanced "First World" faced a choice between reparations and revolution:

> In one world, as in one state, when I am rich because you are poor, . . . the transfer of wealth from the rich to the poor is a matter of right. It is not an appropriate matter of charity.[8]

Ronald J. Sider, equalitarian author of *Rich Christians in an Age of Hunger*, agrees with Nyerere's diagnosis but not his prescription of rich countries giving away far more money. Sider thinks that it would be better for the West to acknowledge that its wealth has been taken from others, then reduce its need for wealth by leading a simpler, less extravagant lifestyle.[9]

5

Are the Rich Necessary?—Yes

THE EQUALITARIAN CASE against rich people is compelling. Questions of exploitation aside, why shouldn't the rich share what they have with the poor? But it is time to turn to other voices and listen to what they have to say:

Argument 4: Our economy needs rich people precisely because they are rich.

The basic idea is as follows. Everyone—rich, middle class, or poor—benefits from an expanding economy. An economy expands by becoming more productive. We become more productive by learning how to produce more and more, better and better, with the same number of workers. Productivity increases as we give workers better tools. In order to afford these tools, we need to put away some of what we make each year. That is, we need to save, so that we can invest the savings in the tools we need.

The problem then arises: how to induce people to save? The poor cannot be expected to save, because they need every dollar for basic needs such as food and shelter. Middle class people will save something for emergencies, children's education, or old age. But they have many immediate needs and desires, and in any case their savings will eventually be consumed, especially after retirement. The rich, however, are different. They have so much money that, in aggregate, they simply cannot spend it all. They are, in effect, forced to save.

As economist Wilhelm Röpke has explained,

> The notion of the rich gluttonously stuffing themselves is inexact, the stomach capacity of most individuals being approximately the same. Of course, the larger . . . a [person's] income, the greater will be [the] consumption of luxury goods. . . . But even such luxury wants [cannot] absorb the whole of a very large income. The result is that the unspent portion of the very large income is saved.[10]

Historian Paul Johnson comments further:

> As people who acquire riches quickly discover, once you are well-fed, clothed and

> housed, you have to spend your money on competitive ostentation—or save it. Either choice brings problems and worries. . . . [In any case,] amassing wealth has nothing to do with happiness.[11]

Of course, one can decide that the state will take over the saving and investment function by taxing away the rich person's wealth. But the problem quickly arises that the state, unlike rich people, never runs out of things to spend money on. Moreover, public officials are like other people: they prefer to spend rather than save, and there is no way to compel governments to become savers, since governments by definition control the social instruments of compulsion. In the case of the Soviet Union, the government chose to spend larger and larger sums on weapons, and that money could not simultaneously be used for productive investment.

Just how important is savings and investment? In the first place, it is precisely the failure to save and invest, and to protect savings, that has kept humanity so poor. In the second place, it may be argued that our very lives depend on the steady increase in our capital. As economic writer Henry Hazlitt has pointed out,

> Aside from the notorious fact that the condition of the masses is enormously better than it was . . . before the Industrial Revolution . . . , there is the still more notorious

> fact that the population of the world since then has increased [many-fold]. It was capital accumulation that made this possible. This means that . . . [many] of us owe our very existence to the savings and investments of our forebears.[12]

Argument 5: There cannot be too much saving if it is invested properly.

Some economists have responded that the rich save too much and spend too little, that jobs would be more plentiful and everyone would be better off if money came out from under mattresses and circulated more freely. This would be true if the rich really kept their money hidden in mattresses. But the lure of earning interest or capital gains usually ensures that money circulates whether it is spent or saved. If a rich person buys a yacht, this creates jobs for yacht-makers. But if, instead, the rich person buys some shares of stock from a company, and the company then uses the money to build a plant, there will also be more jobs for plant construction workers.

In terms of immediate new jobs created, spending and investment are equivalent. But there the similarity stops because investment spurs productivity, which leads to economic growth, which creates new jobs for the future.

Henry Hazlitt again:

Contrary to age-old prejudices, the wealth of the rich is not the cause of the poverty of the poor, but helps to alleviate that poverty. No matter whether it is their intention or not, almost anything that the rich can legally do tends to help the poor. The spending of the rich gives employment to the poor. But the saving of the rich, and their investment of these savings in the means of production, gives just as much employment, and in addition makes that employment constantly more productive and more highly paid, while it also constantly increases and cheapens the production of necessities and amenities for the masses.[13]

The rich should of course be directly charitable in the conventional sense to people who because of illness, disability or other misfortune cannot take employment or earn enough. Conventional forms of private charity should constantly be extended. But . . . those who truly want to help the poor will not spend their days in organizing protest marches.[14]

The most effective charity on the part of the rich is to live simply, to avoid extravagance and ostentatious display, to save and invest so as to provide more people with increasingly productive jobs, and to provide the masses with an ever-greater abundance of the necessities and amenities of life.[15]

Argument 6: The rich have vital work to do too, and if they shirk it or do it badly, they will lose their money.

A superficial reading of Hazlitt might suggest that the rich are rather like the modern, constitutional monarchs of Britain. Their job is simply to be there, they can be as passive as they wish, although they can be more virtuous by living simply and restraining a taste for luxury, avoiding useless status displays, and especially refraining from destroying wealth wantonly or burying it in graves, as has been commonly done throughout human history. But this would be a misreading.

Hazlitt expects more of the rich. He expects them to work, preferably to work intelligently and hard, but at least intelligently, and to earn their keep, not only by saving and investing, but by investing wisely. This can sometimes be accomplished by hiring others to make decisions, in which case the rich are investing in other people rather than directly in businesses. But however the rich do their investing, it is the results that count. If the present guardians of social savings invest well, as measured by business profits and economic growth, they deserve to stay rich or become even richer. If they invest poorly, the system will quickly take their savings away, as it should.

The problem of quality, as opposed to quantity, of investment lies at the heart of economics. But it has received surprisingly little attention from modern economists. Only a rare text focuses on the importance of making sound investments, even though quality arguably matters much more than quantity of investment in producing economic growth.

Economics textbooks generally do recognize the importance of innovation and risk-taking in the economy, which is another important facet of rich people's investment job. Governments can also, of course, supply risk capital, but rich people arguably do it better because their investment decisions are less politicized, their cash is less bureaucratized, and their sheer numbers increase the odds that a long shot, but ultimately good, idea will get funded.

Finally, rich people are supposed to provide general management for businesses, including cost and quality controls, again either directly as owners and executives, or, indirectly, by choosing and supervising managers. It is a major error that so many societies have tried to develop themselves while warring against their own most experienced and motivated developers, the rich.

Argument 7: The charge that the rich can only make others richer through a "trickle-down" process is false.

Equalitarians often mock their opponents for espousing a "trickle-down" theory of economics, one that wants to make the rich richer as the first step in making others richer. Mary Landrieu, Democratic senator from Louisiana, thinks that "This whole [idea that wealth will] 'trickle down' is hogwash."[16]

The first question to be asked here is whether this is what opponents of equalitarianism are really saying, that the rich must benefit first in order for others to follow. Thinker and commentator Irving Kristol describes "trickle down" as a "nasty phrase" for what is really a socially desirable process, but agrees that "the businessman . . . is very likely to reap visible 'disproportionate' rewards, while the benefits of his activity gradually and indirectly 'trickle down' to the rest of us."[17]

Economist Thomas Sowell sharply disagrees and regards the very concept of "trickle down" as erroneous. As he says,

> It is nonsense to [describe economic growth as] "trickling down" [from the rich] . . . . The [rich person's] investment has to happen first, and workers have to be hired and paid first, before the investor has any hope of reaping any gains. Since capital gains come last, not first, they do not "trickle down."[18]

Argument 8: What would actually happen if the government decided to seize rich people's assets entirely in order to give them to the poor?

The rich hold most of their wealth in the form of bonds, stocks, or real estate, all of which rise and fall in price depending on market demand for them. If word spread that wealth would be redistributed, buyers of these assets would disappear and prices plummet. Later, after assets were seized, they would have to be sold in order to provide cash to distribute. But these sales, with few offsetting buyers, would quickly prove impossible. Meanwhile, companies, unsure of the future flow of savings, would stop investing, with the result that many people would lose their jobs. In effect, then, the great risk of all redistribution schemes, however well intentioned, is that savings and investment, that is, the capital underlying the economy, are simply destroyed. Even if the rich voluntarily decided to sell their assets in order to distribute cash to the poor, the same sequence of events would unfold.

Argument 9: Response

Even *if* the rich do currently play an indispensable role, surely no one with ordinary human sympathies can feel completely comfortable about the huge disparities in wealth that exist in every society. If the government has not shown itself to be a reliable or competent saver and investor, and therefore a suitable substitute for the rich, might there be some other alternative? This question will be addressed later in the book. For now, we will look at the problem of the rich from a somewhat different angle and ask whether rich people are compatible with democracy.

Part Three

The Rich in a Democracy

6

Are the Rich Compatible with Democracy?—No

Argument 1: The rich stand in the way of democracy and often intentionally thwart it.

GREAT WEALTH AND DEMOCRACY are incompatible for many reasons. To begin with, the rich use their money to buy political influence and thereby subvert the democratic process. As democracy weakens, the rule of law is increasingly flouted, and the income gap between rich and poor widens further. George Garret, writer, official poet laureate of the state of Virginia, and University of Virginia professor, has described the process:

> White collar and corporate crime . . . and the gap between rich and poor . . . [are] seriously compromising the plausibility of a democratic government. Our votes do not count very much, yours and mine.[19]

Argument 2: We need complete democracy.

The problem in a nutshell is that one cannot have political democracy without economic democracy. The two go hand in hand, together represent complete democracy, and complete democracy is exactly what we need. As economist Paul McCulley has said, "Democracy starts with the socialist notion of one person, one vote. Yes, socialist notion!"[20]

Yet capitalism proceeds on the contrary notion of one dollar (or euro or yen), one vote, which means that rich people have a vastly disproportionate say. One person, one vote and one dollar, one vote are obviously incompatible notions. Incompatibility breeds tension, and the tension can only be relieved by abandoning democracy or by making wealth more equal, so that people have a more equivalent number of dollars.

7

Are the Rich Compatible with Democracy?—Yes

Argument 3: On close inspection, free-market arrangements are more democratic than they at first appear.

For example, take the assertion that the one dollar, one vote free-market system gives the rich a disproportionate voice as consumers. Is this actually true? In the first place, when the rich save and invest, they are not consuming, so they bring fewer dollars into the consumer market than might be supposed. In the second place, the non-rich vastly outnumber the rich. Consequently, the dollars of non-rich consumers outnumber the dollars of rich consumers. Under these circumstances, it is the non-rich "voters" who actually control the direction of production.

Once we understand that non-rich, average consumers actually control the direction of production, we will then have to reconsider the respective roles of employers and employees. If employees, acting as consumers, are in fact the real bosses, then employers must be the real employees.

This idea, that workers in a fully competitive market economy are really working for themselves, is not a new one. British economist Edwin Cannan observed in 1928 that "[Some] try to convince the wage-earners that they are working not for the public and not for the consumers of the things or services which they produce, but for the capitalist employer, [but this is just] . . . sour propaganda."[21]

Cannan's thesis may be disputed at a number of levels. It certainly looks as if the producer is the boss—after all, whose signature is on the paycheck? Beatrice Potter, who along with her husband Sidney Webb led early-twentieth-century British socialism, wrote in her memoirs that "In the business of my father everybody had to obey the orders issued by my father, the boss. He alone had to give orders, but to him nobody gave any orders."[22]

In response, economist Ludwig von Mises pointed out that "This is a very short-sighted view. Orders were given to her father by the consumers, by the buyers. Unfortunately [Potter] could not see these orders. . . ."[23]

Von Mises continues:

> Descriptive terms which people use are often quite misleading. In talking about modern captains of industry and leaders of big business, for instance, they call a man a "chocolate king" or a "cotton king" or an "automobile king." Their use of such terminology implies that they see practically no difference between the modern heads of industry and those feudal kings, dukes or lords of earlier days. But the difference is in fact very great, for a chocolate king does not rule at all, he serves. This "king" must stay in the good graces of his subjects, the consumers; he loses his "kingdom" as soon as he is no longer in a position to give his customers better service and provide it at lower cost than others with whom he must compete.[24]

The notion of consumer sovereignty has been disputed on other grounds. One point of view holds that most consumers are too ignorant, even about their own needs, too easily led and manipulated by propaganda and advertising, to be described as bosses. Is it not an outright deception to refer to consumers as bosses when they are being dragged onto a treadmill of relentless work and endless debts to satisfy appetites that are often unhealthy and have been viciously inflamed to fatten the coffers of the rich? Ludwig von Mises again offers a rejoinder:

> The moralists' and sermonizers' critique . . . misses the point. It is not the fault of the entrepreneurs that the consumers—the people . . . —prefer liquor to Bibles and detective stories to serious books. . . . The entrepreneur does not make greater profits in selling "bad" things than in selling "good" things. His profits are the greater the better he . . . provid[es] the consumers with those things they ask for most intensely.[25]

Argument 4: Rich people should not be described as "bosses," but rather as "trustees."

If we accept the argument that average consumers direct the economy, that they are the ultimate bosses, we are then left with the question of how best to define the role of the nominal bosses, the rich business owners and company chief executives. Von Mises has admonished us that we should not call them kings, barons, titans, and such like, but then what should we call them? Surely they cannot really be described as employees. Economist Abba Lerner suggests the term "social agents":

> People who earn millions of dollars . . . are, in fact, acting as agents for society. It is as if the wealth belonged to society at large, and they were merely looking after it on behalf of the rest of us.[26]

Wilhelm Röpke offers the terms "public servant" and "trustee":

> [Business owners] really fulfill the function of social officials, who are selected on the strict principle of performance, who are responsible for the good management of the means of production and for this get paid a sum that, all in all, is probably less than the pay of officials in a socialist state in relation to their performance. . . .[27] Looked at in this light, people like Henry Ford are really public servants who administer our productive resources after the manner of trustees and who, if their trusteeship is bad, undergo the immediate and heavy punishment of financial loss.[28]

Terms such as social agent, public servant, and trustee may seem fanciful when applied to the rich. The rich themselves would surely be puzzled by such claims. Yet von Mises argues strongly that Lerner and Röpke are right: "In the market society the proprietors of capital and land . . . must serve the consumers in order to have any advantage from what is their own."[29]

Argument 5: As Röpke, von Mises, and Hazlitt have emphasized, the acid test for the idea of the business leader as servant is that there must be downward as well as upward mobility for the rich, that the consumer must be able to give, but also to take away.

If this condition does not exist, then rich people hold their wealth illegitimately, and do not deserve the support of democrats.

The evidence of downward mobility for companies clearly exists, but what about for rich people? Here we have at least the following:

- The US Internal Revenue Service reports that over a nine-year-period since it began compiling statistics on the 400 highest-paying taxpayers, only 1% of the names have been on the list every year;[30]
- *Forbes* Magazine reports that over a twenty-two-year period since it began compiling a list of the 400 richest Americans (assets, not income), only 50 individuals or 13% have managed to stay on the list for the full period;[31]
- Glenn Hubbard, a Treasury Department official and later chairman of the President's Council of Economic Advisors, looked at the top 1% of US taxpayers at the start and end of a ten-year period, and found that over a third

> fell out of the top group and that the initial top group's average income fell by 11%.[32]

Argument 6: As we have seen, a free-market economy is democratic because it is run by average consumers who can hire and fire the rich at will. But this is not the end of the story.

The free-market democratic system of one dollar, one vote is actually superior to the political democratic system of one person, one vote. Indeed, it is, in the final analysis, more democratic.

This argument runs as follows. In a consumer democracy, if I vote for product X, I get product X. If you vote for product Y, you get product Y. This is in sharp contrast to a political democracy, where only one candidate can win, and no one vote counts for much in the final result.

There is even a question whether political elections actually reflect the will of the people. Let us assume a hypothetical election in which 60% of the eligible voters vote, eligible voters represent half the population of the country, state, or city, and the successful candidate carries 60% of the vote. In that case, only 18% of the people have chosen the successful candidate (even fewer presumably agree with all the candidates positions), yet this decision must be accepted by all under force of law. By contrast, a free-market economic democracy counts votes proportionally, not winner-take-all. We get exactly as much of candidate (product) A as the voters want, exactly as much of candidate (product) B as the voters want, and so forth, with both majority and minority will fully expressed, and no one overruled.

Part Four

Profit-making

8

Are Private Profits Necessary?—No

Private business profits are the wellsprings of private wealth. Equalitarians therefore take a dim view of private profit-making, and offer the following arguments:

Argument 1: Private enterprise pits owners and workers against each other in a ceaseless struggle, a struggle that is ultimately self-defeating for everyone.

Businesses may create profits by overcharging consumers. A more common tactic is to underpay employees. The truth is that owners and their profits can only thrive at workers' expense and vice versa.

In this conflict, owners have the whip hand because workers cannot afford to lose their jobs, although labor unions have helped level the playing field.

In the short run, the best way to reduce owner-worker conflict is to develop worker participation and profit-sharing schemes. In the long run, the solution is worker-owned businesses.

Argument 2: The profit system is inherently inefficient.

Profit is an unnecessary, extra cost piled on top of genuine production costs. As such, it is wasteful. If this waste were eliminated, prices would fall and everyone would be better off. As philosopher Ted Honderich has stated this case,

> If there are two ways of [producing] some valuable thing, and the second way involves not only the costs of [producing] it . . . but also [unnecessary] profits of millions or billions of dollars or pounds, then . . . the second way is patently and tremendously less efficient.[33]

Argument 3: Quite apart from its injustice and inefficiency, the profit system does not give us the goods that we need.

Private businesses exist to make money. They must make money right now, or at least soon, not at some indefinite point in the future. Their focus is accordingly on immediate profit opportunities for the owners (that is, the few), not on the present and future needs of customers (that is, the many). In effect, there is a glaring conflict between "production for profit" and "production for people's use," and under our existing system "production for use" takes the hindmost. As history professor and popular commentator Howard Zinn explains this:

> The profit motive . . . has . . . distorted our whole economic and social system by making profit the key to what is produced and therefore leaving important things unproduced and stupid things produced [as well as] leaving some people rich and some people poor.[34]

Young European protestors against "global capitalism" have made the same point on their banners and placards: "People Not Profit."[35]

Argument 4: Even when the profit system produces the right goods, it denies them to those who need them the most, the poor.

This may be tolerable in some consumer areas, but not in areas of basic need such as healthcare. Cynthia Tucker, editorial page editor of *The Atlanta Journal–Constitution*, explains:

> The profit motive doesn't improve every enterprise. . . . [The] healthcare industry [currently] . . . exist[s] to make money. . . . They

> jack up the prices . . . and restrict . . . [service] to those who can afford it. . . . [This] has gone too far.[36]

9

Are Private Profits Necessary?—Yes

Argument 5: Prices and profits work together as an indispensable signaling device.

THE DESIRE AND need, that is, the demand for particular products is constantly shifting. People choose this now, that later. Meanwhile the supply of products also shifts depending on an infinite number of variables (for example, weather affects the supply of crops). Information about both demand and supply is communicated to everyone by prices. Higher prices signal more demand or less supply, lower prices signal the opposite. This radically simplifies economic life.

As important as prices are for signaling conditions, they cannot do their work without profits. For example, assume that I am in the applesauce business and that profits are high because of heavy consumer demand or unusually low apple or sugar costs. The high profits give me the cash (or the credit) to step up my production. In addition other producers will likely do the same, and some new producers may be attracted into the business. In either case, supply will rise until profits fall back to more modest levels.

On the other hand, if profits fall far enough, supply will contract, so that output will again be brought into better balance with consumer demand. Everybody who wants applesauce will then get it, and producers will earn the profits necessary to keep recreating a balance. The key point to remember is that the quest for profits in a competitive market tends to increase supply, thereby lowering, not raising consumer prices. The quest for profits also drives competitors to work hard at lowering their costs. The dynamic of competition eventually translates lower costs into lower prices as well.

The profit system is especially good at identifying "chokepoints" or "bottlenecks" in the economic system, places where production is difficult or inefficient and where profit "tolls" are consequently high. For example, Mark Kurlansky in his book *Cod* has sketched the development of the huge cod-fishing industry since the sixteenth century, an industry that in earlier centuries furnished a high percentage of the total protein available to Europeans. At first the chokepoint was the ships, which were too small and flimsy. This attracted capital and better ship designs, so that the profit of ship owners eventually fell.

The next chokepoint was ports immediately adjacent to the fishing grounds, because the fish could not be kept long without processing, and nearby processors were able to charge high rates. As ships got faster, however, the small ports were bypassed, and the chokepoint moved to larger ports such as Boston. These larger ports were much more efficient than the smaller ones, but still commanded high prices and earned high profits. Finally, refrigerated container ships enabled fishing companies to bypass processing centers entirely.

Step by step, investment flowed to where the process was least efficient, where high profits signaled both a problem and an opportunity. In each case, the problems were solved, the chokepoint profits were reduced or eliminated through investment and competition, and consumers directly benefited from the increase in efficiency through steadily declining prices.[37] Although everyone benefited from this process, the poor benefited especially, because it meant that they could afford more protein in their diet.

Even Karl Marx, the father of Communism, acknowledged that the profit system reduces prices. He said as much in the *Communist Manifesto* of 1848:

> The cheap prices of its commodities are the heavy artillery with which [the profit system] . . . compels all nations, on pain of extinction, to adopt the [profit] mode of production.[38]

When the Soviet Union came into being during World War One as the first Communist state, many of its founders assumed that both prices and profits would be abolished. This was complicated by Marx's puzzling failure to suggest exactly how this might be done. A decision was eventually reached to keep prices and profits, although the latter would be "for all."

Economist Ludwig von Mises responded that a system of public prices and profits was impossible, that only private prices and profits could provide the necessary information flow and calculations, and thus organize, direct, and grow an economy. Von Mises summarized the problem in this way:

> It is not enough to tell a man not to buy on the cheapest market and not to sell on the dearest market. . . . One must establish unambiguous rules for the guidance of conduct in each concrete situation.[39]

Von Mises's thesis was violently disputed but never successfully rebutted, either in theory or in practice. The Soviet Union by the 1960s had from five to nine price and profit systems according to varying accounts, but none seemed to work.[40] As Oystein Dahle, a

Norwegian oil executive, has said, "Socialism collapsed because it did not allow prices to tell the economic truth."[41]

Not every equalitarian, to be sure, accepts the notion that free prices and profits are necessary as a signaling device. A letter writer to the Mises Institute, for example, argues that real "socialism" has yet to be tried:

> The Soviet Union was a system of capitalism run by the state. Nothing more, nothing less. . . . The alternative to a centrally planned capitalist economy or a laissez-faire capitalist economy is a decentralized moneyless marketless economy.[42]

The writer does not specify, but probably had in mind a series of independent, isolated economic communes.

Argument 6: Profits are also indispensable as a system of positive and negative incentives that, importantly, are objectively scored.

We usually think of the game of business being scored in profits, but it is even more importantly scored in losses and bankruptcies. As economist Wilhelm Röpke has written:

> Since the fear of loss appears to be of more moment than the desire for gain, it may be said that our economic system (in the final analysis) is regulated by bankruptcy.[43]

Economist Milton Friedman has similarly argued that the "profit" system should really be called the "profit and loss" system, that the "stick" is at least as important as the "carrot."

The carrot of profit and the stick of loss in general persuade us either to change or to accept change, something that people are more often than not reluctant to do. Economic growth by definition entails change; without it we would all still be hunting and gathering, or at least those few of us who could still survive within such a restricted economic environment. Yet many people are simply uncomfortable with change, others may be lazy, and vested interests will always fight hard against change if they can.

People can of course be motivated to change by other, more directly coercive methods. Stalin bent millions to his will through sheer terror. But, as a general rule, coercion is extremely inefficient, because people have a thousand ways of resisting, passively as well as actively. If one reads the memoirs of large slaveholders in the American South before the Civil War,[44] they are full of fretting about the incessant passive resistance of the slaves, even in the face of cruel punishments. That such an inefficient system survived at all can only be attributed to the boom prices being paid at the time for American cotton by English clothing manufacturers.

Argument 7: At first glance, it might seem that the profit system just produces what rich people want, not what the greater number of people need. But this is wrong.

The profit system is guided by profits, and the greatest profits are earned, not by catering to the wants and whims of the rich, but rather by meeting the genuine needs of large numbers of people. Economist Ludwig von Mises explains:

> Mass production . . . [is] the fundamental principle of [profit-seeking] industry. . . . big business, the target of the most fanatic attacks by the so-called leftists, produces . . . for the masses.[45]

Economist Milton Friedman elaborates this point further:

> Progress . . . over the past century . . . has freed the masses from backbreaking toil and has made available to them products and services that were formerly the monopoly of the upper classes. . . . [46] The rich in Ancient Greece would have . . . welcomed the improvements in transportation and in medicine, but for the rest, the great achievements of [profit seeking] have redounded primarily to the benefit of the ordinary person.[47]

It is natural to feel that something is very amiss when the profit system stops making shoes before all the poor children have them. It is equally puzzling (and disturbing) when the profit system seems incapable of reducing healthcare prices, so that healthcare becomes more and more unaffordable for the poor. But if one looks closely at what is really happening, it will be apparent that profit-making is not to blame.

Nobody wants poor children to go without shoes. But we still operate in an environment of economic scarcity, which means that trade-offs must continually be made. If we keep making shoes, we will have more of them and each pair will be cheaper and cheaper. But then we will have to accept less of something else and higher costs for each unit of that. The only "waste" in the system that one can fairly point to is the portion of rich people's income that is spent on luxuries.

The problem of healthcare differs from the problem of insufficient shoes for poor children. The difference is that the healthcare industry has been socialized, fully in Britain and Canada, half (in terms of payment source) in the United States. Consequently, contrary to Cynthia Tucker, profit-making is only part of the equation, and mixing profit-based and government-led systems virtually guarantees failure.

The crux of the problem is that government has subsidized more and more healthcare costs. This has dramatically increased demand, but government has done nothing to increase supply. Indeed, government regulations and licensing restrict supply, keep it from growing. More demand, together with the same or less supply, leads to higher prices, then more subsidies, then still higher prices, in a vicious circle that particularly injures the poor, the aged, and the unemployed. Moreover, the high cost of healthcare also contributes to unemployment, because, (at least in the US), employers often pay for health insurance, and rising health costs lead to less hiring. Healthcare costs were a particularly important factor in reducing payroll growth in the US at the beginning of the twenty-first century.

Argument 8: It is also understandable that many people think of profits as "stolen" from workers.

After all, do not worker's wages come out of the "skin" of owners and vice versa? Is this not a classic example of a "zero-sum game"? Surprisingly, the answer is no.

A business divided will not stand. Owners and workers must cooperate if they are to survive and thrive and, in particular, to hold their own against competitors, who are surely the more meaningful antagonists. Furthermore, although pay raises and bonuses feel good, and could be taken out of profits in the short run, we have seen that profits are needed to pay for investment, either directly or by attracting investors. And it is precisely this stream of investment that provides workers with the tools, training, and other support necessary to make them more productive, which in turn justifies and pays for the raises or bonuses.

Running a successful business is always a balancing act. If wages are too low, workers will leave. If wages are too high, profits will be too low to pay for productivity-enhancing investments or other planned expansion. Workers should applaud productivity-enhancing investments, because studies show that, over time, they get all the return on such investments in the form of higher wages, or at least all the return that does not go to customers in the form of lower prices.

It is not surprising, on reflection, that over the years a business's profits and wages tend to rise or fall together, with profits leading a bit, or that this same pattern holds for the economy as a whole. Nor is it surprising that overall employment tends to follow profits, since businesses use profits to invest in workers as well as capital equipment. The only part of profits the workers in general do not directly benefit from is, again, business owners' luxury spending, and of course workers in luxury industries even benefit from that. On balance, a rise in genuine, sustainable profits is very good news for an economy, because it means that higher employment levels and wages are coming next.

Argument 9: Raising pay in one company will not increase the overall share of "labor."

Let us assume that a "widget" business is shortchanging its workers on pay and not even investing enough in the business to maintain its existing plant and equipment. This may be because the "widget" business is failing, and the profit-making system is forcing it to wind down and its employees to move on to better opportunities. If the business is not failing, it presumably will be failing soon, because in that case the owners' greed will cause it to lose its best workers and become less and less competitive.

But assume that the business is sound, is simply underpaying its workers, that the workers strike, that wages are substantially raised, and that the owners are compelled to stop being greedy. In this case, a blow has been struck for Labor and against Capital, has it not? Well, no. The answer is no because the workers will take their new wages and buy things with them. These new purchases will in turn swell the sales and profits of other business owners, so that economy wide profits will be unaffected, just as Labor and Capital aggregate shares will be unaffected.

In the meantime, the greedy owners may try to compensate for the higher wages they have been forced to pay by raising prices. This will probably backfire by reducing revenues and profits further. If not, it will raise "widget" prices for consumers who are also workers. This will particularly hurt workers who are retired or otherwise living off savings.[48] So it is impossible to say that the strike-won higher wages in the "widget" company represent a blow for Labor against Capital.

Argument 10: Employee business ownership creates as many problems as it solves.

Advocates of employee ownership or profit-sharing schemes see both as a way to create a better motivated and thus more efficient workforce, a more just workplace environment, and stronger consumer demand.[49] At first glance, it might seem that no one could possibly oppose such a proposal. But, in reality, there are important objections to it. In the first place, workers are not an abstraction. They are individual human beings who grow old and want to retire. What then? Usually the retiring employees want to sell their shares and profit from the sale, so they will sell to the highest bidder, which probably will not be other employees. If, alternatively, shares can only be sold to other employees at modest prices, then the employees have not been full equity owners. In addition, the restrictions on share transfer may make it impossible for the firm to raise outside capital.

Most importantly, if employees owned the entire economy, saving would plummet. As we have seen, it is the special role of the rich to be forced to save and invest—they alone have more than they can possibly spend. Profit-sharing plans are also, unfortunately, subject to the same criticism: more often than not, they represent a form of variable employee compensation, not a true sharing of "profits." In true profit-sharing plans, employees leave some (sometimes all) of their "profits" in the business, just as outside owners do.

Argument 11: The kind of macroeconomics commonly taught in schools is misleading: it does not adequately acknowledge the role of profits.

Economist David Ricardo said in the early nineteenth century that "Nothing contributes so much to the prosperity and happiness of a country as high profits."[50]

Ricardo was right, and given the truth of what he said, one must wonder why modern macroeconomists have so little to say about profits. Macroeconomics texts are full of discussion about production growth, employment, inflation, etc., but profits are kept in the back room, generally out of sight. If profits are discussed, it is generally in the microeconomics section of a text, the part that concerns individual businesses and industries, not the economy as a whole.

10

Are Private Profits Necessary?—No/Yes

Argument 12: Profit-driven change is irrational and disorderly.

THE PROFIT-AND-LOSS SYSTEM, if unchecked, flies out of control. The carrots become too sweet, the sticks too hard, change becomes too rapid, too many people are displaced by it. No one knows where the change will take us, because it is rudderless and unguided, and may quickly plunge us into chaos or ruin.

Argument 13: Response.

A price-and-profit system gives us order, not chaos, an order led and guided by the wishes of consumers. This is a spontaneous order,[51] like the common laws that have been developed through trials over the centuries, or rules of grammar or speech.

To think that order cannot exist without a leader's visible commands is natural, but it is untrue. As economist Friedrich Hayek has written:

> This is not a dispute about whether planning is to be done or not. It is a dispute as to whether planning is to be done centrally, by one authority for the whole economic system, or is to be divided among many individuals.[52]

We can certainly install a more visible central command, restrict the carrots that seem too sweet, soften the sticks, slow or better regulate the rate of change, but we will get more chaos, not less, and more economic corruption and poverty to boot.

Argument 14: The pot-of-gold-at-the-end-of-the-rainbow atmosphere of the profit system, with its uncertain, excessive, and largely undeserved rewards, encourages business owners to adopt a short-term, grab-it-and-flee mentality.

The right kind of economic system should encourage people to regard work as its own reward, to appreciate the joys of serving others, and to approach work with patience and perseverance. The idea of chasing a big payoff is inimical to all these ideals.

Argument 15: Response.

The profit system is not a treasure hunt and does not encourage short-termism. Most new businesses lose money for a time; entrepreneurs must have faith, patience, and the judgment to know when they are failing and when they are simply suffering the usual setbacks in starting something new.

If profit-seekers have patience, and also the gift of good judgment, they will eventually earn profits, and the profits will start to compound. At first this is a glacially slow process. If $10,000 in starting capital, or in initial profits, grows each year by 12%, it will take twenty years to pass $100,000. But, if the growth rate is maintained, the law of large numbers takes over, and in twenty more years the number will reach $1,000,000. If the $1,000,000 keeps doubling every six years, it will become a fantastic figure, as described in chapter 1. Such a system can hardly be said to encourage short-termism.

What the profit system does encourage, apart from patience, is to keep growing, keep compounding, no matter how low the rate of annual increase. Britain became the leading economic power, the wonder and envy of the world, all based on an estimated compound economic growth rate of barely 2% a year from 1780 to 1914.[53] Two percent may not sound impressive to us, but it was far higher than any nation had ever achieved, especially over long periods.

Argument 16: Economic growth requires cooperation. The profit system encourages cutthroat, dog-eat-dog competition, which is the opposite of cooperation.

How can anyone imagine that setting one person against another will encourage cooperation? This defies logic. If we want more cooperation, and we should, we must teach a cooperative ethic, and create economic institutions that support this ethic.

Argument 17: Response.

Profit-seeking economic competition is not anti-cooperative. Nor is it usually cutthroat or dog-eat-dog. It is true that competition channels aggressive tendencies into socially useful purposes, in sharp contrast to warfare or pillage. But business competition in general takes place within a cooperative framework, similar to organized sports such as the Olympics.

Much business competition is not even personal, unlike sports. Economist Milton Friedman has pointed out that wheat farmers tend to view each other as colleagues, because no one wheat farmer's output or actions has much direct impact on another. But strictly speaking, they are economic competitors. Truly ruthless competition is to be found in politics which, unlike business, truly is a zero-sum game, and in any case ruthlessness can be found in any human occupation, including teaching, social services, or religion.

Part Five

Glaring Inequality

11

Are There Alternatives to the Profit System? —Yes/No

Argument 1: Putting aside purely economic considerations, living with others on a share-and-share-alike basis is simply a better way to live.

The proposal here is not one of state control of the economy. That was attempted in Russia and elsewhere during the twentieth century and was not a success.

The proposal is rather one of decentralization; of small scale rather than large scale; of many warm, sharing human communities rather than a single collectivity.

There are examples from the past as well as the present to draw upon for a smaller, more human-scaled equalitarianism. An economic textbook describes the Zuni people of the American Southwest during the 1920s as one model to follow:

> The family . . . comprising as many as twenty-five persons . . . was the main organizational unit of . . . economic life. Houses and land were privately owned, with the title being held by the women of the family. . . . In sharp contrast to the American economy, there was a general absence of acquisitiveness and competition. While there was no sale of goods and property at fixed market prices, there was an organized transfer of goods and services that took place within the framework of the tribe. To some extent, these transfers equalized the levels of living among the families of the tribe, preventing the extremes of poverty and great wealth.[54]

The Israeli kibbutz represents an even more intentional model of shared living, since kibbutz members join voluntarily and share everything as completely as possible on principle. In the early days before the formation of the State of Israel, this shared life was very hard. Malaria and dysentery had to be overcome, along with the harshest privations: cloth sacks stitched together for clothing, primitive communal privies, endless manual labor, three glasses to be shared by an entire community, as described by Prime Minister

Golda Meir in her memoirs. Today the harshness is gone, but the ideal of a shared life remains.

An important manual of small-scale equalitarianism in Britain, America, India, and elsewhere is economist E. F. Schumacher's inspiring little book *Small is Beautiful.* Schumacher was a sensible, practical man who felt that people should simplify and downscale their life wherever possible without indulging in grandiose or utopian fantasies. He recognized that the greatest obstacle to human peace and happiness was not institutional arrangements per se, but the "greed, envy, hate, and lust"[55] within all of us. But he did think that large disparities of wealth inflamed both greed and envy, and he warned about the violence that rampant consumerism does to our soul:

> I suggest that the foundations of peace cannot be laid by universal prosperity, in the modern sense, because such prosperity, if attainable at all, is attainable only by cultivating . . . drives . . . which destroy intelligence, happiness, serenity, and thereby the peacefulness of man.[56]

The director of the E. F. Schumacher Society, Satish Kumar, a former monk, adds that

> we are realizing, after 200 years of industrial revolution, that we have gone too far in one direction. We need to bring some kind of balance between the spiritual and the material.[57]

Spirituality, peacefulness, even pacifism are ever-present threads in the fabric of contemporary small-scale equalitarianism. President Luiz Inacio ("Lula") da Silva of Brazil spoke for most equalitarians when he told a meeting of the Socialist International in 2003 that "The only war we should be waging is against hunger and inequality. That's a war worth fighting."[58]

And 2004 US Democratic Party presidential primary candidate Dennis Kucinich made a similar point by proposing the creation of a federal "Department of Peace, which would seek to make non-violence an organizing principle in our society and to work with the nations of the world to make war itself archaic."[59]

In addition to spirituality, nonmaterialism, and peacefulness, ecology and environmental protection have also emerged as important themes of most small-scale equalitarian thinking. Thus the website of Twin Oaks, an intentional community of about eighty people near Charlottesville, Virginia, states that

> Since the community's beginning in 1967, our way of life has reflected our values of cooperation, sharing, nonviolence, equality, and ecology.

All of this is in the most marked contrast to the old, Marxist, large-scale equalitarian ideology of the past, which specifically attacked spirituality and nonmaterialism, rationalized violence and aggression, and left the most horrendous environmental depredations.

Argument 2: Response.

Small-scale equalitarianism is a vast improvement over the large-scale, state-run alternative. Indeed, large-scale equalitarianism is really a contradiction in terms. If sharing is statewide, it must be enforced. To be enforced, some individuals must be entrusted with police powers. If some people have police powers and others do not, how is that equal? It is simply an inequality of power rather than of money, and will soon mutate into an inequality of money as well, as it did in Communist Russia.

This is why the French Revolutionary slogan “liberty, equality, fraternity” is nonsensical. Liberty and equality are logical opposites. If people have liberty, they will become unequal. Even if government denies liberty to safeguard equality, equality will not last.

Small-scale equalitarianism is not illogical in the way that large-scale, state-run equalitarianism is. But there are reasons to doubt its practicality. The ancient Greek philosopher Aristotle pointed out that a share-and-share-alike approach to cooperation generally leads to conflict, because members of the group will not all work as hard, or will have sincere differences about the balance of work and leisure, either of which may lead to quarrels. From this point of view, an approach to cooperation that emphasizes independence, self-reliance, and reciprocal exchange will ultimately produce more friendship and mutual assistance.

In addition, if people are going to be quarrelsome about work or possessions, it is surely better to channel this aggression into prescribed forms of mutual exchange-based competition. As Samuel Johnson said, "There are few ways in which a man can be more innocently employed than in getting money."[60]

John Maynard Keynes made the same point:

> Dangerous human proclivities can be canalized into comparatively harmless channels by the opportunities for money-making and private wealth, which, if they cannot be satisfied in this way, may find their outlet in cruelty, the reckless pursuit of personal power and authority, and other forms of self-aggrandizement. It is better that a man should tyrannize over his bank balance than over his fellow-citizens.[61]

Opponents of equalitarianism generally take a "harder" rather than a "softer" line on a given social subject, and thus regard the small-scale equalitarian faith in Gandhian non-violence as a hopelessly utopian path to world peace. For example, here's what Joseph Alsop, leading political columnist after World War Two and an individual thoroughly grounded in ideals of independence and self-reliance, thought about the idea of unilateral disarmament or even military weakness:

> What do we need in America to endure? It isn't enough to say that we are very numerous,

or that we are vastly rich in proportion to everyone else in the world. Being that rich simply makes us a target, if you think about it. Everybody else would like to divide up our goods. They'd like to chew us up like a dead whale on a beach, if we'd let them do it. And I have the warmest sympathy for that desire. It is perfectly understandable, and we mustn't complain about it.[62]

12

Should We Accept This Degree of Inequality?—No/Yes

Argument 3: Income inequality is unjust and uncharitable. No one should accept it with a clear conscience. The sooner and the closer we can get to equality the better.

American Socialist Michael Harrington believed that "[the profit system] . . . is outrageously unjust; it requires a continuing maldistribution of wealth in order to exist."[63]

David Gergen, advisor to American presidents from Nixon to Clinton, agrees that "a society where winners take all and losers take the hindmost is one that . . . [is] morally blind."[64]

The evidence for injustice lies on both sides of the vast income gap. On the one hand, billions of people desperately lack money for the barest necessities. On the other hand, a lucky individual will be fêted and showered with money just because he can dribble or throw a ball a bit better than others, or because he or she was born to rich parents. Between the extremes, we have dedicated and talented teachers and social workers who are woefully, even scandalously underpaid.

This system, as John Maynard Keynes said, is both "arbitrary and inequitable." Even if some degree of inequality is desirable for motivational purposes, as Keynes further observed: "Much lower stakes will serve the purpose equally well."[65]

The winners under this system should ask themselves: do I really deserve to have all this when others have so little? And, have I really "earned" it? Even if I have worked hard and made prudent choices, how far would I have gotten without the support of others? How remunerative would a sports talent be if there were not sports entertainment networks, or a talent for business without corporate legal protections and other assistance from government? Does anyone earn anything on his or her own? Is it not self-evident that each of us owes a great debt to others, and that this debt can best be paid by sharing more and by ensuring more equal outcomes? Is any other position truly moral?

None of us feels entirely comfortable when we confront a beggar or a homeless person on the street or see children living in abject poverty. We should heed our consciences, listen to what they are telling us. As Michael Harrington said about poverty statistics:

> These statistics represent an enormous, an unconscionable amount of human suffering in this land. They should be read with a sense of outrage.
>
> For until these facts shame us, until they stir us to action, the other America will continue to exist, a monstrous example of needless suffering in the most advanced society in the world.[66]

Argument 4: Response.

Our personal incomes are in no sense arbitrary. They are determined by supply and demand. Supply and demand tell us, in unequivocal terms, how useful we are in the eyes of others. Norman Van Cott explains:

> Our incomes—be they large, small or somewhere in between—reflect (1) our usefulness to our fellow citizens and (2) the ease with which fellow citizens can find substitutes for us.[67]

We may not want to hear the market's message. But the market does not discriminate. Only people discriminate. Employers who do so become less efficient, lose good employees or customers, suffer higher costs, and thus pay a penalty of lower profits. Over time, markets eradicate discrimination by persuading bigoted employers that they cannot afford to indulge their prejudices.

We may understandably object that markets treat people too much like commodities. But our labor (as distinct from ourselves) is a commodity, and is priced by consumers in exactly the same understandable and consistent way that other commodities are priced. There is nothing inequitable about this.

It may be objected that our financial success depends, not simply on effort or merit, but to a large extent on luck. If so, we are not lucky or unlucky in money alone. We are all lucky to become fetuses, since the odds are infinitesimal that any particular two gene pools will ever merge, we are lucky to be born, and lucky to reach maturity. From there we are lucky or unlucky in the genes we get, the brains, looks, personality, talents, parents, education, health, neighborhood, country, or times in which we live.

If inequality is synonymous with injustice, we live in a hopelessly unjust world. Are we going to try to level all these playing fields? And if so, how, and who will decide what is level? As economist Robert Sowell has observed:

> The difference between a factory worker and an executive is nothing compared to the difference between being born brain-damaged and being born normal, or the difference

> between being born to loving parents rather than abusive parents.[68]

If we are going to try to do something about this, we will first have to figure out how to measure the degree of brain damage or parental abuse. Then we will need to arrive at a reasonable compensation formula. Will we also try to provide equally good parents or equally good teachers for every child? Will we demand that Harvard University agree to teach any child who applies, and what will we do when we run out of Harvards assuming that we can still call it Harvard? Later in life, will we follow the now old people into their doctor's office to be sure that they all get exactly the same pill for the same malady, assuming that it is the same malady? If these examples seem far-fetched, it should be noted that contemporary philosophers have debated similar issues, because they do help us define what exactly we mean by equalitarianism.

Equalitarians might respond that, yes, the Jacobin idea of people being born equal is a fantasy, inequality is deeply imbedded in all life as we know it. But that is not a reason to abandon economic equality, it is all the more reason to pursue it. If life is inherently unequal, then let us make equal what we can, especially the economy, since that is the work of our own hands. But this too is easier said than done. If you give two individuals exactly the same income, one may save, invest, and grow rich, while the other may sink into torpor or debt. What is to be done then? Should we re-equalize the situation? How might that best be done?

There are additional complexities. To promote equality, one must be consistent, because inconsistent outcomes cannot be equal. But equalitarians are often inconsistent. They may prescribe heavy taxation on all incomes over X, which might be an average or a "middle-class" income of people in their own country. But, in doing so, they ignore the fact that a fifth of humanity is living on less than $1 a day,[69] that X may be a king's ransom in other, poorer countries. If redistributive policies are to be followed, why not apply them worldwide?

Similarly, some equalitarians may clamor for multinational companies to pay higher wages in poor countries, but then oppose free trade agreements that bring in more goods made by the same struggling wage-earners. In general, globalization and free trade should decrease inequality between countries, but may also reduce wages of the least skilled in rich countries, at least temporarily. Why do equalitarians notice the latter but not the former?

Consistency is one logical principle; clarity and completeness are others. To their critics, equalitarian arguments are unclear and incomplete, as well as inconsistent, because they fail to distinguish between unequal outcomes that change over time and unequal outcomes that are simply frozen. In traditional societies, inequality exists because of the lack of social mobility, that is, because positions are largely frozen. Free-market competition also creates economic inequality, but in the context of social mobility. Winners and losers change. Moreover, the social mobility implicit in free-market competition tends to reduce inequality over time, not increase it, as is commonly alleged. Economist Milton Friedman has observed that

> The development of [free markets] has greatly lessened the extent of inequality. . . .[70] Nowhere is the gap between rich and poor wider, nowhere are the rich richer and the poor poorer, than in those countries that do not permit the free market to operate.[71]

It should be readily apparent that economic equality, the equality of result, is incompatible with equality of opportunity. Most honest people will see advantages to both. But we must choose. We cannot have both, and if we have more of one we must accept less of the other.

Argument 5: Milton Friedman's assertion that the development of free markets has reduced inequality, and thus helped the poor, is equivalent to saying that inequality reduces inequality.

It is nonsensical. Even if inequality promotes economic growth in some circumstances, which is unlikely, very little of that economic growth reaches the poor.

As Jeffrey Gates, head of the Shared Capitalism Institute, has said, "Capitalism does not raise all boats; it raises all yachts."[72]

Argument 6: Response.

Economist Steve H. Hanke responds to Jeffrey Gates by citing a World Bank study by David Dollar and Aart Kraay. This study looked at eighty countries over four decades and concluded that free markets help "the poor" as much as the "non-poor." In addition, Dollar and Kraay found that the poor are especially benefited by controlling inflation and also by controlling the growth of government spending. Why government spending? As Hanke puts it, "The rich are much better placed to feed at the public trough. The poor get crumbs."[73]

We might also recall that, precisely because money means more to the poor than the rich, a rise in incomes through economic growth helps the poor disproportionately. The rich, earning more, buy luxuries they could already have bought if they had really wanted them. Or more likely they increase their saving, which helps everyone. The poor, earning more, can afford more necessities, or even some luxuries of their own. As Henry Hazlitt reminds us,

> The overwhelming majority of Americans . . . now enjoy the advantages of running water, central heating, telephones, automobiles, refrigerators, washing machines, [music

> players], radios, television sets—amenities that millionaires and kings did not enjoy a few generations ago.[74]

Indeed, a study by the Heritage Foundation found that 41% of the official poor in the United States owned their own home. A majority owned automobiles as well as microwaves, DVD players, and air conditioning.

Argument 7: Response.

Even if all this were true, that equalitarian policies slow economic growth and ultimately retard the progress of the poor, would that invalidate the idea of sharing at least some of the wealth more equally now? Economist Arthur Okun, a former chairman of the President's Council of Economic Advisors, said that "I would prefer . . . complete [economic] equality."[75]

But he has also suggested that trading off some "growth" for some "equity" is a reasonable compromise, an idea seconded by another former CEA chair, economist Alan Blinder, who similarly speaks of reconciling "Principles of efficiency [with] principles of equity"[76] through tax and other policy adjustments.

Argument 8: Response.

Equalitarians like to think of the economy as a machine with bells, whistles, and levers, all of which can be manipulated to produce more of this or less of that. But this is an illusion. As thinker and writer Irving Kristol has observed, "If you want economic growth, only that species of activity called 'business' can get it for you. The 'economy,' as conventionally understood, cannot."[77]

What this means is that, to have more economic growth, you must support businessmen or women, and demotivating them or reducing the savings available to them through income redistribution schemes will not help. Moreover, once you start down this path, intending to go only a short distance, it is often very hard to stop, for reasons explained by economist Sanford Ikeda: "Redistributional policies . . . typically aggravate the . . . problems . . . thereby providing even greater justification for more intervention."[78]

Argument 9: Response.

Income and wealth inequality is in fact increasing, especially in the United States, as confirmed by a succession of studies. The 1994 *Economic Report of the President*, written by the President's Council of Economic Advisors, drew upon some of these studies to state unequivocally that "Starting some time in the late 1970s, income inequalities widened alarmingly in America."[79]

Is society, acting through government, to stand back and do nothing about this?

Argument 10: Response.

What is probably happening is that the emergence of a truly global economy is reducing global inequality by increasing incomes in developing countries.

Unfortunately, as part of this, some lower-paid workers in developed countries are struggling. But even this is only a guess. Most of the studies purportedly showing an increase of income inequality in the United States are based on questionable data.

For example, government personal income data is distorted because many businesses report on personal rather than corporate income tax forms and this trend is sharply increasing, primarily because of the growing use of Limited Liability Companies (LLCs) as the favored form of business organization. When income that used to be reported on corporate returns as corporate income is shifted to personal returns, it can seem that high-end incomes are growing more rapidly than they really are.

Government income data is not reported per individual, but rather per "household." The problem here is that "households" may include zero, one, two or more wage earners. This makes comparison misleading. Moreover, household size changes a great deal over time. In particular, poor "households" have fewer members today than in the past, which may partly explain why they are poor.

Age too is very important: the same individual may be counted as poor when a student, rich in middle age, and poor again in old age, so changes in the average age of the population skew results. Immigration also matters, although it is rarely considered in income inequality statistics. Immigrants, especially in the US, tend to start out as very poor and this can distort what is happening in the bottom decile or quintile.

The way income is defined matters a great deal. Government statistics vary considerably in what they include or exclude, and the decisions often make no sense. For example, transfer payments such as the earned income tax credit, welfare payments, and social security income are not counted. One of the worst mistakes is treating a capital gain as personal income. When people sell a stock, receive cash, and realize a capital gain (that is, sell an asset for more than it cost), they actually exchange one asset for another rather than create economic income (see Appendix B). It would also help to know how many hours people work for their income. If person A works 40 hours and person B works 80 hours, most people would not think it unequal for B to be paid twice as much.

In any case, none of the available US government statistics exclude business income and provide reliable per capita (per person), age-adjusted, immigration-adjusted, work-hour-adjusted, income-definition-adjusted data. Without this information, it is reasonable to think that income inequality has been increasing in the United States, but it cannot be proven one way or the other.

Part Six

Greed

13

Does the Profit System Glorify Greed?—Yes

EQUALITARIANS HAVE NO DOUBTS: free markets not only teach, they demand greed. Opponents of equalitarianism, by contrast, speak with conflicting voices. Some say, yes, a private market system is grounded in greed, and that is a good thing. A larger number reject the word greed, but see nothing wrong with acting in your own self-interest. A minority argue that the whole question is muddled, that a private market system is grounded neither in greed nor in self-interest, but rather teaches people to think of others, to practice social virtues, not vices. We will listen briefly to each of these arguments.

Argument 1: Private markets are indeed grounded in selfishness and greed and are thus inherently immoral.

Private markets not only tolerate naked greed, sharp practice, acquisitiveness, predation, exploitation, commercialism, and materialism. They positively encourage all these evils. In the words of the *Communist Manifesto*, they plunge us into "the icy water of egotistical calculation."[80]

Anacharsis of Scythia warned as early as the seventh century BCE that "The market is a place set apart where men may deceive one another,"[81] a sentiment seconded by Aristotle and many others. In 1933, at the bottom of the Great Depression, Matthew Josephson suggested in his book, *The Robber Barons*, that slavery was not the only contradiction marring the otherwise remarkable story of American economic development:

> To organize and exploit the resources of a nation upon a gigantic scale, to regiment its farmers and workers into harmonious corps of producers, and to do this only in the name of an uncontrolled appetite for private profit—here surely is the great inherent contradiction whence so much disaster, outrage and misery has flowed.[82]

The misery still flows, and it is time, as playwright Tony Kushner told a graduating class of college seniors, to stand up for

> The people and not the oil plutocrats, . . . the multivarious multicultural people and not the pale, pale, cranky, grim, greedy people, . . . the hard-working people and not the people whose only real exertion ever in their parasite lives has been the effort it takes to [get politicians to] slash a trillion dollars in tax revenue and then stuff it in their already overfull pockets.[83]

The problem is not just that some people, given a chance to be greedy, will grind others into the dirt. The problem is the market system itself. Hence, as Bill Moyers, one-time presidential assistant and prominent public television voice, has argued, we must guard against "true believers in the God of the market who would leave us to the ruthless forces of unfettered monopolistic capital where even the laws of the jungle break down."[84]

Moreover, as Moyers continues, these market idolators may wrap themselves in the (American) flag and rely "on your patriotism to distract you from their plunder. While you're standing at attention with your hand over your heart pledging allegiance to the flag, they're picking your pocket."[85]

This is all the more ironic because, as Lawrence Kaplan, has argued,

> The market erodes national sovereignty . . . and, with it, much of the State's legitimate

> authority. [If this process is not arrested], market identity [may] supersede civic virtue and national allegiance [as well as] foster . . . widespread atomism.[86]

Markets are inescapably immoral, and if we cannot eliminate them, we should at least not glorify them. Marcia Angell, former editor-in-chief of the prestigious *New England Journal of Medicine*, recalls that before the 1980s:

> There was something faintly disreputable about really big fortunes. You could choose to do well or you could choose to do good. . . . That belief was particularly strong among scientists and other intellectuals.[87]

It is important to stand up to what President Franklin Roosevelt referred to as "money changers in the temple" and "malefactors of great wealth." But it is also important to recognize, and guard against, the greed that lies within each of us. No one living in an economically developed country can completely escape the charge of greed, because no one can completely avoid participating in a market system that thrives on waste, that ignores the sustainability of resources, notwithstanding the fragility of our increasingly crowded and overtaxed planet. As Bernard Muller has said, in a letter to the editor of *World Watch* magazine:

> Against . . . growth-mania, we have as yet only a disarray of sustainability supporters.

Not one government, not one country has renounced growth. . . . Society and governments must urgently intervene to impose upon the market . . . the objective of negative growth in physical resource use.[88]

14

Does the Profit System Glorify Greed?—Yes, and a Good Thing

Argument 2: "Greed is good."

SELFISHNESS IS A given, is it not? Why be holier-than-thou? Does not Jennifer Beth Cohen speak for all of us when she states in her book, *My Russian Affair*, that

> Everyone's life is all about himself or herself. That doesn't mean that your concerns are all selfish or that you can't or don't care about others. But in the end it does come back to you, doesn't it?[89]

One can alternatively argue that greed and aggression are not perhaps desirable in themselves, but still necessary for economic progress, a position that many commentators have taken:

- "The greatest meliorator of the world is selfish, huckstering trade." (Ralph Waldo Emerson, *Work and Days*)[90]
- "[I]t is precisely the 'greed' of the businessman or, more appropriately, his profit-seeking, which is the unexcelled protection of the consumer." (Alan Greenspan, "The Assault on Integrity")[91]

Economist John Maynard Keynes, by no means in the "greed is good" camp, thought that greed was useful, at least for now:

> Avarice and usury must be our gods for a little longer still. For only they can lead us out of the tunnel of economic necessity into daylight.[92]

The most forceful exponent of the "greed-is-good" philosophy, novelist Ayn Rand, held that greed is only menacing outside market environments

> when money ceases to be the tool by which men deal with one another, then men become the tools of men. Blood, whips, guns—or dollars. Take your choice.[93]

Channeled appropriately through markets, even the most immoderate greed (according to Rand) is only beneficent:

> America's abundance was not created by public sacrifices to "the common good," but by the productive genius of free men who pursued their own personal interests and the making of their own private fortunes. They did not starve the people to pay for America's industrialization. They gave the people better jobs, higher wages, and cheaper goods.[94]

Indeed, Rand insisted, the selfishness of the rich and powerful is not even very selfish, properly understood:

> The man at the top of the intellectual pyramid contributes the most to all those below him, but gets nothing except his material payment, receiving no intellectual bonus from others. . . . The man at the bottom who, left to himself, would starve . . . , contributes nothing [intellectually] to those above him, but receives the bonus of all their brains.[95]

Before leaving this particular segment of our debate, we should note in passing that there are numerous philosophical disputes flickering in the background, technical philosophical disputes among rational choice theorists, welfare economists, and many others about whether it is possible to define concepts such as greed, selfishness, altruism, the collective good, and if so, how to go about it.

15

Does the Profit System Glorify Greed?—No

Argument 3: Whether one disapproves or approves of greed, it is quite erroneous to think that markets encourage it. Markets are just technical, and thus morally neutral, mechanisms for human exchange.

Social philosopher Daniel Bell described markets as a "techno-economic structure."[96]

Milton Friedman took the same position when he said that "[What is often referred to as the market] ethic . . . cannot in and of itself be regarded as an ethical principle; it must be regarded as . . . a corollary of some other principle such as freedom."[97]

Argument 4: No, the market is not morally neutral, it does express an ethical principle, and that principle is certainly not greed. It is instead rational self-interest, something quite different from greed, and this is by far the best principle on which to organize a society.

A defense of rational self-interest was memorably offered by the economist Adam Smith in the eighteenth century:

> It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.[98]
>
> . . . He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. . . . He intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.[99]

The all-important distinction in Smith's system is between rational and irrational self-interest. The world has had many economic systems based on irrational self-interest, and these bring only misery. For example, consider economic historian David Landes's description of the Ottoman (Turkish) empire of the fourteenth–early twentieth centuries:

> The Ottomans had . . . taken over a region once strong, now enfeebled—looting as they went. Now they could no longer take from outside. They had to generate wealth from within, to promote productive investment. Instead, they resorted to habit and tried to pillage the interior, to squeeze their own subjects. Nothing, not even the wealth of high officials, was secure. Nothing could be more self-destructive.[100]

In Adam Smith's and his successors' view, it was the development of free markets that made rational (as distinct from irrational) self-interest possible. Walter Lippmann explained this idea:

> Until the division of labor had begun to make men dependent upon the free collaboration of other men, the worldly policy was to be predatory. The claims of the spirit were other-worldly. So it was not until the industrial revolution had altered the traditional mode of life that the vista was opened at the end of which men could see the possibility of the Good Society on this earth. At long last the ancient schism between the world and the spirit, between self-interest and disinterestedness, was potentially closed, and a wholly new orientation of the human race became theoretically conceivable and, in fact, necessary.[101]

The stress on rational self-interest also helps to explain why free markets are supposed to be "dog eat dog," but are often quite civil and peaceful, indeed more civil and peaceful than authoritarian alternatives. Adam Smith (and many others) stressed that rational self-interest is often a powerful tutor of personal and civic virtues:

> Whenever commerce is introduced into any country, probity[,] . . . punctuality[,] . . . economy, industry, [and] discretion . . . always accompany it. These virtues in a rude and barbarous country are almost unknown.[102, 103]

Economist David Levy takes this further. Hope for personal gain may powerfully motivate us to pay attention to the needs and wishes of others:

> Under [the profit system], even an insensitive man who would not pause to help a blind person across the street develops an interest in other people's wants and whims when he contemplates investing in a business.[104]

Argument 5: The private market system is grounded neither in greed nor in self-interest.

Adam Smith seriously erred in suggesting that it was, and his authority has misled us for centuries. The market system teaches naturally selfish people to put aside their selfishness and practice some of the "highest" values of social cooperation that human beings have ever achieved.

"Market values" are the diametrical opposite of "every man for himself." The "self-interest model" so beloved of economists is completely illusory. A young person may proclaim: I will start my own business in order to be my own boss. But if he or she persists in this illusion, the new business will fail, as most do. In order to start and run a successful business, one must be willing, above all, to subordinate oneself in the service of others. One must serve one's customers and one must also serve and respect and nurture one's employees.

Sometimes "bosses" are so talented or lucky that they do well without fully learning these lessons. Even then, they do not do nearly as well as they might have. The iron rule is: everything else being equal, the better you serve, the better you do. Predation, exploitation, parasitism, or greed may make this transaction, or even this year's profits, fatter. But a business is defined as the present value of all future profits, and these true profits are ruined by selfishness, even so-called "rational" selfishness.

"Market" values are not easy. They are extremely demanding, and in many cases take generations to learn. Nor are they "lower than" or "separate from" religious values. It is true that they are not identical to religious values, but they are rather "complementary" to religion and have arguably done as much as religion to "civilize" us, especially given the dark side of religion exemplified by religious wars. It is no coincidence that it was defenders of free markets who led the battle against world slavery and finally won it, against large odds, in the nineteenth century. As economist George Stigler writes:

> Important as the moral influences of the market place are, they have not been subjected to any real study. The immense proliferation of general education, of scientific progress, and of democracy are all coincidental in time and place with the emergence of the free enterprise system of organizing the market place. I believe this coincidence was not accidental.[105]

A critic of free markets, Liah Greenfield, has asserted in her book, *The Spirit of Capitalism: Nationalism and Economic Growth*, that nationalism promotes free-market growth. The truth is just the opposite. "Market values" are at odds with nationalism, tribalism, racism, and sectarianism of all kinds, and continually teach us to tolerate, work with, and ultimately appreciate people wherever and however we find them.

The hostile attitude of most economists toward the idea of the market as a source of moral values is hard to fathom, although it may simply reflect a lack of personal familiarity with business. Listen to Geoffrey Martin Hodgson:

> The firm has to compete not simply for profit but for our confidence and trust. To achieve this, it has to abandon profit-maximization, or even shareholder satisfaction, as the exclusive objectives of the organization.[106]

This is quite wrong. In truth, confidence and trust do not in the least conflict with profits. On the contrary, one cannot have the latter without the former, as great businesses have shown throughout history.

Perhaps the ultimate wrong note of this kind was sounded by economist John Kenneth Galbraith, past president of the American Economics Association, when he wrote that

> There is nothing reliable to be learned about making money. If there were, study would be intense and everyone with a positive IQ would be rich.[107]

What Galbraith, like others, failed to see is that one does not necessarily need a high IQ to make money, but rather the right personal values, in particular an ardor to serve others and a degree of realism about how to do it (since in markets, as in life generally, good intentions alone do not suffice).

Many economists do, of course, see morality in markets, if not perhaps the very highest morality. For example, *The Economist* comments on a study by Cornell economists Robert Frank, Thomas Gilovich, and Dennis Regan:

> Imagine a world in which people move from one prisoner's dilemma to the next (i.e., the real world). If people can choose their "partners" freely, and if honest types can spot each other in advance, co-operators will be able

to interact selectively with each other—and will therefore do better than cheats. Experiments have shown that people are surprisingly good at telling co-operators and cheats apart, even on the basis of what seems to be limited information.

So there you have it: narrowly self-interested behaviour is ultimately self-defeating.[108]

Part Seven

Government

16

Can Government Protect Us from the Excesses of the Profit System?—Yes

The question posed above has been formally debated for at least two thousand years. We know this because ancient Chinese annals record the then controversial decision of the powerful Han emperor Wu-di (155–87 BCE) to take a more direct hand in guiding and regulating the economy, and in particular to establish government monopolies of certain key commodities such as salt, iron, and alcohol.

Professor Kenneth J. Hammond of New Mexico State University, speaking in a college course lecture, describes these new government monopolies in approving terms:

> Wu-di wants the government . . . to solve problems for people. . . . What Wu-di was against was the manipulation of the market by private interests to enrich themselves, in other words, he was against mercantile profiteering. . . . [Consequently] production . . . [and] distribution [of salt, iron, alcohol] was controlled by the state, so that . . . these things that were needed by everybody could be afforded by everybody. . . . The state [thus] becomes an agency for fostering and creating the good life [with] the job of . . . regulat[ing] private greed and insur[ing] that . . . ordinary people are protected and . . . are not subject to the exploitation of greedy merchants.[109]

In ancient China, it was highly imprudent to criticize the emperor openly, but one of Wu-di's advisors, Sima Qian, did just that. He wrote:

> What need is there for government [economic] directives [or monopolies]? Each man has only to be left to utilize his own abilities and exert his strength to obtain what he wishes. Thus, when a commodity is very cheap, it invites a rise in price; when it is very expensive, it invites a reduction. When each person works away at his own occupation and delights in his own business then, like water flowing downward, goods will naturally flow forth ceaselessly day and night without having been summoned,

> and the people will produce commodities without having been asked. Does this not tally with reason? Is it not a natural result?[110]

Wu-di was not pleased with this response, and castrated Sima for daring to speak his mind. But the debate did not die, either in ancient China or in other countries and eras.

Sir Francis Brewster, a seventeenth-century English writer, was quite unaware of the Han dynasty controversy, but nevertheless offered a rebuttal of Sima's position in 1702: "Trade indeed will find its own Channels, but it may be the ruin of the Nation, if not Regulated."[111]

Later in the same century, the economist Adam Smith rebutted Brewster and restated Sima's case in words strikingly reminiscent of the early Chinese master's own:

> The natural effort of every individual to better his own condition, when suffered to exert itself with freedom and security, is . . . not only capable of carrying on the society to wealth and prosperity, but of surmounting an hundred impertinent obstructions with which the folly of human laws too often encumbers its operations.[112]

This is a very fundamental debate about government regulation and leadership of the economy. We will now discuss it directly from a variety of angles.

Argument 1: A private profit-making economy without government regulation is unbearable.

Recall for a moment the kind of unregulated labor conditions described by historian David Landes in turn-of-the-twentieth-century Argentina:

> In the textile, metal, match, and glass factories, the air was always full of a fine dust that irritated the lungs. In leather factories, the curing process required the use of sulfuric, nitric, and muriatic acids as well as arsenic and ammonia, all of which gave off harmful vapors that filled the building. In the packinghouses, workers trod upon floors that were slippery with coagulated blood, entrails, and animal excrement. The stench was overwhelming. The men who carried meat to the freezers had to wrap their hands and faces in rags or old newspapers . . . lest . . . fresh blood . . . freeze to their bodies.[113]

In unregulated, "sink or swim" markets, women and children suffer even more than men. In early-twentieth-century New York, 146 female workers, mostly immigrant, all desperately poor, perished in the Triangle Shirtwaist Factory fire because their employer had locked the doors to prevent unauthorized work breaks or theft. Civilized communities should never accept such conditions—the full force of law must be brought to bear to prevent them. But similar travesties continue to this day.

Toward the close of the twentieth century, Pygmies in central Africa were working all day for logging companies in exchange for two cigarettes. These were what defenders of completely free markets call "voluntary transactions," which they assume by definition to make both parties better off. But no reasonable person can argue that the Pygmies were better off for these transactions, no matter how voluntary, any more than the nineteenth century Chinese paid by British merchants in opium were better off for theirs.

Argument 2: Protecting workers is only the beginning of what the community, acting through government, must do.

From the late nineteenth century on, progressives and other critics of private profit-making markets have gradually developed a broad program calling for the state to:

- Protect the powerless, disabled, minorities, children, and women, and reduce economic inequality;
- Provide public education and health services, standards, and mandates;
- Regulate and control greed and selfishness among private interests, especially corporations and the rich, and ensure that businesses provide safe working conditions, produce

safe consumer products, and stop polluting the environment;

- Take full responsibility for national employment levels and control of the business cycle.

By the end of the twentieth century, virtually all political parties in the world, and especially those intent on winning democratic elections, took this program for granted, and so did government officials and central bankers. Even the parties that most publicly identified with free markets, such as the Republican Party in the US, firmly embraced it.

17

Can Government Protect Us from the Excesses of the Profit System?—No

Argument 3. Supporters of government intervention in the economy like to describe government as synonymous with community, a community of all citizens. This is false.

GOVERNMENT IS NOT synonymous with community. Like other institutions, it looks upon the world through the lens of self-interest. And because it enjoys a monopoly of coercive force, it has the potential to be the worst predator of all.

We should not assume that government is less selfish, more altruistic, more driven by ideals of the common good than private markets, and is therefore the fittest agent of our community aspirations. All human institutions are flawed, because human beings are flawed, but government is more flawed and more dangerous than private markets.

We can walk away forever from a bad boss, merchant, or customer, but we cannot walk away from the government. Therein lies a paradox. We have concentrated power in public guardians in order to protect us from private violence, theft, and fraud. But, having done so, who will guard us from the guardians?

This is not a hypothetical problem. We began this book by asking why human beings have still not pulled themselves out of often desperate poverty after all these thousands of years of so-called civilized life. Until the eighteenth century, the human economy as a whole barely grew at all, and even since then the rate of growth has not been exceptional. Why is this? Economist John Maynard Keynes said that

> The destruction of the inducement to invest by [a tendency to keep what wealth one had under a mattress] was the outstanding evil, the prime impediment to the growth of wealth, in the ancient and medieval worlds.[114]

But what Keynes overlooked was that people hid their money because they feared theft, and they especially feared theft by government.

In Sung China (tenth century), merchants were classed with undertakers and other "unclean" groups,[115] and the government did not hesitate to confiscate mercantile fortunes that came to its attention, a pattern that persisted throughout Chinese imperial history. The great historian of commerce and capitalism, Fernand Braudel, acknowledges that

> In the vast world of Islam, especially prior to the eighteenth century, . . . ownership was temporary, for there, as in China, [property] . . . legally belonged to the prince. . . . When the [rich person] . . . died, his seigneury and all his possessions reverted to the Sultan of Istanbul or the Great Mogul of Delhi. . . .[116] [In addition,] André Raymond's recent study of eighteenth-century Cairo shows us that the great merchants there rarely were able to maintain their positions for more than a generation. They were devoured by political society.[117]

The historian David Landes records the same thing in Japan. He cites the case of Yodoya Tatsugoro, scion of the leading commercial family in Osaka. The family had made itself immensely rich, had also performed many services to the nation, and had regularly lent money to the ruling classes. These loans could not be refused, but once made, they led to strained relations. In the end, all the family's money was confiscated by the government on the grounds that Yodoya was "living beyond his social status."[118]

Since the eighteenth century, the record of capital accumulation has improved. Governments have gradually learned that it is better to pluck the goose than to kill it, and Lord Macaulay correctly observed that, at least in Britain,

> Profuse government expenditure, heavy taxation, absurd commercial restriction, corrupt tribunals, disastrous wars, . . . persecutions, conflagrations, inundations, have not been able to destroy capital so fast as the exertions of private citizens have been able to create it.[119]

Even so, humanity's capital continues to be very much at risk. If only the recurrent destructions of capital by government can be avoided, the world might yet be awash with wealth. Every child might be, in financial writer James Grant's words, "a trust-fund baby."[120]

Argument 4: Government is also corrupt.

The primary charge against government is that it is predatory, a devourer of society's capital. But predation is not the whole story. More often than not, government is also corrupt. Moreover, the opportunities for corruption multiply the more deeply government gets into the economy.

To be sure, the line between predation and corruption may be indistinct. Demanding a bribe is both predatory and corrupt. Supporting private-market predators, such as trial lawyers, in return for financial support is also predatory and corrupt. But the heart of government corruption lies in the "soft" bribery of ordinary interest-group politics.

This is familiar ground, but some of the deals worked out between politicians and special interests may be complex and only later reveal their true nature. For example, large US tobacco companies were supposedly punished for deceiving the public about smoking risks when they agreed in 1998 to pay 46 states and their lawyers hundreds of billions of dollars in fines over 25 years. In fact a tacit deal was struck in which the same states agreed to limit new entrants into the tobacco business. The existing companies then used their newly protected cartel status to raise prices repeatedly, in unison, thereby generating far more money than was needed for the fines, money that flowed directly into profits.

Not surprisingly, Milton Friedman argues that "Probably the most important source of monopoly power has been government assistance, direct and indirect."[121]

Businesses are among the most important special interests, but so are unions and trial lawyers, each of which also benefit from government monopoly grants and licensing restrictions.

Politicians and their clients are the central figures in interest-group politics, but there are other, almost equally important figures, such as regulators, heads of interest group organizations, and lobbyists. For example, the US Department of Agriculture is supposed to protect the public from contaminated meat. But when small meat producers proposed to test each cow slaughtered for mad cow disease, a deadly illness transferable to humans, the Department repeatedly ruled in the early 2000s that such testing could not be done. In issuing this edict, the department sided with large meat producers who not only wished to avoid the cost of testing, but also wanted to use the power of government to prevent smaller producers from gaining an advantage from it. The regulators clearly saw large meat packers, not the general public, as their clients.[122]

Sometimes "little deals" between regulators and powerful commercial interests have very large historical consequences. For example, in seventeenth- and eighteenth-century France, the rich woolen, silk, and linen producers persuaded the government to ban the production of cotton cloth, which was then a new product. On one level, this produced rather comical results as government spies began "peering into coaches and private houses and reporting that the governess of the Marquis de Cormoy had been seen at her window clothed in calico of a white background with big red flowers, almost new."[123]

All was not gossip and amusement, however. Enforcement of the rules led many thousands of ordinary people to be executed or sent into gruesome labor on ships. Perhaps most importantly, Britain created its industrial revolution and surged ahead economically by producing cotton textiles, while France's refusal to allow cotton meant that it stagnated and fell far behind.

Argument 5: A government that is neither predatory nor corrupt can be of immense help to an economy.

The case for a state that acts only as an economic umpire, not an economic leader, that scrupulously limits itself to setting rules that apply to everyone, that does not try to intervene to assist any person or persons, or otherwise pursue its own aims and objectives—that case has been made in France and in many other countries. Boisguilbert asked the French government in the early eighteenth century to "*laissez-faire la nature*," by which he meant to get out of the way of commerce.[124]

Jeremy Bentham asked the British and other governments to "be quiet."[125] Economist Ludwig von Mises denied that a limited government is that "which governs least," because the state should strenuously "protect the smooth functioning of the market economy against fraud or violence from within or from without the country,"[126] an idea echoed by Harvard philosopher Robert Nozick.

Advocates of laissez-faire have become accustomed to having their words fall on deaf ears. Not long before the French Revolution, Jacques Turgot was appointed Comptroller-General of France and tried in twenty brief months to reform the tottering economic system along free-market lines. But he was forced to resign, thereby sealing the fate of Louis XVI and the old regime. In 1770, Turgot said wryly of his friend de Gournay:

> He was . . . astonished to see the [French monarchy] . . . fancy . . . that it ensured abundance of grain by making the condition of the cultivator more uncertain and unhappy than that of all other citizens.[127]

A few years later, Étienne Bonnot, the Abbé de Condillac, exclaimed that "experience teaches [government] nothing. How many mistakes have been made! How many times have they been repeated! And they are still repeated!"[128]

One can only imagine what the Abbé de Condillac would have thought of life at the beginning of the twenty-first century in Zimbabwe, a country once described as the "breadbasket" of Africa, but which writhed in misery under the iron grip of Robert Mugabe's government. Land redistribution schemes had turned over much of the best cropland to Mugabe supporters who had not the slightest knowledge of farming. As a result, over half of the country's 12 million people were on the brink of starvation. In many cases, government opponents were forcibly relocated to remote rural areas with no means of subsistence at all.

In towns, gasoline supplies had long since disappeared, although rumors caused people periodically to race to closed pumps to see if anything had arrived. Everything was price controlled, often at a price well below the cost of production. To avoid evasion of the price controls, no "new" product, brand, or packaging could be sold without prior written permission from one of the ministries. The economy as a whole was estimated to be imploding at a rate of 10% a year, but property and market values had already lost 99% of their previous value.[129] Throughout all this, Mugabe gave speeches railing against "greedy entrepreneurs, ruthless markets and the forces of globalization."[130]

At the end of the twentieth century, some free-market economists tried to offer broad-based statistical studies purporting to show that government leadership of the economy was a losing proposition. One study looked at 115 countries, ranked each country by measures of government intervention, and concluded that per capita gross domestic product was negatively correlated with such intervention.[131] Another study found a similar negative correlation between government spending as a percent of GDP and GDP growth.[132] Yet a third study found that the poor especially benefited from less government intrusion.[133]

The problem with all such studies is of course that they can and will be rebutted by someone else's study. The misleading idea, as economist Israel Kirzner puts it, that, "Chaos and misery [are] . . . bound to ensue unless market forces are curbed, redirected or superseded by the firm, benevolent hand of an all-wise government,"[134] is simply too entrenched in the human psyche to be displaced by statistical evidence.

A few committed believers in government leadership of the economy are willing to admit that their ideas have not lived up to expectations. The leading British socialist Aneurin Bevin quipped at a Labour Party Conference in 1945 that "only an organizing genius could produce a shortage of coal and fish in Britain."[135]

Walter Lippmann, a progressive who was always sympathetic to the idea of government economic leadership, and kept looking for ways to make it work, admitted that it tended to produce the opposite of what was expected:

> This is the vicious paradox of the gradual collectivism which has developed in western society during the past sixty years: it has provoked the expectation of universal plenty provided by action of the state while, through almost every action undertaken or tolerated by the state, the production of wealth is restricted.[136]

Nevertheless, as von Mises pointed out,

> Government interference with business is still very popular. As soon as someone does not like something that happens in the world, he says: "The government ought to do something about it. What do we have a government for?"[137]

Philosopher Michael Novak, who once believed in state leadership himself, shakes his head at this:

> One of the most astonishing characteristics of our age is that ideas, even false and unworkable ideas, even ideas which are no longer believed in by their official guardians, rule the affairs of men and run roughshod over stubborn facts. Ideas of enormous destructiveness, cruelty, and impracticality retain the allegiance of elites that benefit from them[138]. . . . [or feel that abandoning them would] violate . . . a taboo.[139]

Novak emphasizes that, in his view, it is the poorest who suffer from our mental sclerosis:

> [The] suffering [of poverty] is unnecessary because over the centuries a [free-market] system has been worked out to create "the wealth of nations"—all nations. To bring that system to all the world's poor is . . . our chief unfinished business.[140]

Part Eight

Profit-making and Depressions

18

Does the Profit System Cause Depressions?—Yes/No

Argument 1: The blind selfishness of profit-driven markets is incompatible with employment stability.

JOURNALIST AND PHILOSOPHER Walter Lippmann stated this case clearly during the Great Depression: "An uncoordinated, unplanned, disorderly individualism . . . inevitably produces alternating periods of boom and depression."[141]

A *Washington Post* editorial writer echoed Lippmann over sixty years later: "Markets, following their own blind logic, typically overreact and, left to their own impulses, can do great damage."[142] Investor, speculator, and philosopher George Soros warned that

> there is [an erroneous] belief that markets are self correcting. . . . To put the matter simply, market forces, if they are given complete authority even in the purely economic and financial arenas, produce chaos and could ultimately lead to the downfall of the global [economic] system.[143]

It follows from this viewpoint that "[One of] the most important function[s] for . . . government . . . is ensuring macroeconomic stability."[144]

Lippmann explained how to go about it:

> The state [should] undertake . . . to counteract the mass errors of the individualist crowd by doing the opposite of what the crowd is doing; it saves when the crowd is spending too much; it borrows when the crowd is saving too much; it economizes when the crowd is extravagant, and it spends when the crowd is afraid to spend. . . . [This] compensatory method is, I believe, an epoch-making invention.[145]

Argument 2: Response.

As explained earlier, profit-driven markets are the opposite of disorderly. They are, in fact, the best way to organize ourselves, and are continually led and guided by the wishes of consumers.

The idea that government can in some way "compensate" for market "errors" has proven to be not "an epoch-making invention," but rather a tragic delusion. Politicians are even less likely than consumers to restrain themselves during a boom. They want to spend more, not less, deceiving themselves that the boom will last forever. Their recklessness, more than any other factor, tips the boom into bust.

Argument 3: Profit-driven economies are inherently prone to depression.

This is because business owners try to keep wages as low as possible, assuming that this will fatten profits. What is forgotten is that workers are also consumers. Underpaid consumers will not be able to buy all the goods produced.

Walter Lippmann believed that this was the fundamental cause of the Great Depression of the 1930s: "The heart of the problem . . . [has been] . . . an insufficiency of consumer . . . purchasing power." [146]

Argument 4: Response.

The "employee/consumer purchasing power theory" articulated in Argument 3 is false. It is false because a business owner who underpays employees will take the gains and either reinvest them in the economy, to be earned by other workers, or buy luxury goods, which must also be produced by other workers, or pay dividends to other shareholders, who will also either invest or buy. So long as the money is circulating in this way, there should be no failure or crisis of demand.

What really upsets the system are not low wages per se, but an imbalance among wages, prices, profits, and investment. The right balance of these variables helps workers the most, both in their roles as workers and as consumers. In retrospect, it is tragic that the fallacies of the "employee purchasing power theory" guided (actually misguided) the actions of both the Hoover and Roosevelt administrations during the Great Depression of the 1930s.

Argument 5: To achieve employment stability, we need stable prices in our economy. The profit system gives us erratic prices, occasionally stable, more often rising (inflation) or falling (deflation). Falling prices in particular are a primary cause of depressions.

When we order flour or sugar, we expect to get a specified weight in pounds or kilograms. When we travel from city to city, we also know that we can rely on standard units of measurement, whether miles or kilometers. Imagine, now, that pounds, kilograms, miles, and kilometers all fluctuated in value from day to day. Economic chaos would ensue.

If we do not accept fluctuating weights and distances, why should we accept fluctuating money values? Not knowing what a dollar or euro will be worth tomorrow, expressed against each other, or even more importantly expressed as an underlying basket of goods that each will buy, is confusing, disorienting, and destabilizing.

If I am saving for my retirement in twenty years, it would greatly simplify life to know that a dollar would buy as much then as now. If I am a home-builder and have built a home without a contracted buyer, all my work may be in vain if prices fall just when I am ready to sell. And if I have borrowed a lot of money, and have to pay it back in money that has risen in value (money rises in value as prices fall), I could be utterly ruined. None of this is hypothetical. Prices did fall at the onset of the Great Depression, millions of businesses and especially debtors were forced into bankruptcy, and massive unemployment resulted.

Unfortunately, a profit system virtually guarantees that prices will fall. In the first place, the market system, as we have previously seen, invests its capital in productivity-enhancing equipment in order to reduce costs. Even if the business owner's goal is to reduce costs without reducing prices, competition soon drives prices down with costs.

In the second place, business owners get carried away and overproduce, so that prices may start to free fall. Business confidence will then collapse with prices, and what is called a "debt deflationary downward spiral" will drag even strong businesses and individuals down with it, especially those who have taken on high levels of debt. Falling prices are just exceptionally dangerous for an economy and should not be tolerated.

Argument 6: Response. Stable prices are not what we should want.

Prices have nothing in common with weights and distances. Nor should we want them to be stable. On the contrary, we should want them to fall.

The very purpose of free markets is to reduce prices so that more and more people can afford to buy the goods and services being produced. Many products arrive as luxury goods, far too expensive for the average person to own, but are eventually mass produced at reasonable prices for everyone. Automobiles and computers are particularly dramatic instances of this.

Why should we try to thwart this process by keeping economy-wide prices artificially high, especially when falling prices will do more than anything to help the poor? Wanting lower prices is just common sense. Opposing them is an example of twisted logic, of theoretical economics run amok.

The objective here is, of course, steadily and gently falling prices, not a precipitate collapse, leading to a downward spiral of failing businesses. But if a financial crisis comes, if debt begins to deflate, and debt deflation leads to a weak economy, price deflation, and an even weaker economy, better for government to stand back and let the market sort itself out.

Wages in particular should be allowed to fall with prices. This need not hurt workers, because lower wages can buy the same consumer basket as before if prices are lower. Once the market has sorted out the right relationship among prices, wages, and other costs, profits and employment levels will bounce back and good economic times will return.

In all this, it is important to remember that free markets are so efficient because they offer people an opportunity not just to make money, but also to lose it. Once ideas, investments, businesses prove to be failures, they should be weeded out as quickly and unequivocally as possible.

Before the 1930s, and the advent of an activist government, there were depressions to be sure, but they were brief. As Austrian (and also "Austrian school") economist Friedrich Hayek said in an interview toward the end of his life, "My great example is . . . the US in 1921 and 1922[.] After six months of depression, prices came down by 44%. Then the economy started off on another boom."[147]

This was in sharp contrast to the Great Depression of the thirties, when falling prices were combated and wages kept artificially high by both the Hoover and Roosevelt administrations. As a direct result, unemployment kept deepening and depression lingered on amidst terrible human suffering.

Nor are economic safety nets a good idea. When speculators are bailed out from their soured speculations, they will simply speculate more. When no serious consequences follow from reckless debts or gambling, recklessness and gambling will increase exponentially. This problem of "moral hazard" confronts us whether we are dealing with countries, companies, or individuals. The lesson to be learned, in economist Wilhelm Röpke's words, is that "The more [government] stabilization, the less stability."[148]

Argument 7: Response. Government should "pump" sufficient new money into the economy to prevent falling prices.

If sharp falls in prices could be matched by sharp falls in wages, then, yes, markets might be able to pull themselves out of depressions on their own. But this is completely unrealistic. Modern workers will not, under any circumstances, accept lower wages. If prices fall dramatically, wages will not fall, profits will collapse, massive unemployment will follow, and depression will persist indefinitely. This point was especially stressed by British economist John Maynard Keynes, the most influential economist of the past century, and the chief antagonist of purely free market "Austrian" economists such as Hayek and Hayek's teacher, Ludwig von Mises.

The only way to get out of the predicament is for government to intervene and pump additional money into the economy. If the amount of goods and services remains the same, but the amount of money in circulation dramatically increases, the prices of goods and services should rise.

To see why this is so, imagine yourself on a desert island with one companion, one dollar, two identical knives, and nothing else. The price of each knife would logically be 50¢. But if another dollar landed on the beach inside a bottle, the price per knife would logically rise to $1.

How does government get additional money into the economy? It might borrow it from individuals and businesses and then spend it. But this is only effective if the private parties are keeping their money under a mattress, out of circulation.

Most likely, government will also need to "print" new money. This new money is made available to banks, which lend it in the ordinary way, thereby moving it out into the economy.*

Can it really be this simple to cure or even avoid deflation in the first place and thus avoid economic slumps? Economist Paul Krugman, a "Keynesian" and leading advocate of active monetary interventions, acknowledges that

> To many people it seems obvious that massive economic slumps must have deep roots. To them, [the] argument that they . . . can be cured by [the government] printing a bit more money seems unbelievable.[149]

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* See Appendix D or G for the mechanics.

But he assures us that deflation (and depression) can indeed be cured (or better still avoided) through the simple expedient of expanding the amount of money in circulation whenever prices are falling or seem in danger of falling. The new money in circulation will prevent prices from falling or, if they have already fallen, restore them to former levels.

Argument 8: Response. Pouring new money into the economy is not the answer. Adjusting wages and other interconnected prices is.

When government "prints" new money and makes it available to banks to lend out, there may or may not be borrowers to take it. If people are sufficiently frightened, they will try to repay loans rather than take out new ones. In this case, the government may have to spend the money itself to get it into the economy and thereby boost prices. So far, Keynesians agree.

But even if banks are able to lend the new money, no one can be sure where it will go. Businesses that desperately need a price increase may not benefit from the new money that is circulating while businesses with fat profit margins may benefit instead. Monetary intervention is a crude and uncertain tool at best.

As "Austrian" economic writer Henry Hazlitt has explained,

> The truth is that the only real cure for unemployment is precisely the one that Keynes's whole "general theory" was designed to reject:

> the adjustment of wage-rates to the marginal labor productivity . . . level. This does not mean a uniform *en bloc* adjustment of "the wage level" to "the price level." It means the mutual adjustment of specific wage-rates and of prices of the specific products various groups of workers help to produce. It means also the adjustment of various wage-rates to each other and of various prices to each other. It means the *coordination* of the complex wage–price structure.[150]

As the Great Depression of the 1930s deepened, it was precisely the coordination of the wage-price structure that was missing. Because prices were falling and wages were not allowed to fall with them, profits collapsed. Employers who could not reduce wages had to lay off workers instead. What was the result? Workers who did not lose their jobs saw their wages soar in purchasing power, because consumer prices were falling without corresponding wage cuts. Meanwhile, the unlucky ones, the workers who had been fired, ended up on the streets or in breadlines.

Is it morally just to keep some lucky workers' nominal wages high even if this results in lower total wages as more and more people are fired? Is it not better to allow wages to fall as prices fall, so that everyone can remain employed? If prices and wages fall together, no one need be fired, and workers are no worse off than before, because their lower wages are matched by lower consumer prices.

Consider this as well: is it reasonable to advocate wage freezes when prices plummet, but permit unlimited wage increases when prices soar? Why should wages be inflexible only on the downside? Also: are all current wages equally sacrosanct? Does it matter what recent wage increases have been? Why should we adamantly oppose wage cuts, but generally applaud setting up worker profit sharing or profit participation plans that result in variable compensation, that is, compensation that can fall as well as rise?

And why do we especially worry about wages as opposed to other costs? Do we not realize that all costs are someone's income, whether or not the cost takes the form of a wage? For example, if I am an automobile manufacturer, I probably buy tires from another company. My tire purchases pay the wages of the tire manufacturer's employees. The tire manufacturer in turn buys rubber and thereby contributes to the wages of rubber company employees, and so on. Any falling price, whether it is a wage or another price, reduces someone's nominal income, but efforts to thwart this natural process will harm rather than help workers.

It must be acknowledged that not all unemployment is caused by inflexible wages. Other prices or costs may also be out of proper adjustment. Business owners may fear to invest because they do not know what government will do, especially with respect to the value of money and currencies. Investors who are afraid of inflation or devaluation may build up cash balances or buy gold, even though the latter pays no interest and actually costs money to store securely. But, as important as these other factors may be, inflexible wages are still the chief cause of unemployment.

Argument 9: Keynes was at least partly right.

Critics of Keynesianism are not all of one mind. Some reject each and every Keynesian idea. Others pick and choose. For example, some self-described critics agree with Keynes that government should try to stop a recession from turning into a depression. They also agree that the best way to do this is to "print" large quantities of new money to prevent prices from falling, and, in so far as possible, to maintain the previous price and debt levels. They think he was wrong, however, to recommend monetary stimulus during normal times.

In this view, monetary growth should be moderate, never exceeding the underlying real growth of the economy, and absolutely regular, except during true economic emergencies, which should be rare. Inflation is an evil and should always be avoided. By upsetting the system, it leads eventually to deflation. If inflation cannot be prevented entirely, it should at least be as predictable as possible and buffered by built-in price adjustments such as wage escalators. In general, the "holy grail" of monetary policy should always be stable consumer prices, consumer prices that neither rise nor fall. Stable prices and stable prices alone will ensure a stable economy.

This particular economic advice comes from Milton Friedman and the monetarists. Monetarism was sometimes called the "price-cycle theory"[151] in the 1930s, and was given its modern form at that time by the American economist Irving Fisher. Keynes was originally a monetarist himself, as his *Treatise on Money* of 1930 makes clear. Friedman attacked Keynes for leaving the monetarist fold, but was at the same time deeply influenced by Keynes.

Argument 10: Friedman said he favored small government but was glaringly inconsistent.

Monetarists are inconsistent in their stance toward government. As avowed free-marketeers, they are supposed to be suspicious of government interventions in the economy. Milton Friedman in particular waged a highly publicized campaign against "big government" in speeches, popular books, and television programs, as well as in his scholarly work. Yet Friedman and other monetarists want government to intervene deeply into the economy if deflation threatens and to "print" as much new money as it takes to keep prices from falling. Nor are they generally supportive of proposals to take control of money and short-term interest rates out of government's hands by returning to a gold standard, although Friedman was willing to discuss proposals for "free" banking.[152]

Argument 11: What about inflationary recessions and depressions?

Keynesians and monetarists absolutely agree on the need to "print" and circulate more money when prices are falling and deflationary depression threatens. But what about when the economy slumps, but prices do not fall?

This situation is called *stagflation* and is inconsistent with Keynes' theory. His *General Theory* suggested that recession is caused by too little demand, inflation by too much. Since the two are opposites, one would not expect them at the same time. But in the 1970s, they did strike at the same time.

Monetarism is quite clear what it would do about this. Since price stability is all important, the money supply should be decreased, even if the economy is weak. The Keynesian answer was different: ease monetary policy to help the weak economy, but cut government spending to restrain inflation.

Argument 12: Both Keynesians and monetarists are wrong.

The correct policy for an inflationary slump, says a group of Supply-side economists led by Robert Mundell, is just the reverse of what the Keynesians recommend. Under conditions of stagflation, one should tighten monetary policy ("print" less new money) and simultaneously ease fiscal policy (run a government budget deficit). Moreover, one should not let government borrow and spend more, the Keynesian recipe for easing fiscal policy. One should instead ask government to cut taxes without cutting spending, and then cover the resulting budget deficit by borrowing. If everything goes as hoped, the tight monetary policy will quell inflation while the tax cuts boost the economy. If the economy is sufficiently strengthened, tax revenues will rise again, even with tax rates kept low.

Supply-siders think that Keynes went wrong by putting so much emphasis on demand (spending) when dealing with a weak economy. The right answer is to strengthen producers (the so-called supply side) by reducing taxes. If producers do well, their profits will pay for more hiring and investment, and demand (spending) will follow.

Note that Supply-siders still hew to the basic Keynesian/monetarist policy synthesis framework. Inflation is regarded as an evil, but deflation as an even greater evil. If deflation threatens, government must aggressively intervene to prevent it. The quarrel is over the kind of stimulus to apply to slumps, not whether such stimulus is a good idea in itself.

Argument 13: Keynesians, monetarists, and Supply-siders all miss the main point about slumps.

The Keynesian/monetarist/supply-side policy synthesis framework is all about using government policy interventions, especially "easy money," to fix a slump. But there is something actually perverse about doing this. After all, it is usually "easy" money that lures people into taking on excessive debt in the first place during the boom phase, before the inevitability of the succeeding bust becomes apparent.

As the "Austrian" economist Friedrich Hayek said in the 1930s,

> To combat the depression by [printing more money and encouraging more debt] is to attempt to cure the evil by the very means which brought it about.[153]

In effect, trying to cure an economic slump caused by easy money with even easier money is like trying to cure a hangover with more alcohol. And if this policy is combined, as it often is, with tighter and tighter business regulation and an abandonment of free trade in favor of protectionism, the effects can be particularly disastrous.*

Argument 14: Response. It does indeed make sense for government to intervene at the beginning of a slump and to "pour" more money into the economy at that time. It makes sense because this new money can be "drained out" again as soon as the economy recovers.

Government should inject additional money and debt at a time when existing money and debt levels are collapsing. The new money and debt does not increase

* For a systematic exposition of the "Austrian" view on economic instability and what to do about it, see Appendix D.

the total; it just replaces what is being lost. Later, when private companies and individuals regain their confidence and start borrowing again, the new money and debt can be withdrawn by raising interest rates. This "compensatory method" (described by Walter Lippmann in Argument One) balances what the private sector is doing and thus stabilizes the system.

Argument 15: Response. The idea that government planners will know when to inject or withdraw money and credit is completely fallacious.

Politicians want to survive the next election. Their focus is very short term. Government officials answer to politicians. Even if they could discern the right times to add and subtract money and credit, which they cannot, they would still always want to add and not subtract.

The US Federal Reserve poured in money and credit during the Internet and Technology ("Dot Com") bubble of the 1990s; it poured in more during the "Dot Com" bust starting in 2000; it kept on pouring in more during the housing bubble of 2002–2007, and then it poured in even more prodigious amounts during the housing bubble bust. Can anyone imagine that the trillions of US dollars poured in will ever really be withdrawn?

New money and additional debt were used by Japan to counteract the collapse of its bubble in the late 1980s. Twenty years later, interest rates are still kept artificially low by the government, forcing savers to send their money outside the country to earn even a minimal return; the economy has never really recovered from the bust; bad investments from the past have never been fully liquidated; and stock market prices are still 80% below the peak.

Moreover, even if a government had the will to withdraw money and credit from a revived economy, it is a very difficult thing to do. With each crisis, the government pours in new money and credit. With each recovery, debt levels increase. Unfortunately, the amount of new economic growth obtainable from each new dollar (or euro or yen) of debt steadily declines. But the growth in total debt makes the economy increasingly sensitive to even the smallest restriction of the flow of new money and credit.

For much of the early 2000s, the US Federal Reserve kept short interest rates below the level of official consumer price inflation. This was virtually giving money away. When interest rates were finally raised, it was only by a little. Rates never got much past 2% over inflation. But even that amount of interest rate increase was enough to start unhinging the financial system and raise the specter of "debt deflation."

Ben Bernanke, chairman of the Federal Reserve at the time, promptly lowered the "Fed Funds" interest rate again, bringing it to the vanishing point (one quarter of 1%) by 2008. This rewarded borrowers and left prudent savers wondering if they could ever earn a decent and safe return.

Ironically, Bernanke's initial lowering of interest rates in 2007 just made matters worse. It persuaded Wall Street to take one last, large gulp of leverage (debt), additional debt that it would soon regret. It also set off a race to buy commodities as a hedge against inflation and a falling dollar. The price of oil in particular doubled in only a few months. This hit consumer and business confidence hard.

What if Bernanke had held interest rates steady in 2007? This would probably have helped. A recession might have come, but it came anyway, and the crash of 2008 might have been avoided.

Argument 16: Response. The solution to a faltering boom is never higher or even stable interest rates. It is, on the contrary, lower rates.

Bernanke's actions in lowering interest rates, eventually to the vanishing point, reflected his standard Keynesian views. Keynes put his doctrine in its most extreme form in *The General Theory of Employment, Interest, and Money* (this form is sufficiently extreme that Bernanke and other contemporary Keynesians would not accept all of it):

> The rate of interest is not self-adjusting at a level best suited to the social advantage but constantly tends to rise too high. . . .[154] There was wisdom in [16th and 17th century economists'] intense preoccupation with keeping [interest rates] down. . . .[155]

> The austere view, which would employ a high rate of interest to check . . . [a booming economy lest it "overheat" and cause inflation has] no foundation at all apart from confusion of mind. . . .[156] The remedy for the boom is not a higher rate of interest but a lower rate of interest. For that may enable the so-called boom to last. The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom. . . .[157]

Keynes continues:

> The owner of capital can obtain interest because capital is scarce. . . . But . . . there can be no intrinsic reason for the scarcity of capital [since government can always "print" and distribute more of it]. . . . Thus we might aim in practice . . . at an increase in the volume of [money] until [investment capital] ceases to be scarce. . . .[This] would mean the euthanasia [that is, the death, but the medicated or painless death] of the rentier [private lender], and, consequently, the euthanasia of the cumulative oppressive power of the capitalist to exploit the scarcity-value of capital. . . .[158]

Argument 17: Response. Keynesian “easy money” policies are not a sustainable solution.

“Austrian” economist Ludwig von Mises pointed out that “easy money” just leads to more “easy money.” The economy becomes so addicted to the flow of new money and credit from government that any interruption, even a tapering off in the growth rate, provokes a crisis. Government reacts to the crisis by stepping up the flow of new money and credit at an even faster rate, and this seems to avert the crisis. But the seeds of the next crisis are sown, and each succeeding crisis will be bigger, until the system finally collapses.

Prices and profits provide the all important signals that make economies work. Interest rates are the most important prices in the economy, with currency prices a close second. When government intervenes and manipulates these prices, almost always driving them down to “stimulate the economy,” these actions affect all other prices, because prices are interconnected. Market participants can no longer get the information they need to make rational decisions, and the system increasingly fails.

As Oystein Dahle stated in Part Four, Communism collapsed primarily because it did not permit prices to “tell the economic truth.” Keynesian and related economic planners do not let prices “tell the economic truth” today, with ever worsening consequences.

Argument 18: Quite apart from the perverseness of active monetary intervention, there are other reasons to be suspicious of it.

Why is it that monetary intervention is done in such a stealthy, indeed in such a clandestine manner? The straightforward way for government to print new money and inject it into the economy is to run it off printing presses and then spend it. This is what governments used to do. But now, instead, they first borrow money from private parties, especially banks, by selling bonds, then buy in the same bonds through their central banks. Since the central bank checks used for this purpose are drawn out of thin air, the effect is identical to printing money outright, but concealed from the eyes of all but a few experts.

One reason that governments prefer to "print" new money stealthily is that "printing" new money is really a form of taxation, albeit an indirect and thus more easily concealable form. A bit of math will illustrate why this is so. Assume that an economy consists of one dollar and various goods and services. The government can either take 25¢ in tax revenue or "print" 33.3¢ for its own use. Either way, the authorities now command 25% of all goods and services (25¢ is a quarter of $1.00 and 33.3¢ is a quarter of $1.00 plus 33.3¢). Because the government now commands 25% of all goods and services, private individuals have 25% less, although they will generally be much more aware of the change when directly taxed.

The preceding example assumes the government itself spends the new money. If, instead, it injects the new money into the banking system to be used for loans, who then gains most from this new loan money? This is a complicated question, but suffice it to say that the rich, who do most of the borrowing in a capitalist economy, are in the best position to gain from it. The poor, who lack the credit to borrow much, gain least, and if they do borrow (as in sub-prime mortgages), often come to grief. Wall Street, which generally gets the new money first, potentially gains the most, provided that it does not get too greedy or foolish, as it did during the US housing bubble.

Part Nine

Central Banks

19

Can Central Banks Protect Us from Depressions and Lead the Economy?—Yes

Although governments are in charge of a nation's money, they usually delegate day-to-day control to a central bank. The central bank will then decide whether there is too much or too little money in circulation, whether money market (short-term) interest rates are at an appropriate level, whether the banking system is operating safely and smoothly, and so on. In most cases, the central bank will also directly supervise and regulate private banks.

As a general rule, political progressives are supporters of central banks, because they favor more government leadership of the economy, assume that economic conditions will lapse into chaos without such leadership, and think that central bankers are more qualified to carry out this critical task than politicians. Laissez-faire advocates, by contrast, take a dim view of this, since they think that the government should not try to lead the economy. Nor are they convinced that central bankers will be that much wiser or successful than politicians.

Argument 1: Without a central bank, there would be no way to control the dangerous excesses of the banking system and otherwise keep the economy on a steady course.

The US Panic of 1907 provided some of the impetus for the Federal Reserve Act of 1913. Although the 1907 panic was unusually severe, it was only the latest in a long series of such episodes. As the *Washington Post* pointed out in an editorial,

> The world's . . . history . . . [has been] a succession of panics, slumps, and crashes in which markets were working, all right—but working as they sometimes do, perversely and blindly.[159]

The creators of the Federal Reserve hoped that it would prevent both bank excesses and bank runs, and by doing so help stabilize the economy. Despite uncertainties about how "loose" or "tight" monetary policy should be, the US "Fed," as it is commonly called, has been a signal success. Economic writer Jeff Madrick states that "By 1913 the US federal government created a stable financial system with the creation of the Federal Reserve."[160]

Given the convulsions of the Great Depression, economist Geoffrey Moore, architect of the government's index of leading economic indicators, offers a sensible qualification: "I think in general the Federal Reserve has had a stabilizing effect on the economy, especially since World War II."[161]

George Moore, who built the banking colossus Citibank, agreed and added that "The Federal Reserve has learned that at the very least you have to put a floor under the economy [by expanding the money supply whenever deflation threatens]."[162]

Alan Greenspan's long eighteen-year tenure as Federal Reserve Chairman at the end of the twentieth century and the start of the twenty-first was at the time particularly singled out for praise. Employment during that period remained high, inflation averaged less than 3% a year, and the chairman earned, in economist Robert Solow's words, "Massive respect, even awe. . . . "[163]

Some observers did express concern about the growing US trade and current account deficits* of the Greenspan era. Because the US was buying far more from foreigners than it was selling, it was borrowing more and more to

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* A trade deficit occurs when a country buys more goods from abroad than it sells. A current account deficit occurs when more money flows out than flows in and reflects a wide variety of transactions including products, services, foreign investment income, corporate profits earned abroad (and repatriated), and so on.

pay for the purchases. In many cases, the same foreigners who sold the goods provided the financing.*

Worry about mounting US international debts was natural, but it was wrong. Trade and current account deficits do not really matter; it is probably a waste of effort even to measure them. The US ran in the red in both accounts for its first century. By the 1890s, foreigners owned sizeable minority and even majority stakes in the largest American companies, especially the railroads.[164] What harm did this do? Only thirty years later, circumstances had reversed and Europeans were borrowing from America. We should not pay much attention to global financial flows and who owns what at any given moment.

It is also important to emphasize that the US, as a global currency reserve country,† is able to borrow in its own currency, in dollars. This is unusual—most countries have to borrow money denominated in

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* International seller financing works as follows. Assume that a Chinese company sells some goods to the US. The American party pays in dollars, the Chinese company takes the dollars to the Chinese central bank and is given Chinese renminbi, currency that has either been borrowed from domestic savers or that has been newly created for this purpose. The Chinese central bank then commonly invests the dollars by buying US bonds through the US Federal Reserve. To the degree that new remnimbi have been created, they increase the Chinese domestic money supply, and all else being equal, increase the likelihood of domestic Chinese inflation.

† A global currency reserve country issues currency that other central banks are willing to hold in their financial reserves, and which both governments and businesses all over the world use in their financial transactions.

a foreign currency. Then, if the value of their own money falls in relation to the foreign currency, the amount of money owed can explode. By contrast, the US need not worry, since it can repay its debt in dollars, can even print new dollars for this purpose. If foreigners who have lent money to the US lose confidence in the dollar, the international value of the dollar will fall. But that hurts the foreign lenders, not the American borrowers. All the US has to do is to ignore financial writer James K. Glassman's odd advice to borrow in yen, since the US cannot print its own yen, and all should be well.[165]

US economist Merton Miller has explained the situation clearly:

> We've actually been playing a cruel trick on the Japanese [and Chinese]. We've persuaded them to send us expensive [goods]—and in exchange we give them pictures of George Washington. . . . [If] they want . . . their money. . . , "Okay," we say, . . . "[but if you try to sell the US currency that we give you on world markets, you may only get] 20 cents on the dollar." They're the losers at this game.[166]

Economist Paul McCulley agreed:

> To those with Calvinistic tendencies, always looking for what can go wrong, . . . the notion of . . . [the United States financing its consumption by borrowing from China] just

doesn't seem right. . . . But . . . [at least for the moment] it is good, very good.[167]

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Can Central Banks Protect Us from Depressions and Lead the Economy?—No

Argument 2: The record of the US Federal Reserve has been poor. The country did much better before its founding.

FROM THE END of the US Civil War to the founding of the Federal Reserve almost a half century later in 1913–14, consumer prices fell more years than they rose, but ended up about where they started. This was a time of excellent economic and employment growth and also included some of the best stock market returns. At least one study of stock returns from 1872 showed that periods of mild deflation, such as we had in the latter half of the nineteenth century, have produced the best stock market returns of all, even better than periods of mild inflation.[168]

Shortly after the founding of the Fed, inflation surged. This was generally explained by the need to finance World War One. After that war ended, prices fell again, although not to pre-war levels. They declined gently during the 1920s, fell dramatically during the Great Depression (but again not to pre–World War One levels), rose during World War Two despite price controls, continued to rise after the war, and then surged again in the 1960s and 1970s. At the very end of the 1970s, the Fed under chairman Paul Volcker seemed to declare war on inflation, and double digit inflation rates fell dramatically. But in the quarter century following, consumer prices doubled again. All in all, during the first ninety years of the Fed, the US dollar lost 95% of its purchasing power.

Federal legislation requires the Fed to control inflation. Successive chairmen and board members have repeatedly affirmed this objective, and there is no doubt that the Fed could stop inflation if it wished to. All it would have to do is print less new money. As production grew without new money being created, the ratio of goods to money would increase which would mean more goods for less money or, in other words, lower prices.

Yet by the early twenty-first century, the board was pursuing an unacknowledged two percent inflation target similar to the European Central Bank's acknowledged 2% target. Since the price of manufactured goods was generally falling, an overall rise in prices could only be engineered by subsidizing the relative lack of productivity and oversize price increases in services such as healthcare, housing, and education.

In 1985, Thibaut de Saint Phalle, author of *The Federal Reserve: An Intentional Mystery*, wrote that,

> It is puzzling that no one in Congress ever points out that it is the Fed itself that creates inflation and, more recently, permits Congress to ignore the growing budget deficits. The Fed, by financing the federal deficit year after year, makes it possible for Congress to continue to spend far more than it collects in tax revenues. If it were not for Fed action, Congress would have to curb its spending habits dramatically.[169]

Economist Murray Rothbard thought that there was no mystery about the Fed at all:

> If the chronic inflation undergone by Americans, and in almost every other country, is caused by the continuing creation of new money, and if in each country its governmental "central bank" (in the United States, the Federal Reserve) is the sole monopoly source

> and creator of all money, who then is responsible for the blight of inflation? Who except the very institution that is solely empowered to create money, that is, the Fed (and the Bank of England, and the Bank of Italy, and other central banks)? . . . In short . . . the Fed and the banks are not part of the solution to inflation. . . . In fact, they are the problem.[170]

By the 1990s, even the widely respected Paul Volcker, deemed one of the most successful of Fed chairmen, concluded that "By and large, if the overriding objective is price stability, we did a better job with the nineteenth century gold standard and passive central banks, with currency boards or even 'free banking.'"[171]

As some economists see it, the economy not only had more stable prices before the creation of the Fed; it was more stable, period. Economist Gottfried Haberler observed that

> During the second half of the nineteenth century there was a marked tendency for [economic] disturbances to become milder. Especially those conspicuous events, breakdowns, bankruptcies, and panics became less numerous, and there were even business cycles from which they were entirely absent. Before [WWI], it was the general belief of economists that . . . dramatic breakdowns and panics . . . belonged definitely to the past.[172]

Milton Friedman has been even more critical:

> The severity of each of the major contractions—1920–21, 1929–33, and 1937–38—is directly attributable to acts of commission and omission by the Reserve authorities and would not have occurred under earlier monetary and banking arrangements.[173]

Free-market economists do not all agree about how past economic contractions occurred. But all would agree with Friedman's assertion that "The stock of money, prices and output was decidedly more unstable after the establishment of the Reserve System than before."[174]

Argument 3: Price-fixing is especially toxic for an economy, and central banks are basically price-fixers.

As we have previously noted, interest rates represent the price of money, or technically the price of credit. The price of credit in turn is really the price paid for time, for deferring consumption from the present into the future. That is, if I lend you money, I am putting off my own immediate consumption. Once you pay me back, I can spend my money, but not for the time period covered by the loan. Since money and time are involved in virtually every transaction in the economy, there is no more crucial price than the price for credit. Nineteenth-century economist Jean-Baptiste Say was right to say that "[The] rate of interest ought no more to be restricted, or determined by law, than . . . the price of wine, linen, or any other commodity."[175]

But it is important to emphasize that restricting this particular price is especially dangerous, because (as noted in Part Four), the economy depends on free prices for information, and on this price more than any other.

Economic writer Gene Epstein has correctly stated that "[The chairman of the Federal Reserve] is the head price fixer of a price-fixing agency."[176]

The agency not only fixes the short-term cost of credit, which in turn influences other interest rates. In addition, it heavily influences what is perhaps the second most important economic price, that of the US dollar in world markets.

Moreover, this is a form of price-fixing whose deleterious effects are notoriously difficult to detect. As economic writer Gene Callahan explains:

> Because [interest rates are paid over] . . . time, the negative effects of the artificial [credit] price take time to appear. . . . And because of that time lag, it is harder to trace the later problems to the earlier intervention.[177]

Argument 4: Central banks are national economic planners, and national economic planning does not work.

Like the debate about price controls, there is an ebb and flow to the perennial debate about economic planning. Adam Smith wrote at the end of the eighteenth century that:

> The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.[178]

For a considerable time, Smith's view prevailed, only to be superseded by Keynes's ideas and by what Barbara Wootton called in 1935 "The Necessity of Planning":

> There should be some body of nation-wide authority charged with the duty of constructing [an] . . . economic . . . plan for the whole country, or at least with the duty of reviewing all our partial plans—plans for housing, plans for the relief of distressed areas, agricultural marketing plans, and so on—so as to make sure that they fit together.[179]

By the time the Berlin Wall fell in 1989 and Communism collapsed in the Soviet Union and elsewhere, the pendulum appeared to swing again. Economist Robert Heilbroner, a prominent friend of national economic planning, wrote in that same year:

> The contest between capitalism and socialism is over: capitalism has won. [We now have] . . . the clearest possible proof that capitalism organizes the material affairs of humankind more satisfactorily than socialism.[180]

Some years later in 1997, *The Economist* agreed that "Almost any discussion of public policy nowadays seems to begin and end with the same idea: the state is in retreat."[181] And economic historian David Landes added that "[All] sides blithely assume that free markets are in the saddle and riding the world."[182]

But was this assumption valid? Throughout the 1990s, central banks throughout the world were tightening their control of interest rates and currencies and taking on even more responsibility for guiding capital markets and economies. As economic writer James Grant observed,

> Central planning may be discredited in the broader sense, but people still believe in central planning as it is practiced by . . . [The US Federal Reserve]. . . . To my mind the Fed is a cross between the late, unlamented Interstate Commerce Commission and the

> Wizard of Oz. It is a Progressive Era regulatory body that, uniquely among the institutions of that era, still stands with its aura and prestige intact.[183]

Economist William Anderson agreed about the "aura," but was even more sharply critical:

> Central banking, for all its "aura," is no less socialistic than the Soviet Union's Gosplan [the Soviet agency charged with creating Communist Russia's economic plan].[184]

The growing power and prestige of central banking was surprising in other ways as well. Throughout the 1990s, the Fed published its own forecasts of economic growth, usually expressed as a rather broad range. But a study of sixty quarters through year-end 2004 revealed that actual growth had fallen within the range only a quarter of the time.[185] The Fed, like a majority of economists, has never correctly forecast a recession.[186]

Gene Callahan has compared the Fed to a hyperactive pediatrician determined to intervene to ensure that a child under his or her care is growing at the "right rate."[187] In reality, no doctor, and no Fed chairman, can be sure what the "right" rate is, and interventions are little better than stabs in the dark.

Argument 5: The way that central banks operate, in particular the reliance on exceedingly flimsy tools and rules, is not reassuring.

The most famous rule for guiding monetary policy was Milton Friedman's: just pick a money supply growth rate and expand or contract the money supply to meet the target. This was an attempt to take discretionary decision-making away from unreliable central bankers, but proved impractical because the money supply could not be precisely defined, much less tracked, especially in a global economy. Another much cited rule developed by economist John Taylor of Stanford University also utilizes variables (e.g., potential output, inflation rate) that are hard to define or observe, and thus subject to endless debate and disagreement.[188]

These and many other formulas used by Fed and other monetary economists bring to mind a story told by social philosopher Irving Kristol about a friend's mother. The friend, who eventually became a leading novelist, used to bring college friends home to his family's New York City apartment for endless political debates. It was the 1930s, everyone was some stripe of Marxist, and the finer points of Marxist doctrine were argued into the night. The friend's mother, a Jewish immigrant without much formal schooling, hovered wordlessly and provided tray after tray of food and drink. Then:

> Late one night, after they had all left, she turned to her son and said: Your friends—

> what brilliant young people! Smart! Smart!—and then, with a downward and dismissive sweep of her arm—Stupid.[189]

The thought that the world's monetary policy is worked out through discussions and equations vaguely reminiscent of what went on in that 1930s living room is not reassuring. How then do the monetary authorities get away with it, get away with taking so much decision-making away from the market with so little intellectual basis to what they do? One explanation is that easy money policies generally suit whatever party is in power, whether ostensibly of the left or the right, and central bank chairmen want to be reappointed.

Another, equally cynical, explanation has been offered by Milton Friedman:

> [The Federal Reserve] System . . . blames all problems on external influences beyond its control and takes credit for any and all favorable occurrences. It thereby continues to promote the myth that the private economy is unstable, while its behavior continues to document the reality that government is today the major source of economic instability.[190]

Argument 6: The Greenspan Fed represents a case study in how an overactive central bank can create unintended consequences—without people understanding what has actually happened.

On the surface, Fed policies under the chairmanship of Alan Greenspan during the late 1980s, 1990s, and early 2000s seemed to work well: the economy boomed, the years stretched on without a recession, inflation (as measured by the consumer price index) remained largely dormant. But under the surface all was not well. A sharp increase in the US money supply engineered by the Fed led to excessive corporate borrowing, much of which found its way into corporate stock repurchases (companies buying back their own stock), which fueled a stock market bubble, which inflated consumer spending and other bubbles. Greenspan seemed to pour fuel on the speculative fires by bailing out profligately overspending and overborrowing financial institutions and countries, intervening with sometimes dramatically timed interest rate cuts whenever stock prices softened, and preaching that technology had created a "new economic era."

After the 1990s bubble burst, corporations were so saddled with unproductive debt that their borrowing and investing had to be sharply curtailed. This would normally have led to a serious recession. Greenspan responded by cutting Fed interest rates to only 1% (less than the then-current inflation rate) in order to lure consumers into a similar overborrowing binge, and even counseled them in a celebrated speech to abandon the safety of fixed-rate home mortgages in favor of far riskier variable-rate mortgages. After this performance, Loews Corp CEO James Tisch only half-jokingly referred to the chairman of the Federal Reserve as "the Minister of National Speculation."[191]

As consumers responded to almost unprecedently easy money by borrowing and spending more, many of their purchases and much of the money they borrowed came from abroad. This had several negative consequences. In the first place, consumer purchasing power was drained out of the country by a growing trade and current account deficit and thereby created foreign, not US jobs.

In the second place, the money borrowed from abroad was mostly being spent, not placed in productive, long-term investments. Because the US chose to spend rather than invest much of its foreign borrowing, the interest was piling up without creating the wherewithal to pay it back. The US had in effect become addicted to easy Japanese and then Chinese money. When it stopped, as it eventually would, US interest rates would rise, consumer spending would fall, home and stock prices would also fall, as Paul Krugman and other economists predicted.[192] In the end, this could lead to waves of bankruptcy. For the moment, Americans felt secure and rich, just as the

Spanish felt secure and rich after they captured the gold of the Aztecs and Incas. But unless Americans recommitted themselves to the right path of working, saving, and investing, they would become, as the Spaniards became, "new poor."

The US Federal Reserve has charge of American money, directly at home and indirectly abroad. But it also has charge of US financial institutions, directly in the case of banks and indirectly in the case of other lenders. During Greenspan's tenure, the activities and balance sheets of banks changed radically, most dramatically in the issuance and trading of derivative securities such as financial futures and options. In 1990, the national value of all derivatives held by US commercial banks was about $6 trillion; by 2004 this had exploded to almost $80 trillion[193] or almost seven times the value of US annual output. Greenspan, speaking in his role as a bank regulator, testified that this proliferation of highly leveraged and little understood financial instruments was good for the health of the economy. Others wondered whether banks were not getting in over their heads and potentially jeopardizing themselves and the economy.

Looking back at the record of the Greenspan Fed, economist Marc Faber concluded that the concatenation of so many misjudgments and policy errors would eventually lead to demands for the dethronement of central bankers as national economic planners:

> If monetary policies and central-bank interventions in the market economy [continued by Greenspan's successor as chairman of the Fed, Ben Bernanke] should now fail—as I believe they will—the economic textbooks of the post Second World War period . . . will have to be rewritten. I would also expect the power of central banks to be significantly curtailed. . . . When . . . the public . . . finally realizes that central bankers are no wiser than the central planners of former communist regimes, the tide will turn and monetary reform will come to the fore. . . . At that time . . . market forces [will again] drive economic activity, and not some kind of central planner: regardless whether they stand forth as senior officials of totalitarian regimes—or come cleverly disguised as central bankers.[194]

Argument 7: Central banking represents a moral, not just a practical, problem.

Economist John Maynard Keynes spent most of his lifetime mocking the values of ordinary, middle-class people. It is not surprising that his economic theories, the theories that underlie modern central banking, turn the old copybook maxims of morality on their head. In the Keynesian world, technical cleverness matters more than hard work, spending is a virtue, saving is almost an antisocial act. People will be willful, capricious, subject to emotional extremes. But a wise government, staffed by people with the right kind of technical expertise, will guide the masses in the right direction, and will, if necessary, resort to a bit of seduction or mendacity to achieve necessary ends.

In the following passage, Keynes discusses how greedy and befuddled people are, but how they can be gulled through the device of a central bank:

> Unemployment develops, that is to say, because people want the moon [i.e., want their wages to be uneconomically high]. . . . There is no remedy but to persuade the public that green cheese is practically the same thing [as money] and to have a green cheese factory (i.e., a central bank) under public control.[195]

Keynes has now passed from the scene, but his less nimble and witty heirs still run the central banks. The amount of debt that governments, businesses, or consumers take on, they all chorus together, is a purely technical matter. It has nothing to do with morality. Spending and even borrowing in order to spend is good for employment. Leave it to the experts, working stealthily behind closed central bank doors, to ensure that we get neither too much nor too little, but just the right amount. People who criticize all this—who, along with Paul Kasriel, chief economist for the Northern Trust Company, say that central banks are little more than "legal counterfeiters,"[196] that societies must save in order to become wealthy, that heavily indebted consumers are on a treadmill that will keep them poor forever—these people are just out-of-date.

Argument 8: Central banking serves the interests of politicians primarily, rich people secondarily, and the poor not at all.

Does central banking better serve the interests of the rich or the poor? This particular debate, already glimpsed in Part Eight, is a very old one, and can be traced to the beginning of the United States. The conventional wisdom, embodied in most history texts, records that Alexander Hamilton, secretary of the treasury under George Washington, correctly perceived the need for a central bank to guide the infant republic's economy. Unfortunately, President Thomas Jefferson displayed an ignorant antipathy toward banks, especially central banks, and his congressional followers succeeded in shutting down the first Bank of the United States in 1811. A second Bank of the United States was established in 1817, but Jefferson's even more radical heir Andrew Jackson closed it in 1836. Thereafter, the banking system and economy drifted through unnecessary crises until the Federal Reserve Act of 1913.

There are a number of flaws to this oft-told tale. First of all, Hamilton did want a central bank, but he specifically warned against governments or central banks printing paper money, as they do today:

> The emitting of paper money by the authority of Government is wisely prohibited. . . . Though paper emissions, under a general authority, might have some advantage . . . yet they are of a nature so liable to abuse—and it may even be affirmed, so certain of being abused—that the wisdom of the Government will be shown in never trusting itself with the use of so seducing and dangerous an expedient. . . . The stamping of paper is an operation so much easier than the laying of taxes, that a government, in the practice of paper emissions, would rarely fail . . . to indulge itself too far in the employment of that resource. . . . even to [the point of creating] . . . an absolute bubble.[197]

Hamilton did not object to private banks issuing notes that were the equivalent of paper money. That was different, because it could be regulated by market forces. If a private bank overdid it: "It will return upon the bank."[198]

It is a complete mischaracterization of Jefferson and Jackson to say that they opposed banks, business, or modernity itself. What they especially feared, and with much justification, was that central banks would become the tools of politicians and their rich supporters. As Jackson said, "The mischief [in a central bank] springs from the power which the moneyed interest derives from a paper currency which they are able to control."[199]

When the Federal Reserve Act of 1913 came up for congressional consideration, Senator Elihu Root argued that Hamilton's and Jackson's words should be heeded. If a central bank were needed, it should at least be barred from issuing paper money. But most of Root's colleagues thought this precaution needless, since under the original legislation any paper money would be backed by and exchangeable into gold. How surprised they would all be to see that paper money is now backed by nothing at all.

In any case, the Fed did come into being, and the question remains: has it helped the poor? Again, the conventional wisdom would argue that it has, that an expanding money supply helps the economy grow, which helps the poor. This is the point of view of Alan Blinder, a former Fed vice chairman under President Clinton who has always focused on reducing income inequality. He argues that even if an expanding money supply brings with it some inflation, "The harm [which] inflation inflicts on the economy is often exaggerated."[200]

But is this true, especially for the poor? The poor after all are not generally able to borrow the new funds made available by the Fed to banks. When they are able to borrow, they may lack the knowledge to do so wisely, as seen in the sub-prime mortgage debacle. It is businesses, rich people, people with assets and good credit records, Wall Street firms especially, who are best able to tap into these funds and take advantage of lower, Fed-reduced interest rates. Although the poor are generally unable to borrow, they do have to buy, and inflation relentlessly drives up the cost of everything they need.

Domingo Cavallo, the Finance Minister of Argentina in the 1990s, argued that the poor are the most "punished" by inflation, and this has been substantiated by numerous studies. For example, David Dollar and Aart Kraay of the World Bank studied eighty countries and found that reducing inflation was one of the most effective ways of helping the poor.[201] Allowing mild deflation of the sort that naturally occurs in an unhampered free market would help even more, and would have no adverse consequences for those without debts. And of course the destabilization produced by the Fed's attempt to stabilize the economy ultimately costs the poor more dearly than anyone else.

Argument 9: Central banking can and should be replaced.

Defenders of central banking allege that there are no real alternatives to the present system. This is false. Among the better alternatives are either gold or private (free) banking without a central bank. These alternatives made sense to Alexander Hamilton and other financial sages of an earlier age, and we could return to both.

Private (free) banking could also be strengthened by tightening reserve requirements, perhaps even requiring 100% reserves against loans.

In the meantime, simply monetizing gold as an alternative currency and allowing gold-based checking accounts and interest-bearing deposits would represent a step in the right direction.

Part Ten

The Global Profit System

21

Does Global Free Trade* Destroy Jobs?—Yes

Argument 1: Free trade destroys jobs, especially good, high-paying jobs.

Lawrence Summers, former World Bank chief economist, US secretary of the treasury, and president of Harvard University, has summarized the case against free trade as follows:

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* "Free" trade may be defined as the opposite of "protectionism" or "managed" trade. Protectionism or "managed" trade generally consists of: tariffs (taxes on imports); non-tariff barriers (regulations that inhibit imports); quotas (direct limits on imports); restrictive trade rules (e.g., "antidumping" laws that demand minimum prices for imports); or asset purchase restrictions (e.g., forbidding foreign majority ownership of domestic industries).

> Abe Lincoln captured the basic intuition of almost anyone . . . when he said that . . . if he bought a coat from an American, he had a coat and an American had a dollar, and that . . . it seemed to him better to do it . . . [that] way.[202]

Summers went on to say that he disagrees with Lincoln's point of view, as indeed a majority of economists do. But Jerry Flint, a *Forbes* automobile-industry columnist, has his own response to that:

> You can't help noticing that the folks supporting free trade never have their jobs threatened: editorial writers, economists, professors. . . . Imagine colleges replacing those two-classes-a-week professors with brainiacs from India at $50 a class.[203]

Peter Lynch, a legendary American investment fund manager, has also been skeptical about finding jobs in a free-trading global marketplace:

> We keep showing more workers, but they're all making [low wages]. . . . It seems to me that if you give a dollar more to the consumer and he buys a Japanese-produced Toyota with it, you don't help the US economy much. . . .[Other nations are] doing [to the US] what [John D.] Rockefeller [Sr.] did. . . . They dump a product, they drive everybody out. . . . It's totally unfair trade.[204]

Argument 2: Left to itself, unrestrained free world trade produces a "race to the bottom" for labor and environmental standards.

The central flaw of a free market, whether domestic or global, is its underlying ideology of greed. Profit becomes the be-all and end-all of existence; human decency be damned. The result is not just cutthroat competition and rampant product "dumping," but labor, social, and environmental "dumping" as well. In effect, to attract global capital, governments everywhere dismantle safeguards against child labor, unbearable working conditions, inhumane wages, and pollution. As William Greider has written,

> Finance capital . . . is . . . the Robespierre . . . of this [global capitalist] revolution . . . collectively act[ing] . . . like a Committee of Public Safety presiding over the Terror.[205]

Al Sharpton, preacher and 2004 candidate for the Democratic nomination for US president, adds that

> We cannot [allow a] trade policy that overlooks labor, overlooks workers' rights, overlooks environmental concerns. . . . African-Americans are here [in the US because of] . . . bad trade policy.[206]

Some critics of global capitalism hope to tame it, to negotiate global regulations ensuring decent working and environmental standards. But these hopes are naive at best. Historian Arthur Schlesinger, Jr. understands what is really happening, and how helpless nation states are to rein in world markets:

> The computer turns the untrammeled market into a global juggernaut crashing across frontiers, enfeebling national powers of taxation and regulation, undercutting national management of interest rates and exchange rates, widening disparities of wealth both within and between nations, dragging down labor standards, degrading the environment.[207]

Argument 3: Free trade is ultimately about exploitation.

No one should be under any illusion that the billions of dollars of investment poured into the developing world are intended as a charitable act. The money is intended to create an abject dependency, and rarely fails to achieve this end. Richard Gephardt, candidate for the Democratic nomination for US president in 2004, courageously noted the "raw human exploitation for the profit of a few corporations"[208] in global trade. Some headlines in Roman Catholic publications have also captured the real story:

- "Nearly 1 Billion Starve while Markets Boom" (*National Catholic Reporter*)
- "Making Profit the World's Highest Law" (*National Catholic Reporter*)

- "A New Imperialism" (*Commonweal*)
- "Global Village or Global Pillage?" (*Commonweal*)
- "Who Pays the Price for Trade: Farmers, Workers, and the Unemployed" (*Commonweal*)

Activists around the world are committed to fighting the inhuman values of global capitalism and regularly turn out to protest at meetings of the World Bank, the International Monetary Fund, or the World Trade Organization, institutions supposed to facilitate world trade. One such activist, Jaggi Singh, explains that his activism is

> about changing the world, creating structures, frameworks, institutions, communities, neighborhoods that are based on our values, which are values of social justice, mutual aid, solidarity, and direct democracy.[209]

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Does Global Free Trade Destroy Jobs?—No

Argument 4: Free trade produces more and better jobs.

The preservation or protection of jobs is a dead-end policy. As noted previously, if everyone had preserved and protected their jobs from the stone age on, we would all be hunting and gathering. We have escaped that fate by learning to innovate, to specialize, and, in global trade, to pursue our comparative advantage.

The phrase "comparative advantage" is often misunderstood. It does not mean that a country should find something that it can produce more cheaply than other countries and specialize in that. If a country can produce something more cheaply than any other country, that is called an "absolute advantage," not a comparative advantage.

Comparative advantage refers to what a country does best, without regard to whether there is an absolute advantage. The basic idea, sketched by Adam Smith in the eighteenth century, and formulated more precisely a few decades later by David Ricardo, is that a country, like an individual, should concentrate on what it does best, and then trade with other countries to obtain what others do best. Even if (hypothetically) one country has an absolute advantage in everything and another country has an absolute advantage in nothing, the two countries will be well-advised to divide up the tasks and exchange their work.

In his book *Basic Economics*, Thomas Sowell provides a good example of this. He asks us to assume, for purpose of illustration, that the United States makes both shirts and shoes more cheaply than Canada. In other words, the US has an absolute advantage in both articles. Specifically, the US makes shirts more than twice as cheaply and shoes 25% more cheaply. Based on these numbers, one might conclude that the US should continue making shirts and shoes for itself, but this would be incorrect. Since the US is much more cost effective in shirts, relatively speaking, than it is in shoes, it will still pay to concentrate on shirts and leave the shoes to Canada. If the US and Canada team up in this way, the total production of shirts and shoes mathematically increases by about 20% and 11% respectively. Just by specializing and trading, the two countries in this hypothetical example become measurably richer.[210]

Comparative advantage also tells us that when we buy a cheaper foreign import we may be helping to put a fellow countryman out of a job, but we are also helping another fellow countryman, probably more than one fellow countryman, to find a job.

Assume, for example, that we live in a completely closed economy without foreign trade. The ban on foreign trade lifts and many adjustments are necessary. If our domestic steel manufacturers are selling their product at higher than the world price, they will have to reduce prices and probably lay off workers. Many of our other companies, however, are steel users, not steel sellers. The math of comparative advantage suggests that they will gain more from the lower steel prices than the sellers will lose. The converse is also true: if steel prices before opening to world trade are lower than the world price, the steel companies will gain. And they will gain more than domestic steel users will lose, so that employment will also increase in this case.

Assuming that it is the steel users who gain, and the steel workers who lose, there will be a tendency for the public to see only the unemployed steel workers, not the newly employed auto or other workers. Voters may then listen to steel industry blandishments that steel tariffs are needed to save steel jobs without realizing that the net effect of tariffs would be to reduce, not increase, overall employment. The bottom line is that people cannot be in two places at once. By allowing cheaper foreign imports to come in, workers can be placed in more productive, and therefore better paying, jobs.

These principles are well established for the import or export of goods. It is not as widely recognized that they are just as relevant for the "outsourcing" of service jobs over the internet or telephone lines. The savings achieved by importing electronic services has enabled many companies to prosper, where they otherwise might have stagnated or failed, and thus to hire more employees rather than fewer.[211]

As a general rule, if we are going to specialize, and then exchange the fruit of our specialized labor, it helps to broaden the circle of shared labor, not restrict it. The United States is a good example of this. It represents the largest free-trade zone in the world, as measured by the volume of goods and services exchanged. In fact, the volume of trade inside the US may be as large as the total volume of global trade among countries.

Within the US, at the present time, approximately one in twenty jobs disappears each year.[212] This in turn makes it possible for the economy to keep changing and growing. Indeed, the most economically thriving US regions tend to have the greatest job loss, but also the greatest job creation. Job turnover can be hard on employees, especially older ones, but it is essential for job growth, economic growth, and an improving standard of living.

Whatever its critics say, the math of comparative advantage still works. Sharing the work of the world makes everyone richer, even the already rich nations. It is true that, on a purely relative basis, the developing nations should make bigger strides. In effect, all nations should benefit, but the gap between rich and poor should close, because the poor should grow faster. The already rich may then feel poorer, because the income gap has shrunk and there is more competition for the most prized consumer goods and collectibles. But, subjective feelings aside, there is no reason why the already rich should lose wealth, or why comparative advantage will suddenly produce winners and losers rather than mutual winners.

The protection of existing jobs through trade barriers is a formula for impoverishment under any circumstances. But, as Llewellyn Rockwell, the president of the Ludwig von Mises Institute, has noted,

> The tragedy of [government trade restriction and protectionism] is that it tends to creep up when it can do the most damage, that is, during economic downturns.[213]

The one thousand economists who argued against the Smoot-Hawley Tariff Act, which imposed stiff new taxes on goods coming into the United States just as the country was falling into the Great Depression, would presumably agree.

Argument 5: Global markets are not trashing labor and environmental standards.

Economist Jagdish Bhagwati replies to this charge:

- "Lower [labor and environmental] standards may . . . repel, instead of attract [Direct Fixed Investment from abroad].[214]
- "Several empirical studies . . . find that multinationals pay what economists now call a 'wage premium' . . . [of about] 10 percent. . . . Affiliates of US multinationals sometimes pay . . . a premium that ranges from 40 to 100 percent."[215]
- "Demands (for enforcement of more uniform global standards) . . . [often reflect a] desire to raise the costs of production of rivals abroad. . . .[216] Antidumping processes have become the favoured tool of protectionists today. Their extension to eco-dumping (and equally to social-dumping) . . . will lead . . . to . . . more [of] . . . the same."[217]

Argument 6: Global free trade is not at all about exploitation.

Global free markets are not a new form of imperialism launched to oppress and exploit the poor. These ideas, which originated with Marxist–Leninist Communism, should have perished with it.

It is perfectly true that global markets make the life of the rich more prosperous and comfortable. Lord Keynes described the pleasures of the first global economy, the one that was shattered by World War One. It enabled the wealthy and even the not-so-wealthy

> inhabitant of London . . . [to] order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend. He could secure forthwith, if he wished it, cheap and comfortable means of transit to any country or climate without passport or other formality,

> could dispatch his servant into the neighboring office of a bank for such supply of precious metals as might seem convenient, and could then proceed abroad to foreign quarters, without knowledge of their religion, language, or customs, bearing coined wealth upon his person, and would consider himself greatly aggrieved and much surprised at the least interference.[218]

Now by contrast consider what it is to be poor. A poor person may have some assets, even if only a farm animal. But the farm animal cannot be sent halfway around the world to fetch the best price. It must be sold locally at whatever price and on whatever terms are available. If the poor wish to buy something that might make them more productive, they are similarly constrained. The object can only be bought locally, usually at a high price, and this applies to the American slum dweller as well as to the poor and isolated Asian farmer.

If the poor do buy imported goods, the things they need will probably have a higher tariff attached to them than the luxury goods intended for the rich. This is true in almost every country. For example, a study by the Progressive Policy Institute in the US showed that imported goods bought by poor or middle class people (e.g., clothes and shoes) had an average tariff of 10.5% versus an average tariff of only 0.8% on luxury goods.[219] Tariffs are not only a tax, albeit a hidden tax; they are a peculiarly regressive tax.

Proponents of trade-as-exploitation tend to regard foreign aid and multilateral loans as a kind of reparations for the damage done to the poor by greedy global capitalists. Viewed in this light, trade should be restricted and foreign aid vastly increased. But listen to Harvard historian Niall Ferguson:

> The authors of . . . one recent study of 30 sub-Saharan African countries conclude . . . that . . . roughly 80 cents on every dollar borrowed by African countries flowed back [to the West] as capital flight in the same year. A similar story can be told for aid payments, a large proportion of which are simply stolen.[220]

The bottom line is that global free markets are imperfect, because people are imperfect, but they offer the best hope for the poor. Even economist Paul Krugman, a vocal critic of the profit system and especially the people who run it thinks so:

> [Opponents of global trade], whatever their intentions, are doing their best to make the poor even poorer.[221]

To which columnist David Brooks adds,

> Just once, I'd like to see [rock star] Bruce Springsteen stand up at a concert and speak the truth. . . . If you really want to reduce world poverty, you should be cheering on those . . . investors jetting around the world.[222]

Part Eleven

Four Economic Value Systems

23

Competing Economic Value Systems

"Equalitarianism"

When people embrace equalitarianism, the philosophy of living on a complete share-and-share-alike basis, they generally know that the way forward will not be smooth. They will have to overcome many obstacles in attempting to realize their vision. But what counts most to them is the vision itself—of helping others, living unselfishly. These are appealing ideals, appealing even for most opponents of equalitarianism.

Life is complex, however, and in addition to the equalitarian system of values, there are other, competing economic value systems. At the risk of greatly oversimplifying, there are at least three alternatives which we shall call: "fraternalism," "reciprocalism," and "philanthropism." A brief sketch of each follows.

"Fraternalism"

This particular economic value system appears to date from the very beginning of human history, and incorporates a series of powerful ideals.

The first and most commanding ideal is one of community, a community that provides safety and security for each of its members, physical but also economic safety and security. This community, it should be emphasized, does not operate on an equalitarian principle of share and share alike. On the contrary, it divides its wealth in ways which can be extremely unequal, but nevertheless looks out for the poorest, weakest, or least intelligent members of society and maintains some kind of "safety net" for them.

The next ideal is one of order, since a community cannot function in chaos. Order in turn has three further correlates: stability, strong leadership, and authority because order cannot be maintained without them. The last ideal is power because insecurity and powerlessness are seen as twin evils, the former curable only by curing the latter, which in turn requires a disciplined and well-led community. Of course, complete security and power for one community may mean complete insecurity and powerlessness for another, which can lead to trouble, but this gets ahead of our story.

According to the logic of fraternalism, relying on the power principle also means that government, not markets, should have the final say over the production and division of wealth in the community. Markets may flourish, as they generally do under advanced fraternalism, but they should be closely guided and regulated. Fraternalist governments tend not to be doctrinaire about globalized markets and free trade, but rather support or restrict them based on a calculation of how it affects the national interest.

Fraternalism seems to reflect the most basic human wants and needs. Life is hard and dangerous. We need each other. So like all primates, we subordinate our selfish desires for pleasure and status sufficiently to come together, to form families, clans, and larger family analogue communities under the guidance of powerful leaders.

Both the ideals imbedded in fraternalism and the heroic actions that may be inspired by them have become the stuff of legend: ancient Spartans standing at Thermopylae, facing certain death, to defend Greece from Persian invaders; Horatio standing alone on a bridge of ancient Rome defying an entire enemy army; Churchill defying Hitler early in World War

Two; a handful of almost unimaginably brave British airmen saving their nation from Nazi barbarism at the same time; everyday Americans feeding each other and lending a hand to each other during the devastation of the Great Depression; Japanese and Germans scrimping, saving, and working together to rebuild their economies from the ruins of World War Two, and so on throughout history.

As of this writing, fraternalist values are not only the foundation for others. They still largely dominate, in advanced economies including America's, Europe's and Japan's, as well as elsewhere in the world. The Democratic Party in the US is largely fraternalist in orientation, but so is the Republican Party notwithstanding their differences, both real and rhetorical. And so it goes in most countries.

Fraternalist-inspired economic systems of the fifteenth through eighteenth centuries are sometimes referred to by historians as "mercantilist." Contemporary fraternalist systems are also sometimes called "neo-mercantilist," mostly by critics. A more sympathetic term to describe them might be "state-led capitalism."

"Reciprocalism"

As reciprocalists see it, the place to start in building an economic system is not with an ideal of huddling together for safety and security, nor with the related ideals of community, order, stability, directive leadership, authority, and power. Yes, we all need each other; no one can stand alone. But in order to foster the right kind of cooperation, the place to start is with an ideal of independence, of each economic player taking personal responsibility for himself or herself, doing his or her part, standing as far as possible on his or her own feet, not being an unnecessary burden on others, and thereby earning not only self-respect and good will, but also the communal assistance of others. The trouble with the family model writ larger and larger in fraternal social systems is that it feeds the grandiosity of parental leaders, bestows far too much power (with all its temptations) on them, and infantilizes everyone else.

Moreover, we are told, a philosophy of independence, personal responsibility, and reciprocal cooperation makes us happier. As naturalist and philosopher Alexander Skutch has written,

> If we remember that the stranger of whom we ask a direction owes nothing to us, his courteous response will be more appreciated and will lighten our steps if the journey is long. If we never expect anything of anybody, we shall . . . be more grateful for everything that is done for us.[223]

Reciprocalism further teaches that:

- We serve ourselves best by serving others, for example by producing the finest goods we can make and honestly exchanging them for those of others;

- Exchanging is healthier than giving, because neither giving nor taking are healthy if isolated from each other;*
- Competition is healthy if channeled into constructive projects for the betterment of humanity;
- Free economic markets are the right place for competition;
- Free global markets should be fostered and will reduce or someday even extinguish war;
- Pluralism is better than centralized, hierarchical leadership;
- Change should be welcomed, not resisted as socially destabilizing;
- Competing entrepreneurs, operating in free markets, are the essential agents of constructive change, economic growth and progress;
- Knowledge and discovery are critical to successful entrepreneurship;
- People should not be protected from the consequences of their own choices or actions;
- Whenever people are protected from their own errors, mistakes accumulate instead

* This is evidently quite an old idea, since the ancient Indo-European root for the modern English word "giving" seems to have meant either giving or taking or both giving and taking, which suggests that early humans viewed these actions as being so closely related that a single word sufficed for both.

of being liquidated, and economic growth grinds to a halt;

- Trust, honesty, decency, self-discipline, thrift, saving, and patience (what in the nineteenth century was called "character"), will eventually lead us, through the power of compounding, out of poverty and deprivation.

Laissez-faire, the economic and social system in which reciprocalist ideas of "independence first, then cooperation," are most boldly expressed, has been called cold, heartless, soulless, unethical (or alternatively machine-like and thus non-ethical), greedy, exploitative, war-mongering, mean, materialistic, etc. But a fair reading of the larger reciprocalist philosophy is that it is loaded with ideals, just different ideals than are to be found in fraternalism, and that both are due at least a respectful hearing.

"Philanthropism"

Charity is an ancient ideal, one with the explicit authority of the New Testament:

> Then shall [the king of heaven] say unto them on the left hand . . . I was hungry, and you gave me no food. I was thirsty, and you gave me no drink. I was a stranger, and you took me not in. Naked, and you clothed me not. Sick, and in prison, and you visited me

> not. . . . And these shall go away into everlasting punishment.[224]

Although the concept of charity seems ingrained in us, it is not without its critics. Again, the naturalist and philosopher Alexander Skutch:

> In an ideal society, universal friendly cooperation [i.e., the kind of friendly cooperation defined by reciprocalism] would prevail, but material charity would be rare. . . . Almsgiving fosters feelings of inadequacy and dependence, and is as likely to generate envy as gratitude. Nature provides many examples of cooperation among organisms of the same or different species, but few that resemble almsgiving.[225]

When people undertake private acts of charity, we tend to think of this in moral rather than economic terms. But charity inevitably begets and becomes embodied in charitable institutions. Especially in the United States, such institutions (often referred to as the not-for-profit or nonprofit sector) represent a separate and complementary economic system—a system that is distinguishable, on the one hand, from the world of private ownership and, on the other hand, from the world of government. In effect, nonprofits embody an alternative vision, as well as an economic and social system, one that could play an even more meaningful role than it does.

In summary, we have now identified four alternative economic value systems:

Fraternalism. These values reflect our tribal origins and provide a foundation for all economic arrangements. Among the most important fraternalist ideals are: community, safety and security, order, stability, leadership, authority, and power.

Reciprocalism. These values have always been with us, but came to particular prominence as an eighteenth-century protest and reform movement aimed at correcting the alleged defects of fraternalism, especially government predation and corruption. Among the most important reciprocalist ideals are: independence, personal responsibility, reciprocal cooperation, openness to change, and indirectly, a limited role for government in the economy.

Equalitarianism. These values are equally ancient, and also gathered force as a protest and reform movement, this time as a nineteenth-century protest against the reciprocalist acceptance and even promotion of human inequality. The contrary ideal of complete economic equality is compatible with either strong centralized government control or, alternatively, no government role at all.

Philanthropism. These values—of charity, altruism, and service—have been approved, to a greater or lesser extent, by every known human society, and

> are especially recommended by all leading world religions. Yet even they have their critics. Some charge that charity degrades the receiver and creates dependency. Others charge that philanthropists are Pharisees, hypocrites, egoists, even surreptitious power mongers.

In differentiating these value systems, it is important to remember that all of them may claim a specific ideal for its own. But, if so, they will usually define, interpret, or rank it differently. Thus, reciprocalists will insist that they too believe in equality, albeit an equality of opportunity rather than outcome. They may also extol charity, although a strict application of the principle of reciprocity would seem to forbid it. And so it goes, with words being continually redefined and reinterpreted and values being traded off one against another.

The broader issues raised by the four alternative economic value systems are as old as human beings, or indeed as old as higher primates. Long-term studies of chimpanzees, for example by Jane Goodall in the wild or by Frans de Waal in more closely observed captive settings, suggest that any group of primates must make choices between independence and community, stability and change, social power and reciprocal cooperation, and so forth. The choices that individual primates or groups of primates make are quite eclectic, often inconsistent, as well as inconstant.

As human beings, we operate on a higher plane. Our choices often take the form of ideas, even of ideals, as we have emphasized. But, in true primatological fashion, we prefer not to choose among our different ideals; we want to have everything. In the end, we choose between alternatives because we have to, because life will not simultaneously give us both complete independence and a warm feeling of community. Moreover, we may further complicate or confuse matters by deceiving ourselves or others about we want or believe, by failing to live up to what we believe, by forming temporary alliances with others through the expedient of glossing over or ignoring differences in what we want or believe, or simply by changing our mind.

Whatever the twists and turns of the human valuation process, we are always confronted with some fundamental economic questions, questions that cannot be evaded, that must be answered and answered anew in each generation.

So far in this book, we have offered many answers, but none of our own. We will now deviate from this course a little by looking more deeply into what we have called philanthropism, and by suggesting that an expansion of philanthropic values along with the nonprofit economic sector might conceivably help bring together equalitarians, fraternalists, and reciprocalists, heal some of the battle wounds, and foster more of the economic cooperation that almost everyone wants.

Part Twelve

Reconciling Opposing Viewpoints

24

Expanding the Nonprofit Sector

I personally find the ideals of fraternalism, reciprocalism, equalitarianism, and philanthropism to be all, without exception, profoundly moving. How could anyone not think that each of these philosophies makes an important appeal, one that reflects important aspects of human experience?

The reality, however, is that we cannot pursue all of these ideals, at least not at the same time and in the same context. In important respects, they are in conflict. We have to pick and choose.

My own belief is that equalitarianism, as admirable as it is, should only be pursued on a small scale. If it is to be enforced by government, it becomes coercive, loses its way, and becomes non-equalitarian. Even on a small scale, it is difficult to implement. For example, families provide a possible setting for it. But when there are young children, some form of authoritarianism is needed, and it is a very difficult matter of judgment to decide when the authoritarian relationship can be relaxed and then eventually replaced with relations of complete equality.

Community is another powerful ideal that appeals to all of us. But I am wary of the idea that government is a form of community, that it somehow embodies our form of national community. I am more inclined to see government as a vitally important institution, but one institution among others. And I worry that as government gets more deeply involved in leading the economy, the opportunities for financial corruption multiply.

If I were to choose an economic system, it would be founded on bedrock reciprocalist principles, including a principle of sound money. This would require many changes in law, so government would be very much involved. In particular, I would want to reform the banking and financial system to bring an end to its chronic instability, and this would mean changing the way that lending expands and contracts the amount of money in the economy.

The chief charge against reciprocalism is that it does not do enough for the poor, the disadvantaged, and the handicapped, or at least that it only improves their lot over the long term. It is true that most systems do not even offer a gradual improvement for them. But I agree that a pure reciprocalist system can seem or actually be heartless.

My proposed solution relies heavily on philanthropism, on an expansion of charity, but also on a change in the legal basis of charity. This is not the charity of past ages that depended entirely on the willingness of the donor to give without receiving a material reward in return. The philanthropism I have in mind is a new kind, is meant to bring equalitarians, fraternalists, reciprocalists, and traditional philanthropists together to create a vibrant private market in charitable giving. If successful, this new kind of philanthropic system might heal wounds and foster economic cooperation, as well as help the needy and make the world a better place.

This might sound utopian, but please withhold judgment. To see how it might work, let us begin with contemporary equalitarians. As noted previously, they are of two minds about how best to end economic inequality, some favoring persuasion, others favoring draconian government programs to reallocate wealth. But, despite this difference, most agree that "progressive" taxation, that is, subjecting the wealthy not only to higher taxes, but to higher tax rates on income and estates, is the only decent way for government to raise its revenue.

Fraternalists do not embrace the idea of equality per se. But they do embrace "progressive" taxation for reasons of their own. In the first place, extremes of wealth are thought to undermine a sense of community, an all-important value for fraternalists. In the second place, a real community should have a social "safety net" for the poorest and most disadvantaged, and heavier taxation if the rich can help fund this. In the third place, fraternalist politicians know that they need equalitarian voters to reach a majority, and that appeals for heavier taxation will help bring in these voters. The fraternalist/equalitarian electoral alliance has been successful all over the world, and very few democracies have not embraced the basic goal of reallocating wealth to at least some degree through the tax system.

Reciprocalists remain the lone dissenters from all this. "Progressive" taxation, they say, merely swells the size of government without actually reallocating wealth to the less advantaged. Most of the extra money raised from the rich does not reach the poor—indeed in a majority of developed democracies, including the US, government subsidies for the well-off considerably exceed subsidies for the poor. Moreover, heavy taxation of the rich dissipates society's savings, actual or potential, which reduces economic growth, and harms the poor most of all. All things considered, reciprocalists believe that a "flat" tax is best, even if social "safety nets" have to be reduced as a result.

We need not revisit these quarrels, except to note that "progressive" and "flat" taxes, as conventionally conceived, do not exhaust all the possibilities. Another alternative is to keep "progressive" taxes, but to use them, not to expand government, but rather to expand the nonprofit sector of the economy.

At the present time the nonprofit sector represents about 8–12% of the US economy, and considerably less elsewhere.[226] The question we will now address is whether this sector could play a larger role in the US and elsewhere, especially in social services for the poor and disadvantaged, but also in healthcare, education, and other critical areas.

One obvious way to expand the nonprofit sector is to increase government funding. It is estimated that the one hundred largest US charities already receive over 20% of their income from the government.[227] With the model of government funding already well established, these numbers could rise dramatically. As political columnist Joe Klein has said about Andrew Cuomo, the secretary of housing under President Clinton:

> Andrew Cuomo is a guy with [a] . . . brilliant . . . idea: Government cannot provide social services. The best thing for government to do is to provide a check to the altruistic people who should provide services and who have the flexibility to change their programs on a dime.[228]

This notion also has its critics, however. They cite one or more of the following objections:

- If government funding increases, charities will lose both their independence and their flexibility.

- Government funding blows with the political winds, and will never be a reliable source of support.
- Present quarrels over whether government should fund religious charities (Republicans for, Democrats against) will only intensify.
- Government subsidies always fail because they increase the demand for services without increasing the supply. The result is inflation, with soaring prices outrunning subsidies by a mile. This has already happened in medicine, housing, and education, with dire results for the poor especially. Why add anything else to this list?
- Charity should always represent an act of personal compassion. Redistribution of income and assets through progressive taxation represents a different act and the two should not be confused. No one fulfills a personal charitable obligation by paying taxes, no matter how heavily, and certainly no one fulfills that obligation by voting in favor of others paying higher taxes.

Direct government funding of charities is not, however, the only way that government could foster the growth of the charitable sector. Another way would be to revise the tax code. At the present time, donors to Internal Revenue Service–approved charities may deduct their gift. If I am in a 39% tax bracket, and deduct my gift from taxable income, that means the government in effect bears 39% of the cost of my gift. The gift still represents a personal sacrifice, because I bear 61% of the cost, but government is making it easier to give. Taking all aspects of the tax code into account, many wealthy people pay 50% or more in taxes and thus benefit from a comparable charitable deduction.

An alternative idea would be to convert a deduction (on taxable income) into a credit (on tax owed). This would leave the taxpayer with a simple choice: would I prefer my money to go to the government or to charity, since a credit would mean that the government is bearing the full cost.

Clearly, government could not afford to offer this choice unrestrictedly, since it could lead to a collapse of tax revenue. But, to begin with, the tax code could be revised to provide a credit for social service donations only, or for donations made from what would otherwise be taxes paid in the top tax brackets, or for donations made from what otherwise would have been estate taxes.

Providing a credit for social service donations would increase the flow of money to the poor and needy. These funds could further supplement government support or gradually replace government support with the more "entrepreneurial," "flexible," and "cost-effective" private programs that Joe Klein and Andrew Cuomo want. Moreover, if it wished, the government could see how much money was being raised this way and adjust its own programs accordingly: more if donations are down, less if donations are up.

It will be objected that services would be less uniform this way. But social services already vary greatly in the US, because they are primarily administered by the individual states. Management by private charities could be more creative and responsive to the particular needs and character of the individual poor or needy person. If additional oversight and monitoring were desired, "credit-worthy" social services donations might have to go to grant-making foundations which would then pay it out to on-the-ground operating charities.

The idea of a social services tax credit is not new. Senator Dan Coats of Indiana proposed in 1996 a "poverty tax credit" of $500 for individuals and $1,000 for couples filing jointly, provided that the donation was made to organizations primarily working to help the poor and the disadvantaged.[229] Leading Republican pollster Frank Luntz thought that Coats was, as the *Washington Post* put it, "onto something big," a way to reframe and redirect the increasingly sterile debate about government social services.[230] The proposal sank without a trace. But some proponents thought that it failed by being too modest, too tentative in what it tried to accomplish.

A bolder proposal might look like this. Everyone in the US would pay a simple income tax, with only a few permitted deductions (including ordinary charitable deductions), to support the operations of the government. The threshold income required to trigger the tax would be set high, so the poor would not pay income tax at all. Above the initial tax bracket used to fund the government, there would be one or at most two brackets more for the rich, however defined. The rich could either pay these additional taxes to the government or receive a full tax credit by donating the same amount to registered social service charities (or grant-making foundations required to pass the funds on to social services charities).

If this approach were adopted, the tax code would be vastly simplified; the system would still be "progressive" because the rich would still have to pay more; the government would set upper rates based on society's needs, not its own; and more support would reach the poor.

The last point is worth emphasizing. If one assumes that the larger purpose of progressive taxation is to redistribute income, to move income from the rich to the poor, this would be a more efficient way to accomplish that aim. It would be more efficient because, as previously noted, very little of upper-bracket tax money is actually flowing through to the needy. The greater portion by far is simply used by government for its ordinary expenses, including major subsidies for the rich and middle class.

There are other advantages to a system of charitable tax credits. One of the chief criticisms of progressive tax rates is that they curtail savings, especially the savings of new business owners.

Established rich people and businesses already have savings to draw upon for investment. A rising entrepreneur may obtain income, but find that it takes years to save and accumulate capital from income, because so much is taken in taxes. This is a kind of hidden "subsidy" of the rich, one which to some degree protects their firms and investments from "new men and women" and "new business ideas." It also reduces the rate of overall capital formation and therefore of economic growth.

A way to address this issue would be to let entrepreneurs escape upper-bracket taxation if they saved and reinvested the savings, but with the investment gains required to be paid to charities. In effect, the entrepreneurs would have the use of the funds when they needed them for business purposes, but would gradually become partners with their own or others' charities. The likely mechanism would be for the entrepreneur to donate to a charity, but be able to stipulate that the gift will be reinvested (or simply remain in) the business in exchange for ownership.

Estate taxes, payable after a person's death, are a special case. The arguments in favor of them are that:

- The government needs the revenue;
- Large pools of private wealth should be discouraged;
- Unearned income is socially undesirable;
- Society has a right to redistribute the money to those in greater need;

- No one is harmed, because it is a tax on the dead, and the dead cannot be harmed.

The arguments against are that:

- The money has already been taxed in one way or another (including at the company level), often several times;
- The desire to leave money to one's children is instinctual and the right to do so is a powerful motivation to work, save, and build wealth;
- The money is already working hard meeting society's needs if it is invested;
- Taxing it means that a lifetime's savings, carefully nurtured by experienced investors, disappears overnight into the maw of government spending;
- Government's tendency to prey on and recklessly consume investment capital over the millennia is precisely what has kept the human race so poor.

These arguments will never be resolved, but they might be reconciled to a degree through an estate-tax credit for charity. If an entrepreneur were able to leave money to his or her own family charity, with assurance that family control would be maintained, the motivation to build fortunes would not be much compromised. If the capital could be donated and preserved as an endowment, the capital accumulation of a lifetime would be maintained, not dissipated, and the family would have good reason to want to keep tending and growing it from generation to generation.

But is it wise to use tax credits to build up the charitable sector in the US and elsewhere? Columnist Ted Rall thinks that charitable givers are just "so many suckers [who] let . . . lazy, incompetent and corrupt politicians off the hook" from their responsibilities to care for the disadvantaged with tax revenues. Rall continues: "We live in the United States, not Mali. . . . [Must] the sick, poor and unlucky . . . live and die at the whim of . . . charit[able] contributors[?]"[231]

There are many other possible objections as well. When charitable institutions grow and grow, they may become worlds unto themselves, rich but still money hungry, fat, self-satisfied, too quick to add or overpay staff, reward friends, build buildings. If a business corporation falls prey to these ills, the board of directors is supposed to demand change. If not, shareholders can replace both board and management, although the process may be expensive, difficult, or time-consuming. Charitable organizations have neither profit and loss statements nor shareholders, so accountability is difficult to achieve.

For some, the answer lies in more government regulation. At the present time, there is a great deal of US regulation of charities, but little enforcement, because neither the Internal Revenue Service nor the states' attorneys general have much staff for the purpose. If tax credits diverted billions of new dollars to charities, no doubt both the amount of regulation and of regulatory staff would multiply, but this could be a very mixed blessing. It could make charities much more bureaucratic, much less flexible. It could make them look more and more like government itself.

There are many other possible objections to more government regulation of charities. In particular, it may be argued that much of the regulation already in place is seriously misguided. For example, at present self-dealing and other rules make it impossible for an entrepreneur to donate nonmarketable shares in his or her own business to a charity. This is not wise, because more charitable ownership of business would be good for both charity and business. Perhaps even more seriously, charity law has increasingly assumed that "family" control of foundations and charities is undesirable. Numerous additional proposals, not yet enacted into law, would have virtually banned family control.

In reality, "private" control of charitable organizations has major benefits. As in businesses, it both motivates and provides skilled, focused, innovative managers, individuals who will search out pockets of opportunity overlooked by others or squeeze every bit of value out of a dollar. The alternative of so-called public (i.e., not individual or family) control is not a bad one; it may be the only alternative after the passing of a founder. But one must guard against "public" control becoming bureaucratic control, or control by a group of unproductive insiders, and new forms of accountability must be found. In particular, members of the general public might be given legal standing to challenge a charity that does not seem to be operating according to the rules.

In any case, whatever the current regulatory errors, whatever the risks, whatever the caveats, an expansion of philanthropic values (along with an expansion of the nonprofit sector of the economy through tax credits) could offer a way forward out of the old, bitter, and often sterile economic quarrels of the past.

Appendices

Appendix A

What Is a "Fair" Price?

THE "COST" THEORY OF VALUE was originally formulated by laissez-faire proponents Adam Smith and David Ricardo. In essence, it holds that products are worth what they cost to produce. Karl Marx pointed out that, in this case, it is difficult to justify adding a profit margin.

The Marxist "labor theory of value" holds that the only true costs are labor costs, and that workers, not owners, should receive any "surplus value" created by selling a product for more than it cost in wages. In making this argument, Marx was not blind to the role of factories and machine tools (i.e., capital) in making products. But he considered capital to be simply embodied labor, previous labor that was now wrongfully controlled by capitalists.

Most economists eventually concluded that Smith and Ricardo were wrong to think that a product has an objective value, and also wrong to think that this objective value would be a function of cost. Economic value is subjective, not objective; it is in the eye of the buyer. A desk may cost $75 to make, but if no one wants it, it has a value of zero. Conversely, if many people want it, it may be worth much more than $75. It is precisely because I value the desk at $100, and you (who own the desk) value it at less than $100 that a mutually advantageous trade develops. If the desk had an objective value, and everyone agreed about it, there might never be a trade.

There are other inconsistencies specific to Marx. If capital is previous labor, why should current workers get all the profit from it? Why not the previous workers themselves (although they may be dead or, if not, impossible to locate)? Also, if people should be paid "according to their needs," as Marx says in passages unrelated to the labor theory,[232] why should workers profit even from their own work? And Marx never did explain how to divide the profits among the workers, if they did receive them.[233]

Even if we accept the proposition that economic values are subjective, and therefore have no theoretical connection to cost, many of us will still feel that prices should not be too much higher than production cost. For example, according to this line of thought, a price that is twice as high as production cost would definitely be an “unfair” price and therefore represent price “gouging.”

Free-market proponents respond that, when demand is strong, very high prices are helpful, because they will persuade producers to step up production and also attract new competitors into the industry. Additional production will then bring prices back down and, even better, may reduce unit production costs. If this analysis is correct, most prices over long periods of time should not exceed costs by a large amount. Of course, the idea that markets are reliably self-correcting in this way is much disputed.

Appendix B

What Exactly Are Profits?

DEFINING WHAT PROFITS are, and estimating their size in a market economy, is no simple task. We might start with the problem represented by capital gains.

We often become aware of a person's wealth when he or she sells a company, sells shares in a company by taking it "public," or otherwise sells property. Assuming that the asset is sold for more than the purchase price, the rich person realizes a capital gain, sometimes a dramatic capital gain, and it is natural to think of capital gains as the larger part of rich peoples' income and the most important way that they realize profits. This assumption, however, is incorrect, as explained by economists Jay and David Levy:

> Capital gains are not profits. . . . When one investor sells property to another investor . . . [,] they merely exchange property. One gives the other money and gets a work of art, securities, or other assets. The net holdings of the "investor class" are unchanged![234]

This requires some reflection. If capital gains are not profits, they are still linked to profits. We often realize a capital gain by selling our right to a future stream of profits, as for example when we sell a stock. Also we may increase our capital gain if we sell at a time when the economy is booming and profits are generally high. But the Levys are right to caution us. It is commonplace to say that a company chief executive officer "made" $15 million in a given year. On closer inspection, it becomes apparent that most of the money came from the sale of stock or options that had been held for much longer than the year in question and that represented the net present value of a stream of profits expected to continue far into the future.

There is also legitimate debate about whether the interest from loans or bonds that rich people receive should be counted as profits. This is another complicated issue that may depend in part on the type of bonds we are talking about. For example low-quality corporate bonds issued by companies as an equity substitute are different than high-quality bonds. On balance, it seems simpler and defensible to include all business interest payments as well as stock dividends when trying to calculate what investors actually receive in profits.

It is common for economic textbooks to discuss profits in general by focusing on "corporate" profits. The first point to be noted about "corporate" profits is that they refer only to so-called "C" corporations, which are subject to the corporate income tax, and not to sole proprietorships, partnerships, "S" corporations, limited liability companies, and business trusts, all of which are subject to personal rather than corporate taxes. Owners of these "non-C-corporate" businesses have a great deal of flexibility about whether they pay themselves a salary and, if so, whether it is a "market" level salary. Consequently, their business income may or may not represent true profit, which should be net of the fair value of their labor.

When looking strictly at "C corporation" profits, one should also ask whether the figures are net of losses, net of taxes, and adjusted for inflation. Corporate profits were negative at the bottom of the Great Depression, then reached a high of 15% of gross domestic product coming out of World War Two; but that was pre-tax, and corporate taxes were over 50% at the time, so the tax adjusted figure was closer to 7%.

Appendix C

What Makes Prices Unstable?

In chapter 18, we asked whether stable, falling, or rising prices are best. We also discussed how "printing" new money and injecting it into the economy can raise prices. In this appendix, we will take a closer look at all the factors that might make prices go up and down and why price stability, whether desirable or not, is so difficult to achieve.

To explore all the factors contributing to price changes, we will begin with a very simple example. Assume once again that an economy consists of only two people, one of whom (person A) owns four apples and the other (person B) one dollar. Assume also that Person A, the owner of the apples, sells to Person B, the owner of the money, two apples for 25¢ each or 50¢ in total. That way, both parties would end up with equal shares of apples and money.

Now assume that demand changes. Person B decides that he or she prefers apples to cash, and offers to buy one of Person A's remaining apples. Unless Person A suddenly prefers cash, Person B will probably have to offer more than 25¢ to induce Person A to give up the third apple.

There are of course other ways that the price of an apple might rise. If one of the apples is eaten, we now have three apples and one dollar. In that case, each apple might be worth a bit more than 33¢ rather than 25¢. Or the two people could find an additional dollar. Then the price of each of the remaining three apples might rise to just under 67¢.

As the preceding illustrates, any combination of rising demand, more money, or falling supply may individually or together raise prices. We must, however, keep in mind what turns out to be an important proviso, namely, that it is not the total supply of cash which matters, but the portion of cash people can and will use. If Person A and Person B are shipwrecked on a deserted island, cash they have back at home does not count.

We should also be wary of attempts to describe price formation in highly mathematical terms. Relative prices in the end always reflect people's choices, preferences, or fears, all of which help shape demand, and these are inherently changing and unpredictable. Just knowing the number of apples, the amount of money available, or other mathematical relationships will not in itself suffice to tell us for sure what will happen to prices. Economists are not wrong to discuss these matters on an "all else being unchanged" or "all else being equal" basis. There are occasions when people's preferences shift radically, especially when they begin to worry about rapidly rising or falling prices, and then "all else is not equal."

We will now proceed to test prevailing ideas about inflation against our parable of the apple, and we will find many of them deficient. One popular idea is that prices rise because business owners are "greedy." A variant of this idea is the *oligopolistic* theory of inflation: "greedy" business owners band together into cartels so that we have to accept their inflated prices. Alternatively, business owners may blame "greedy" unions for demanding excessively high wages. Both business owners and unions may in turn blame "greedy" oil producers for cartelizing and raising global oil prices.

The parable of the apple should, however, remind us that greed alone cannot raise prices. Prices only rise if demand increases because of a change in consumer preferences, supply shrinks, or the supply of money used in transactions increases, and greed per se cannot affect any of these things.

Assuming that available money remains the same, price increases devised by "greedy" business owners, unions, or global oil producers will lead to falling sales.

The falling sales will lead to lower profits and employment, and lower profits and employment to lower prices and wages again. It is only when government "accommodates" rising prices by "printing" and circulating more money that the higher prices can "stick" and result in inflation.

Another common and closely related idea about inflation is that it is caused by economic *overheating*, that is, by a too rapid increase in economic growth. In particular, it is assumed that such growth will lead either to production bottlenecks (in which producers' goods become scarce and expensive) or to escalating labor wage demands.

There is something wrong with this logic. Economic growth as a whole does not decrease society's supply of goods. On the contrary, it increases the supply of goods. And we know that an increase in the supply of goods should reduce rather than increase prices. Here again, the answer to our conundrum lies in the supply of money. If the supply of money remains constant, bottlenecks and wage demands may raise some prices, and these price increases may in turn slow the overall rate of growth. But nothing should show up in the general price level. It is only if additional dollars are "printed" and circulated, in an amount exceeding the increase in production, that general inflation should arise. When economists say, as they often do, that "growth must be curtailed lest it lead to inflation," they really mean: "growth will lead to inflation if more money is printed, that is, in the jargon of the trade, if current monetary policy remains expansive."

Yet another explanation of inflation is offered by critics of government intervention in the economy. As these critics see it, government intervenes in certain industries, notably health care, education, and housing, to ensure that everyone has access to these critical products and services. The initial method of intervention is to provide financial subsidies. Because these subsidies tend to increase demand without increasing supply, prices rise, so that access is actually restricted rather than improved.

These problems then lead to government controls. But controls typically shrink supply even more, in addition to causing inefficiencies. Also, as free markets are hobbled, innovation is thwarted, which inflates prices further, all of which leads to more demands for government to "fix it." As prices in the quasi-public sectors of the economy grow and grow, these sectors represent more and more of the economy, so that it is increasingly difficult for the efficient private sector, with its steady price decreases, to bring down the overall consumer price index.

Expressed in terms of a three factor model of inflation (demand, supply, and money), the case is rather simple. Demand for something like health care is potentially infinite. Supply, however, is limited. Markets would normally sort this out by identifying a price that held back demand sufficiently to match supply.

Government intervention is intended to help those who cannot pay the market price, but changes neither infinite demand nor limited supply. It simply introduces more money into the equation and thus raises prices. If government paid for its subsidy by raising taxes, demand would be reduced elsewhere in the economy, so that overall prices should not rise. If the subsidy is instead covered by "printing" more dollars, overall prices would be expected to rise.

Based on the above, it is easy to see why economist Milton Friedman famously said that, "Inflation is always and everywhere a monetary phenomenon."[235]

And added that:

> "Just as an excessive increase in the quantity of money is the one and only important cause of inflation, so a reduction in the rate of monetary growth is the one and only cure for inflation."[236]

These are exaggerations. As we know from the parable of the apple, inflation may come from any of three sources: demand, supply, or government engineered money supply changes. But, very often, money does lie at the root of the problem.

If excessive monetary growth, that is, government "printing" and circulating too many dollars, is the principal cause of inflation, it might then follow that inflation is relatively easy to manage. "Print" more dollars, and it will go up. "Print" fewer, and it will go down.

Friedman, at least, seemed to think so. But it is not so simple, for a number of reasons.

In the first place, the money supply cannot be reliably measured. It could not be measured in years past, and it is inconceivable that it can be measured today when so many new financial instruments have been devised. If I can borrow at any time against the equity of my home, does that make home equity money? And what about futures and other derivatives capable of transforming a long-term bond into cash and back again in the flash of an eye?

In the second place, inflation itself cannot be reliably measured. The accuracy of the government's consumer price index is much disputed. Even if we agree with how it is constructed, it is just one number: it does not attempt to capture the complex interrelationship of prices, which is arguably more important for the economy than the overall level. In addition, are we sure that it is right to focus solely on consumer prices? When government "prints" new money, does not a portion of it "leak" into home prices, stocks, bond, other assets, "credit spreads,"* and such? Should our concept of inflation be more comprehensive?

We must also keep in mind that a change in the quantity of money, as important as it may be, is really less important than people's expectations about where

* The difference between interest rates: short-term versus long-term, low quality versus high quality, etc.

the quantity of money is headed. In an extreme case, if people think that the government is going to run its currency "printing press" faster and faster, they will try to convert their cash into tangible assets or goods, thereby changing the demand mix of the economy and ensuring that tangible asset and goods prices will rise even faster than the quantity of money. In this sense, the quality of money, or at least perceptions about quality, count for as much or more than quantity, which is why inflation rates during the German Great Inflation of the 1920s ultimately outstripped the actual rate of currency printed, even with the printing presses going full throttle.

As a general rule, governments try to keep their inflationary intentions as cloaked as possible. They do not take the direct route of "printing" additional currency and distributing it directly to citizens (deciding who gets how much would be interesting). Nor do they "print" and then spend the new cash for public purposes, with full public disclosure of what they are doing. In fact, they do not run printing presses at all, except to supply relatively small amounts of cash to banks, which is why we have used quotation marks when we wrote about "printing" money.

As alluded to previously, the usual method of increasing the money supply is to issue bonds, collect existing money from investors in exchange for the bonds, then have the country's central bank buy back some of the bonds from banks using fictitious central bank "checks." Logically, one would think that these two steps, the selling and buying of bonds, would cancel each other out, and it would be as if the government had simply written itself a check. But for complicated reasons (see appendix D on "Austrians" and appendix G on the Federal Reserve Board), the process actually injects much more cash into the economy than the bonds are worth.

Such a circuitous, virtually opaque way of creating new money is indeed confusing. But even with this smokescreen, business owners, workers, and investors do get some sense of what government is doing, do form their own conclusions about the likely direction of prices. And it is their conclusions, along with their actions, that ultimately determine the future of prices, even more than the government's actions in expanding or contracting the money supply.

Because of these and other complexities, Friedman's "quantity theory of money" does not turn out to be a reliable tool for forecasting or controlling inflation. One cannot calculate what government is doing and then derive what inflation will be. Yet, having said this, there is a close link between the amount of new money injected into the economy by government and the amount of subsequent inflation. During the second half of the twentieth century, US consumer prices quintupled. This simply could not have happened if the government had not fueled the inflation with a great deal of new money.

Appendix D

The "Austrian" Theory of Economic Instability

According to "Austrian" economists, and contrary to Keynesians, monetarists, and supply-siders, the economy does not need ever larger quantities of money. The truth is that the boom/bust cycle which has bedeviled capitalism for centuries cannot be solved by "printing" and circulating more money, for the simple reason that monetary expansion is the cause of the cycle in the first place. This is even true if the new money does not lead immediately to inflation.

This argument, which is often referred to as the Austrian or Misesian theory of the business cycle in honor of its principal progenitor, the Austrian economist Ludwig von Mises, has many facets. We will present it step by step through a series of assertions, beginning with:

Assertion A: Free markets are especially vulnerable to a boom/bust cycle because of the unfortunate way in which the banking system is organized.

To see why this might be so, we need to step back for a moment and consider the rather curious way in which banks operate. A bank takes in deposits, promises to repay the money at any time requested (although in the case of time deposits early payment is penalized), and then lends the money out. Since bank loans are typically repayable at a fixed date or dates, it will be obvious that the promise to repay depositors on demand is only possible because depositors do not usually want all their money back at the same time.

If depositors do want all their money at the same time, it is probably because they have lost confidence in the bank. In that case, there is said to be a *run* on the bank, and the business may fail. In some sense, therefore, all banks are technically "insolvent" all the time, because they never keep enough money in their vaults to meet their promise to repay depositors on demand.

Building free markets on a foundation of banks that are in some sense "insolvent" all the time is clearly a chancy undertaking. If people lose confidence in a specific bank and start a run, the bank will call in all the loans it can. That will cause borrowers to try to withdraw deposits from other banks, and both the sudden need for cash and the panic that usually accompanies it can easily lead to runs on many banks and a complete interruption of normal business activity.

This problem was recognized as soon as gold depositories began to evolve into modern lending institutions. The question was what, if anything, to do about it. At least in early nineteenth century Britain, at that time the banking capital of the world, informed opinion fell into three broad camps. In order to follow the debate between the three camps, we need to know that British banks made their loans in one of two ways. Very commonly, they printed their own bank notes, gave them to the borrower, and these then circulated from hand to hand as money. Alternatively, they set up a checking account for the borrower, who then wrote checks against the account.

One group of informed observers, known as the "currency school," thought that it was too risky to allow banks to issue their own bank notes unless every note was backed by a corresponding amount of money (gold) in the vault. If this principle were abandoned, what would keep banks from flooding the country with notes? Another group of observers, loosely allied with the currency school, went further and held that banks should be required at all times to maintain reserves worth 100% of all deposits, so that depositors would always be assured of getting their funds back on demand as promised.

According to this line of thought, maintaining *fractional reserves* (that is, less than 100% reserves to back up a promise to pay on demand) was inherently fraudulent, and should therefore be illegal. Restricting the issuance of bank notes would solve part of the problem, but only part of it, since banks could still expand their loans beyond reserves through the checking account mechanism. A third group, known as the "banking school," thought that banks should be allowed to do as they pleased, since the fear of a run should provide sufficient discipline.

An effort to require banks to maintain 100% reserves against all deposits failed in British courts in 1811 and 1816. The House of Lords also confirmed the right to maintain fractional reserves in 1848.[237] In some respects, these decisions were anomalous, since grain depositories were always required to keep all deposits on hand, and were not allowed to enter the grain lending business. Sir Robert Peal's Bank Act of 1844 did end most private banks' issuance of notes, but loans through checking accounts were not similarly restricted, and the modern pattern of banking was set.

If the courts had decided otherwise, modern banks would operate on entirely different lines. They might lend their owners' capital, act as agents for others' capital, or offer absolutely fixed time deposits (so that the depositor's repayment date could be matched with a borrower's repayment date). However banks operated, they would not promise to repay on demand money that they did not have or expect to have, and could not therefore be described as in some sense perpetually "insolvent."

The technical "insolvency" of banks mattered enormously in the Great Depression of the 1930s, when bank runs proliferated, and the entire banking system was temporarily shut down by the Roosevelt administration. It is usually argued that government deposit insurance (in which the Federal Government guarantees repayment of deposits up to a specified amount) has solved the problem of runs. But the Federal guarantee is itself not quite what it appears.

In the event of a cataclysm the government could only make bank deposits good by "printing" vast sums of new money, which would then debase the value of existing money, and thus debase the value (as expressed in purchasing power) of the deposits. Furthermore, even if the threat of runs has receded, which is far from certain, the existence of fractional reserve banking introduces another element of potential instability into a free market economic system. To see why this is so, we need to delve more deeply into the methods through which new money is "printed" and injected into an economy.

When people commonly speak of the government "printing" new money or "expanding the money supply," they usually think of this as a government operation, however mysterious it may be. But a fractional reserve bank can also "print" new money and thus expand the money supply. In the early nineteenth century, when banks made loans by issuing bank notes, this was more apparent, because the bank notes went hand to hand and were directly substituted for gold coin. But bank checks today function very much like the bank notes of old, and banks lending far beyond their reserves through check-book accounts are also creating what functions as new money.

To illustrate how this works, let us assume that depositors put $1,000 into a bank. The bank keeps $100 as a reserve and loans out $900. Because the depositors still have $1,000, and the borrowers now have $900, the amount of money in the economy has increased from $1,000 to $1,900. Nor does the story end there. The borrowers may use the new money to pay other people who then deposit it in their banks. The original $1,000 deposit may thus move from bank to bank and, assuming a 10% reserve requirement, keep ballooning until it has increased to $10,000. Note, however, that this is not the Gospel parable of the fishes and loaves. As the money increases, so do people's debts, so no new wealth is created.

In effect, then, the government can print new money on its printing presses. Or banks can increase the money supply by deciding to loan more, at least until they reach whatever reserve limit the government has imposed on them. Or, most importantly, government indirectly "prints" money by inducing banks to lend more, which is done in a variety of ways.

For example, an easy way to do this is for the government's central bank (e.g., the United States Federal

Reserve Bank) to reduce the loan reserve imposed on commercial banks. If the reserve requirement is reduced from 10% to 5%, a bank can lend twenty times its reserves instead of ten times, or twice as much. This is not the preferred method, however. The preferred method is for the central bank to engage *in open market operations*, which means the central bank will write one of its own checks to repurchase government bonds. Since central bank checks are in reality drawn against nothing, this is the functional equivalent of the government actually printing new money, new money which will then be multiplied by the banks. Contrariwise, if the central bank decides to reduce the money supply, it can simply reverse course by selling rather than buying government bonds, and the process will operate in reverse.*

Open market operations are not only reversible. They also possess the considerable advantage (in the eyes of public officials) of being more discrete, less noticeable, than running currency printing presses. The money enters the economy almost invisibly, and goes to whichever sectors are willing to borrow. Best of all, even small amounts of central bank intervention may accomplish what is desired, because the central bank's phantom checks will expand themselves through the *money multiplier*† of the commercial

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* See Appendix G for a more complete description.

† Not to be confused with the so-called Keynesian multiplier which relates to government spending.

banks' lending operations. Quite appropriately, central bank bond purchases and sales are referred to in financial circles as *high-powered money*.

Governments and central banks do not, however, always have their way. In the first place, the two must agree, and central banks may be sufficiently independent of other government officials to go their own way, at least for a time or to a degree. In the second place, and importantly, commercial banks may have minds of their own.

Assume, for example, that the government wants to expand the money supply and that the government central bank, in complete agreement, begins to buy government bonds from banks with phantom checks. This will only succeed if the banks which receive the new cash are willing to lend it. If banks are fearful at the moment when the central bank wants to expand, or ebullient when the central bank wants to contract, the government's hopes may be at least partially thwarted.

The upshot of all this is that fractional reserve banking introduces more than a risk of bank runs and failures. It also introduces a money supply that may fluctuate sharply, with or without government intervention and manipulation, depending on banks' willingness to lend. None of this could be characterized as a recipe for economic stability.

The idea that fractional reserve banking is inherently destabilizing leads us to further assertions of the Austrian or Misesian business cycle theory:

Assertion B: The continual pouring of new money into the economy and draining of old money out of the economy (mostly the former) by governments and government influenced banks takes an unstable situation and makes it far worse. It does this by misleading and deranging the price system.

The principle job of prices is to convey reliable information to business owners and consumers, information needed to reconcile supply and demand in the most efficient way. Because new money engineered by the government pours into the economy in completely unpredictable ways, entering first into this sector, then into that, the price system is increasingly distorted. As Richard Ebeling has written, "Monetary increases have their peculiar effects precisely because they do not affect all prices simultaneously and proportionally."[238]

If the money flows first into housing, it will seem that demand for housing has increased, but this will be a false signal. If it flows into additional computer sales, business owners may increase computer production capacity in the mistaken belief that consumers' preferences really have shifted toward computers. John Stuart Mill explained all this in the nineteenth century:

> An increase of production . . . takes place during the progress of [money expansion], as long as the existence of [money expansion] is not suspected. . . . But when the delusion vanishes

> and the truth is disclosed, those whose commodities are relatively in excess must diminish their production or be ruined: and if during the high prices they have built mills and erected machinery, they will be likely to repent at leisure.[239]

It is not infrequently stated by economists that monetary expansion leads to price inflation which then leads to an overheated economy, that is, an economy growing at a disruptively rapid rate. But this is not correct. As economic writer Henry Hazlitt has explained:

> Say's Law [referring to the 19th century French economist Jean-Baptiste Say], properly understood, . . . tells us that general overproduction is impossible. What is possible [and to be expected with monetary expansion by banks and governments] is unbalanced production, misdirected production, production of the wrong things. . . .[240] [all of which lead inexorably] to unemployment and malemployment.[241]

Assertion C: Money supply fluctuations through bank credit especially distort the single most important price in the economy: the price of money itself as reflected in interest rates.

Interest rates tell us what money costs, or, technically, what the ability to borrow money (i.e. credit) costs. If we think about it, the cost of money mostly depends on how people value time. If I want to persuade a teenager to lend me money, I will probably have to pay a very high rate of interest, even if I am a sure bet to repay the loan at the agreed upon date. This is because teenagers tend to focus on the here and now and accordingly prefer to buy something at once rather than to defer the purchase in the hope of having more money later.

By contrast, if I want to induce a middle-aged person to lend me money, I might be able to pay a lower rate of interest because middle-aged people are often thinking about saving for retirement rather than splurging on purchases. There will always be many exceptions to these stereotypes, but they illustrate that our valuation of money depends on our valuation of time. In finance at least, the old saw that "time is money and money is time" is especially apt.

Money (and time) is of course involved in virtually every economic transaction, so it should be obvious that the price of money (and time) is a critical price, arguably the most critical price. If interest rates fall, it should tell us that consumers are valuing future money more highly, consequently more has been saved, and the increased supply of savings has in turn reduced the cost to borrowers. Lower borrowing costs should mean that some investment projects which previously looked unprofitable now look profitable. This would be especially true for projects that are expected to take a long time to bring to fruition, since interest (actual or implied) represents a large part of the expected cost in these cases.

Finally, if lower money market interest rates are accompanied by lower bond rates, as they often are, investors may find stock dividends more attractive. If so, they may be willing to pay higher prices for stocks. In addition, borrowed money may be used by a company's management to buy in the company's stock, which should further boost stock prices. Companies will then find that financing costs less, whether it is obtained by borrowing or by selling stock. In the jargon of finance, it will be said that the cost of capital has fallen.

It is observable that employment levels are closely linked to investment levels. If the cost of capital falls, the number of viable and thus sound investments should increase; most investments require employees, and workers directly benefit. But the same cannot be said when interest rates fall for artificial reasons. In this case, interest rates fall, not because people have shifted their time preferences and increased their savings, but rather because governments are "printing" more money and distributing it through banks, deliberately driving interest rates down and easing credit terms. The result is a false boom. This false boom will encourage, not sound investment, but rather malinvestment and malproduction, which must eventually end in bust.

As we have stressed, the money market interest rate is the pivotal economic price. All prices are ultimately connected to each other in a seamless web, but this is the price that most resonates through all other prices. Tampering with it is particularly dangerous and foolhardy. Governments not only attempt to manipulate it through bank credit; they attempt to manipulate it and other interest rates in a great variety of other ways as well, most notably through housing and educational loan subsidies. As a result, business owners and consumers are blinded about the real state of economic affairs, and everyone pays a price in misdirected and stunted economic growth.

Assertion D: Manipulating and distorting interest rates is bad enough. But governments also manipulate and distort international currency prices.

When a government "prints" more and more money, prices will tend to rise. If prices would normally be falling, the rise in prices may not register as a significant increase in consumer prices, because much of the inflation is hidden. Hidden or not, however, inflation will raise wages and business costs above what they otherwise might have been. This in turn will make the goods and services of the country in question less competitive in global markets, which will mean lower levels of employment. If this situation begins to bite hard, the country may decide to devalue its currency.

Devaluation seems to be an easy way out. If Ruritanian goods will not sell abroad, reduce the value of the Ruritanian ruble and, presto, the overseas price will fall, overseas sales will rise. With luck Ruritanian voters will not much notice that they must now pay more for imported goods, since they do not generally see international prices. A devalued currency may increase domestic inflation (not only because imported goods cost more, but also because domestic producers may take advantage of this to raise their prices). It may also raise interest rates because foreigners who have lost money in Ruritanian bonds as a result of the devaluation may refuse to buy any more. If so, cause and effect should still be sufficiently obscure to protect political incumbents.

Now imagine, however, that other countries refuse to accept a Ruritanian devaluation. They refuse to accept it because they do not want their currencies to become more expensive, which would make their goods less competitive in global markets. The Ruritanian government is printing rubles and selling rubles on international exchanges, all designed to reduce the ruble price, but other governments now respond by printing more of their own money and using it to buy rubles.

As this proceeds, the price of money (in this case the price of money itself, not of credit) is more and more distorted, and less and less able to communicate and balance supply and demand in the world economy. Business owners and consumers already have a hard enough time reading genuine price signals, especially in a global economy where production may be in one currency and sales in another, a situation that is already confusing and financially risky. The more government intervenes for its own opportunistic reasons, the more business owners and consumers have to stumble forward without any genuine or reliable price signals.

In the early nineteenth century, the British reformer Richard Cobden stated that

> I hold all idea of regulating the currency to be an absurdity. . . . The currency . . . must be regulated by the trade and commerce of the world; I would neither allow the Bank of England nor any private banks to have what is called the management of the currency.[242]

Now that governments have decisively rejected Cobden's advice, is it any wonder that so-called free markets, which are in truth hardly free at all, should be so subject to instability?

Having sketched the mistakes, we are now ready for the consequences according to Austrian business cycle theorists.

Assertion E: Pouring in new money, reducing interest rates, and confusing the price system may produce a temporary boom, but it will sow the seeds of its own destruction.

The grain of the idea that printing too much money leads to an artificial boom and then inexorably to bust was first formulated by Ludwig von Mises in his 1912 book, *Theorie des Geldes und der Umlaufsmittel (The Theory of Money and Credit)*. The grain was then developed into a complete theory in later works. The first presentation to English speakers, however, came in two books by Mises' student Friedrich Hayek, one written in English and the other translated into English in the early 1930s. Partly because Mises correctly anticipated the Great Depression, he and Hayek dominated economics until John Maynard Keynes' *General Theory of Employment, Interest, and Money* arrived in 1936 and swept everything else away.

Hayek eventually won a Nobel Prize in economics in 1974. But it seemed to "Austrians" that the recognition was grudging, because it came so late, and because it was shared with another economist of diametrically opposed views. There was also speculation that the Nobel Committee had waited until the unfashionable and unpopular Mises had died a year earlier in 1973, since the prize could not be awarded posthumously.

In trying to explain the business cycle, Mises and Hayek stressed that the attempt to lower interest rates through monetary expansion would initially create a business investment boom as more and more projects became feasible because of reduced lending costs. This would in turn create an employment boom in those industries that sold to businesses rather than directly to consumers. The new and better-paid employees of these producer industries would, however, want to spend their earnings on consumer goods. Consequently the new money would in short order stimulate demand both in producer and consumer industries, and everyone would feel richer.

A problem would then present itself. Although new money can stimulate additional demand, it cannot conjure up the supply required to meet the demand, the extra iron ore, lumber, oil, or even, after a point, the additional skilled laborers. As demand begins to exceed supply, business owners must start bidding against each other at higher and higher prices to get the supply needed. Printing more and more money can keep final goods' prices rising as fast or even faster than underlying costs. But eventually governments will lose their nerve and print less, or alternatively consumers will finally catch on, will become afraid to hold money as it depreciates before their eyes, and the "crack-up" stage of the artificial boom will unfold.

As Mises sums up:

> Boom . . . followed by . . . depression, is the unavoidable outcome of the attempts, repeated again and again, to lower the gross market rate of interest by means of [money and] credit expansion. There is no means of avoiding [this]. . . . The [choice] is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved.[243]

Mises' analysis of business cycles, while new, drew upon the work of many earlier economists including the Currency School in early nineteenth century England, the Swede Knut Wicksell, who differentiated between natural and artificial interest rates, and the Austrian Böhm-Bawerk. Some glimmers of it can be seen in even earlier thinkers such as Etienne Bonnot (Abbé de Condillac), David Hume, and David Ricardo. For example, Condillac clearly identified government manipulation of money as the source of a boom/bust episode in pre-Revolutionary France:

> People found it very easy to borrow. This ease deceived incautious merchants who thought they must seize this opportunity to form some new enterprises. They took this money that was offered them, and they bought, but dearly, either because their competing demands raised prices, or because they paid with money which, from one day to the next, was to fall in value.
>
> However, . . . the king . . . began to lock up the silver in his strongboxes. . . . Merchants who had borrowed it did not have enough for everyday essential expenditure. Then, forced to empty their warehouses and to sell at a 50 or 60 per cent loss, they saw how they had been deceived in their speculations. The majority became bankrupt.[244]

If inflation accelerates immediately during an easy money and credit induced boom, and if governments and banks respond promptly by printing less money, harm will have been done, but the damage contained. There are times, however, as previously noted, when monetary inflation will creep in "under the radar screen," will hardly register at all in the closely watched consumer price index, and these times are especially dangerous.

For example, in both the 1920s and 1990s in the United States, new productivity-enhancing technologies and a great influx of cheap imports from abroad tended to drive costs and prices down. Without any monetary inflation, these would have been eras of "good deflation" with workers and business owners, but especially workers, benefiting from lower prices. Unfortunately, governments and banks together printed so many new dollars that prices rose rather than fell, but rose so slowly and stealthily that alarm bells did not sound and there was no check on easy money.

For a time, indeed, nearly everyone was euphoric. All the investment that came pouring out increased productivity even further. In the 1990s, as consumers earned more, many of them left rental properties and bought homes. Since the important housing component of the government's consumer price index (CPI) was calculated based on rental, not home, values, this helped to slow the CPI's rise and made inflation seem even lower than it actually was. The CPI was also distorted by new government calculation techniques (hedonic adjustments) that sought to capture quality improvements in consumer goods.

By the end of the 1920s and 1990s, financial and business "bubbles" had formed, commodity and labor bottlenecks were common, speculation was rampant, and huge sums had been wasted in malinvestments of every kind. Most observers were puzzled, at a loss to explain what had happened, but in each case the "Austrians" had both predicted and explained it.

As noted earlier, John Maynard Keynes said in *The General Theory* that the proper policy for booms was to prolong them indefinitely, not to try to arrest their speculative excesses, and the way to prolong them was to keep reducing interest rates until money became virtually free. If Keynes' policy had been followed in the late 1920s or in 2000, the US Federal Reserve would have eased further rather than tightening ("printing" fewer dollars) as it did. But it is not clear how further easing could have succeeded in economies that were already severely capacity constrained, that had temporarily run out of readily available commodities and highly skilled labor of every kind, just as von Mises, Hayek, and their Austrian successors had forecast. The problem then, as always, is that real wealth does not consist of money, but rather of goods and services and the ability to produce goods and services. If we temporarily exhaust our capacity to produce, "printing" money and reducing interest rates can only produce higher prices, not additional wealth.

There are a number of criticisms of Mises' business cycle theory that need to be considered. The first is that banks were a primary source of business capital in the 1920s, but are no longer so today. This is indeed a valid observation, especially after the advent of the junk bond market made it possible for more and more companies to borrow from sources other than banks. If banks play a much smaller role in corporate finance, can government/bank credit creation really explain the contemporary business cycle?

The answer in a word is yes. Although the banks do play a reduced role, other, new factors tend to reinforce even more strongly the trends that government/bank credit creation sets in motion. For example, in Mises' day, consumers did not have credit cards or home equity loans. Consequently, a reduction in interest rates primarily affected businesses, especially, as noted, businesses producing capital goods. Now consumers respond to lower interest rates as well, both by borrowing and spending more, and by saving less. Thus the consumer side of the boom, and the competition of producer and consumer industries for inputs and workers gets off to an even faster start.

Another factor is the proliferation of financial institutions that in some respects mimic banks. For example, banks are said to "borrow short and lend long." This means that they accept deposits which (except for time deposits) are payable on demand without penalty, and then lend this money out for longer periods. When it is clear that central banks are committed to keeping rates low by "printing" more money, investment pools and other financial institutions also borrow at low money market rates, and then invest the borrowed money in longer bonds in order to capture the longer bonds' higher interest rate.

The net effect of these transactions, which are known as the *carry trade*, is to reduce longer bond rates. In effect the carry trade provides central banks with a way to influence longer bond rates that are outside their (customary) direct control. If both short and long interest rates are reduced by central bank monetary manipulation, then a credit fueled boom can proceed on an even more runaway course.

Yet another factor increasing the potential for runaway booms, followed by wrenching busts, is the very "safety net" that central banks are assumed to have placed under the economy. If central banks will step in with stronger and stronger doses of easy money whenever a major financial institution, market, or country gets into trouble, then it becomes more rational to speculate, to take excessive risk, and not at all rational to save, to take precautions, to be prudent. In this respect, as we have previously discussed, so-called stabilization is actually de-stabilizing.

Another objection to the Austrian theory of the business cycle is that business owners cannot be so foolish as to be repeatedly gulled into expanding operations by government/bank credit expansion. A rational business owner might very well fall for central bankers' tricks the first time that interest rates were artificially lowered, but why would this happen over and over again?

This is a good question, but it does have an answer, or rather two answers. First, a business owner may know that today's interest rate is artificial, unsustainable, and misleading. But he or she cannot know what the rate would be without government interference, and without this vital information can only guess at the best course.

Moreover, once a boom gets underway, most businesses cannot choose to stand aside. Assume that company X's industry market share (share of customers' purchases) is 20% before the boom starts. Interest rates then fall and competitors start to expand. If company X refuses to expand, its share may fall to 15%, 10%, or less. Long before the boom is over, company X may have been virtually wiped out, and, if so, will not be able to regain its share after the boom collapses. At best, all company X can hope to do is to be somewhat more prudent than its competitors, to borrow and expand less, and thus to stand firmer when the weather turns and the wind begins to howl.[245]

Assertion F: When easy money and credit lead directly to hyper-inflation, as in Germany in the early 1920s, governments may finally be forced to stop running their monetary printing presses.

As previously noted, however, there are times when easy money and credit are partially offset by deflationary factors such as productivity gains or cheap imports. In this case, inflation is masked and larger and larger economic bubbles inflate. Governments may then tighten money for a time, out of fear of inflation, but will typically try to cure the ensuing bust by starting up the printing presses all over again.

After economic bubbles such as those in the US in the 1920s and 1990s and Japan in the 1980s finally burst, businesses inevitably retrench. Having borrowed and invested far too much, often in overpriced or unrealistic projects, they typically cut borrowing and investing to the minimum, knowing that they have been left with excessive production capacity, unproductive investments, and excessive debt. Since business investment is so closely linked to employment, joblessness begins to rise, and central banks begin to worry about deflation. Given the prevailing Keynesian and monetarist view that any kind or amount of deflation is dangerous and unacceptable, it seems necessary to reflate, to start pumping money once again into the economy.

In post-bubble Japan, new yen were aggressively printed and credit expanded, but this did not prevent years of recession and a mild deflation. By 2002, total debt had reached an amount equal to six times gross domestic product, business as a whole arguably had liabilities exceeding assets, and banks had a negative net worth equivalent to a trillion dollars. Some observers, including US Federal Reserve economists writing years after the fact, felt that monetary expansion should have come even sooner and faster. But Japanese such as Eisuke Sakakibara, former vice finance minister, vigorously deny that the response was slow or half-hearted. Sakakibara, at least, argues that the monetary measures would have worked better if they had been more targeted. For example, the government might have done better to inject new money directly into banks and companies, thereby wiping out their bad debts.

In the United States, the Federal Reserve chose an easy money policy in 1998 and 1999, even as the bubble became increasingly apparent, then tightened, which almost immediately precipitated a mild recession or at least a pause, then began to loosen again to forestall deflation. Altogether between 1998 and June 2002, net Federal Reserve bond purchases (high powered "new" money) totaled $170 billion dollars. Assuming that this was multiplied ten times through bank credit, an additional $1.7 trillion entered an economy with a then gross domestic product of about $10 trillion, an amount of new money equal to the total money supply (as measured by M3) only two decades earlier at the beginning of the Reagan administration. Simultaneously, the Federal Government began to run large budget deficits and the dollar was encouraged to fall (not openly, but discretely) on international currency exchanges. All three steps were deemed stimulative, but the last was also designed to protect business sales abroad as inflation kept increasing the prices of American goods.

These measures were widely hailed. Barton Biggs of Morgan Stanley, at the time the dean of US financial commentators, wrote that:

> When bubbles burst, the risk always becomes deflation. . . . What the world needs now are deflation hawks. . . . [246] Before becoming too bearish, it is well to remember that the Authorities in the West have provided massive amounts of fiscal and monetary stimulus, which reduces the probabilities of an apocalyptic outcome.[247]

Another respected commentator, Bill Gross of Pacific Investment Management Company, spoke for many when he expressed the view that the Federal Reserve's stimulative measures would at least buy the economic system "some more time" in which to recover. And time did seem to have been bought. Although companies largely ignored all the new money and credit banks were offering, thanks to Fed largesse, consumers did borrow at a hectic pace. They borrowed to buy homes especially, or to take money out of their homes through home equity loans, and the resulting consumer spending produced what appeared to be a fairly normal business recovery, albeit one with slower than usual employment growth.

Was the early 21st century monetary expansion a brilliant response to perilous economic times? Hardly. It lead to the Housing Bubble and the 2008 economic collapse. This brings to mind some comments made by Friedrich Hayek in the 1930s:

> The same stabilizers who believed that nothing was wrong with the boom and that it might last indefinitely because prices did not rise, now believe that everything could be set right again if only we would use the weapons of monetary policy to prevent prices from falling.[248]
>
> . . . Instead of furthering the inevitable liquidation of the maladjustments brought about by the boom during the last three years, all conceivable means have been used to prevent that readjustment from taking place; and one of these means, which has been repeatedly tried though without success, from the earliest to the most recent stages of depression, has been this deliberate policy of credit expansion.[249]

Laissez-faire Redux

We are now ready to try to summarize the Austrian, laissez-faire, or free market point of view:

A fractional reserve banking system, with its over elastic but generally expanding money supply, makes the economy especially prone to boom and bust.

- Business errors proliferate when money and credit are inflated and interest rates artificially reduced by government, because some of the most critical price signals are distorted. An economic system sick from easy money and credit will benefit from more easy money as much as a drug addict will benefit from more drugs.
- Recessions, even depressions, are critical to liquidate past errors. If liquidation is not permitted, growth will be retarded, as in a garden choked with weeds.
- Economic pain deferred is not pain avoided, but rather pain compounded.

If one accepts this thesis, one can still ask whether government can or should take any action as boom collapses into bust. Not unexpectedly, Austrian economists are not of one mind about this. The most orthodox view is expressed by economist Murray Rothbard:

> What the government should do, according to the Misesian analysis of the depression, is

> absolutely nothing. . . . Anything it does will delay and obstruct the adjustment process of the market; the less it does, the more rapidly will the market adjustment process do its work, and sound economic recovery ensue.[250]

The Misesian prescription is thus the exact opposite of the Keynesian: It is for the government to keep absolute hands off the economy, and to confine itself to stopping its own inflation, and to cutting its own budget.[251]

For Rothbard, two conditions must be met for a real recovery to take place. First, the mistakes of the past must be liquidated. Second, prices (including wages) must fall until they are again in approximate balance with the amount of money in circulation. Since the money supply will contract as people take fright and stop buying and borrowing, prices must be flexible enough to adjust to whatever money supply exists. Government intervention will thwart both liquidation and flexible prices.

Wilhelm Röpke, a German who was "Austrian" in spirit but an admirer rather than a follower of Mises, thought for a time that easy money and credit creation might be justified if applied at the bottom of a severe and intractable depression. But he came to reject this judgment, in part because it would be impossible for public officials not to cheat and use the prescription too liberally, in part because he finally decided that easy money would hurt more than help.

Some other Austrians think that, if the government intervenes at all in the bust phase of the boom/bust cycle, it should raise rather than lower interest rates. The presumption is that this will speed up the liquidation process, and the sooner liquidation is over the better, no matter how intense the momentary pain. The respected financial analyst Ned Davis, who does not describe himself as an "Austrian," wrote in 2003, after the US bubble of the 1990s had burst, that, "Our biggest problem, in my opinion, is insufficient savings and excessive debt."[252]

He then went on to note that a policy of raising interest rates and eliminating the tax deduction on interest payments would most directly encourage savings. He further suggested that the *economic drag* produced by less borrowing might be offset by eliminating the current double tax on corporate dividends (paid once at the corporate and again at the personal level) and by making it easier to write off investment losses on tax returns. If these measures were adopted, "The tax code [would no longer] favor . . . debt over equity."[253]

This echoes economist Wilhelm Röpke's comment that "The attempt to make good the shortfall of genuine savings by inflationary credit creation . . . is one of the main causes for the insufficiency of saving. . . . This vicious circle has to be broken through."[254]

Austrians would presumably agree that one of the worst ways for government to intervene after the collapse of a bubble is to induce businesses, already overindebted and over-expanded, to take on even more debt and expand even more. The US Federal Reserve's policy in 2000–2004 of inducing the consumer to borrow instead might seem to be less harmful economically. But it is morally suspect, because consumers are the least financially sophisticated players in the economy. And it is dangerous, because consumers represent two thirds of gross domestic product. If consumers become too burdened with debt, everything may come crashing down, which is exactly what became apparent by the end of the consumer led housing bubble of 2002–2007.

On balance, if the government is determined to intervene, to make things better for a while at the cost of making them worse in the future, the most honest and least harmful strategy is to borrow on its own behalf, to run government deficits and expand the Federal debt while leaving businesses and consumers alone.

Whatever government does, the bottom line is that government intervention cannot cure business cycles, because it has caused them in the first place. As Murray Rothbard states:

> The business cycle [is not] a mysterious series of random events to be checked and counteracted by an ever-vigilant central government. On the contrary, the business cycle is generated by government: specifically, by bank credit expansion promoted and fueled by governmental expansion of bank reserves.[255]
>
> . . . [One might object that] if banking is the cause of the business cycle, aren't the banks

> also a part of the private market economy, and can't we therefore say that the free market is *still* the culprit, if only in the banking segment of that free market? The answer is No, for the banks, for one thing, would never be able to expand credit in concert were it not for the intervention and encouragement of government. For if banks were truly competitive, any expansion of credit by one bank would quickly pile up the debts of that bank in its competitors, and its competitors would quickly call upon the expanding bank for redemption in cash. In short, a bank's rivals will call upon it for redemption in gold or cash in the same way as do foreigners, except that the process is much faster and would nip any incipient inflation in the bud before it got started. Banks can only expand comfortably in unison when a Central Bank exists, essentially a governmental bank, enjoying a monopoly of governmental business, and a privileged position imposed by government over the entire banking system.[256]

Such a pure laissez-faire position is very uncommon among economists today, but it once was dominant, and it appears to be finding its voice again. As financial writer James Grant has noted, "In time, Austrian economics could be again seen as the mainstream theory. It should be."[257]

To which Rothbard, blunt as ever, adds:

> We will never break out of our economic stagnation or our boom–bust cycles and achieve permanent prosperity until we have repudiated Keynes as thoroughly and as intensely as the peoples of Eastern Europe and the Soviet Union have repudiated Marx and Lenin. [We should] hurl all three of these icons of the twentieth century into the dustbin of history.[258]

The pure laissez-faire position recommended by Rothbard should not, however, be confused with complete government inaction. To restore laissez-faire, many government actions would be required, from the abolition of fractional reserve banking and labor union exemptions from monopoly to the restoration of gold as the world's primary money.

Keynes Redux

During his lifetime, Keynes had little or no contact with Mises, Rothbard's mentor. But Keynes and Mises' protégé Hayek knew each other well, and their rivalry for dominance in economics was intense. Keynes' biographer Robert Skidelsky has described the relationship:

> In Hayek's view, *The General Theory* was not a general theory of economics at all but rather a dressed-up specific theory to get around a

> political impasse in Britain. Keynes was no less slashing in his rejoinders. Hayek, he said, had started in one article "with a mistake" and then proceeded to "bedlam." Another Hayek article, he said, was "the wildest farrago of nonsense." In 1933 Keynes wrote his wife about seeing Hayek in Cambridge. Keynes sat next to him at dinner and also lunched with him the following day. "We get on very well in private life. But what rubbish his theory is."[259]

But was Keynes, after all, a true Keynesian? Could Hayek be right that *The General Theory* was really a work of propaganda, designed to sell a particular policy prescription for the Great Depression, rather than the theoretical treatise on economics it purported to be? There is some evidence for this in the book itself. It seems to have been written in haste, as evidenced by its sloppiness, its shifting definition of key terms, its many ambiguities and structural and logical deficiencies, its long passages of opaque and execrable prose (albeit interspersed with sparkling gems). These lapses were uncharacteristic of Keynes, who was generally a clear expositor and a master of the English language. Perhaps *The General Theory* could be regarded as a kind of lawyer's brief, hastily incorporating any argument that might convince the jury, without too much regard for consistency or other logical niceties.

There are also a few hints that Keynes himself thought he had overstated his case, had inadvertently encouraged others to go too far. In his last journal article, written almost a decade after *The General Theory*, he somewhat mysteriously referred to "much modernist stuff, gone wrong and turned sour and silly."[260]

A friend also reported that:

> In my last talk with Keynes . . . [he] complained that the easy money policy was being pushed too far, both in England and [the US], and emphasized interest as an element of income, and its basic importance in the structure and functioning of private capitalism. He was amused by my remark that it was time to write another book because the all-out easy money policy was being preached in his name.[261]

Whatever Keynes came to believe, what is now called Keynesianism continues to flourish. Its most contemporary academic form is called "New Keynesianism," about which economist Paul Krugman had this to say: "In reality Keynesianism *is* basically right, so it's nice to have a [new Keynesian] theory that lets us admit it."[262]

Deep-dyed Keynesians, new or old, are especially appalled by the heretical Austrian idea that the seeds of an economic bust may be found in the preceding boom. In their view, booms are good; they do not lead to malinvestment. Even bubbles do no lasting harm, and printing extra money to nourish the boom or restart a new one does not distort prices, derange the system, or create a destructive addiction as the Austrians have alleged.

Not every Keynesian, it should be said, agrees with this. Wynne Godley, a former professor at Keynes' university, Cambridge, and self-described "unabashed Keynesian," thinks that, "The entire expansion [of the 1990s] was based on an unsustainable foundation and will have to be completely unraveled."[263]

But, in offering this opinion, Godley is departing from Keynes. As economist Axel Leijonhufvud has written:

> Keynes' reaction to the overinvestment theory of Hayek . . . was . . . that overinvestment in the past . . . should [not] cause any problems in the present; the only result would be to leave us with more capital in the present—and so much the better off for it. . . .[264]

The main object, always, is to keep the deflationary wolf from the door. Both Keynesians and monetarists deny any suggestion that the Federal Reserve set in motion events that led to the Great Depression by "printing" too many dollars during the 1920s boom. Monetary policy in the 1920s had been just right, as reflected in the general price stability.

If anything, the Fed erred by tightening too abruptly in 1929, and thereafter failed to "print" enough new dollars to prevent the falling prices that precipitated depression. Since interest rates fell sharply after the

Crash, and neither money supply nor outstanding credit fell for the next year,[265] the charge is not exactly that the Fed was "tight." It is rather that policy was "loose," but not "loose" enough (although there is uncertainty about how much "looser" the Fed could have been under then existing law).

Robert Mundell, the supply-sider, has yet another hypothesis about what caused the Great Depression. In his view, the transition from a pure gold standard to a gold-based standard after World War One had been botched. Most world currencies (not just the British pound as is often alleged) had been pegged at the wrong price in gold. This idea should not be confused with the notion that the gold standard caused the Depression, because it acknowledges that the pure gold standard had been abandoned several decades earlier.

In any case, all of these interpretations—Keynesian, monetarist, supply side, or Austrian—have one thing in common: they stress the role of money. By contrast, one of the leading economists of the time, Joseph Schumpeter, said that, "I do not think that . . . Federal Reserve Policy . . . made much difference [in the years before the Depression]."[266]

This underscores Mundell's comment that "[so many] years after its beginning, there is no general agreement on the causes of the [G]reat [D]pression."[267]

Appendix E

Did the US Congress Trigger the Stock Market Bubble of the Late 1990s?

A NUMBER OF CONGRESSIONAL actions may have contributed to the US stock market and economic bubble of the late 1990s. For example, a law passed in the early 1990s limited the cash compensation of leaders of public companies. This shifted more and more executive compensation to stock options and thus may have inadvertently encouraged stock speculation. The accounting profession's policy board was also warned by leading senators that if it persisted in a plan to require companies to treat stock options as ordinary business expenses, legislation would put a stop to it. The policy board chose to bow before congressional pressure.

Tax laws throughout these years permitted companies to deduct the cost of borrowing money, but treated dividend payments to shareholders as taxable twice, once at the company level and again at the shareholder level. This made equity financing much more expensive than debt financing, and thus encouraged companies to borrow heavily. In part, companies borrowed heavily to buy back shares, a move that sent share prices higher and higher and (not incidentally) made the value of company executives' stock options soar. Meanwhile, prominent financial experts such as Franco Modigliani and Merton Miller were encouraging companies to incur more and more debt, on the assumption that debt and equity were interchangeable, that the risks of leverage were not as great as previously supposed. It may have been good theory, but dangerous theory for companies that edged too close to insolvency.[268]

Other tax laws required companies selling capital goods to book their earnings all at once, but permitted companies buying the capital goods to recognize the expense over a number of years. This treatment exaggerates reported corporate profits during a boom, when capital goods are most in demand, then exaggerates the decline in profits after the bust, when the sellers have few orders and the buyers are still expensing the purchases of prior years, many of which will have turned out to be mistakes.

The US Federal Reserve probably had more impact on the US economy than Congress in the late 1990s, but Congress also arguably played an important role.

Appendix F

Other (Non-monetary) Theories of the Business Cycle

THE BUSINESS CYCLE theories that have been reviewed so far in this book are all monetary in nature. That is, they think that money problems lie at the root of the problem of boom and bust. But there are also non-monetary theories which either compete with or complement the monetary approach.

Non-Monetary Theory A: The business cycle reflects human nature.

Keynes expressed this point of view when he wrote about the importance of "animal spirits" in an economy. The general idea is that the ups and downs of an economy merely reflect the ups and downs of the human psyche, which in turn reflect our genes, our collective DNA. John Stuart Mill pointed out the connection as early as 1830:

> Unreasonable hopes and unreasonable fears alternatively rule with tyrannical sway over the minds of a majority of the mercantile public; general eagerness to buy and general reluctance to buy, succeed one another in a manner more or less marked.[269]

The tendency to emotional extremes is in turn reinforced by our tribal behavior, a subject explored by Charles MacKay in his mid–19th century book *Memoirs of Popular Delusions and the Madness of Crowds*.*

There is more to this particular business cycle theory, however, than manic-depression or herd behavior. Another aspect of human nature, well documented by social scientists, is that we generally expect present conditions to persist into the future. In other words, we tend to over-estimate the probability of continuity, of more of the same, and to under-estimate the probability of discontinuity, of some significant disruption or deviance from trend.

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* Other books worth mentioning in this connection are British economist Frederick Lavington's 1922 work, *The Trade Cycle*, which theorized that economies rose and fell with the public's collective level of confidence, and economist Charles Kindleberger's 1978 book *Manias, Panics, and Crashes*.

This latter tendency is quite important because it leads us to take more and more investment risk as economies or stock markets rise sharply. Rationally we should do the reverse. If we all moderated our enthusiasm somewhat as things improved, we would not only be better prepared for adversity. We might avert adversity altogether.

For example, the investment firm Grantham, Mayo, Van Otterloo has studied historical periods when US stock prices have been high, and found that they tend to follow years when gross domestic product has been very stable, inflation has been low, and corporate profit margins have been high. When all three factors converge, investors' confidence soars and stocks are bid up. If investors would only look more closely, they would find that corporate earnings are historically mean-reverting. That is, they tend to fall when high and rise when low, so that betting on the indefinite continuation of nearly ideal conditions is unwise.

It should be noted that some Austrians and other opponents of monetary expansion think that the "human nature" theory of the business cycle complements rather than conflicts with their own theory. Austrians hold that business cycles are caused by monetary over-expansion. But why do governments and banks over-expand the money supply in the first place? What is their motive? Government officials think that extra money will help them win the next election. Banks over-lend because they are looking to this year's earnings report and no further. But both public officials and bankers also over-expand because they become over-confident or manic like everyone else. In this sense, monetary and psychological explanations of business cycles are simply different sides of the same coin, with each explaining aspects of the other.

James Grant, who describes himself as an Austrian, a follower of von Mises and Hayek, thinks that monetary over-expansion does much harm, but also credits a psychological interpretation of business and market cycles. He states that

> the underlying source of recurring cycles in an economy is the average human being. . . .[270] Even if some all-knowing central bank could create a state of economic perfection— . . . human beings would respond by overpaying for stocks and bonds. In this way they would restore imperfection [because overvaluation would lead to malinvestment, disappointing returns, and transition from boom to bust].[271]

Non-Monetary Theory B: The business cycle reflects not only human nature, but also the moral failings of the market system. So long as we have a market system, the best we can do is to palliate the problem with government regulation.

This thesis runs as follows. It is human nature to fall into extremes of overoptimism or pessimism and to follow the crowd, but it is also human nature to be greedy. According to this view, free markets inflame rather than regulate greed, and give rise to a war of employers against employees, sellers against buyers, and ultimately all against all.

Alan Greenspan, chairman of the US Federal Reserve Board, looked back at the US economic and stock market bubble of the late 1990s in 2002 and discovered, "[an] infectious greed in the business community" [along with] "a once in a generation frenzy of speculation."[272]

Joseph Stiglitz, who served as chairman of President Clinton's Council of Economic Advisors from 1995–97 and chief economist of the World Bank from 1997–2000, thought that the economic record of the 1990s had been generally excellent. There had been no artificial boom and therefore no predictable bust. But he acknowledged some excesses and thought these could be traced to the deregulation of markets begun in the 1980s by President Reagan. If America had only been wise enough to keep its regulatory apparatus firmly in place, it could have had the 1990s boom without the excesses of greed and speculation that contributed to the bust.

Stiglitz' emphasis on regulation as a key facet of boom and bust also provides a possible answer to what has always been a particularly nagging question. If business owners are greedy, they must be presumed to be greedy all the time. Why then are boom and bust so episodic? Why does greed manifest itself at certain times and not at others? The Austrians would say that boom/busts happen when government "prints" too much money and thus misleads people about the economy and also "enables" some of them to gamble and ruin themselves. Stiglitz by contrast believes that they happen whenever government lets down its regulatory guard and allows business owners to run amok. Many people thought that this was exactly what happened to Wall Street during the US housing bubble of 2002–2007.

Non-Monetary Theory C: We should not look for a single cause of business cycles. They are complex and involve a shifting variety of factors.

William Beveridge noted in 1931, "Unemployment is like a headache or a high temperature—unpleasant and exhausting but not carrying in itself any explanation of its cause. [One has to] find . . . out which of . . . many possible causes is at work."[273]

What might these many possible causes include? The US President's Council of Economic Advisors in 1990 cited three broad categories:

> External shocks. . . , policy errors, or widespread imbalances, such as an overaccumulation of inventories. . . . Expansions end because of [one or more of these. They] do not die of old age.[274]

When speaking of external shocks, the Council had in mind events such as a war or the Arab oil embargo in the early 1970s, which was itself connected to an Arab–Israeli war. When speaking of policy errors, the Council did not refer to government "printing" too much money, as per Austrian theory, but rather to other policy errors. An example would be the Smoot-Hawley Tariff Act, which raised US duties after the stock market crash of 1929. At least one observer has argued that congressional debate favoring tariff protection had begun well before the Crash and thus might have precipitated it. Whether or not it precipitated the Crash, most historians now believe that protection made the Great Depression much deeper than it otherwise would have been.

Non-Monetary Theory D: Business cycles are caused by the ebb and flow of new technology and other innovation.

This idea was developed by the economist Joseph Schumpeter. He believed that free markets bring with them "creative destruction" in the form of new technology and other innovation. Innovation is initially disruptive, even destructive; it shatters whatever existing equilibrium exists. But eventually order and equilibrium are regained, albeit in a new form. Both owners and workers, producers and consumers (as a group) should then find themselves richer, with many new improvements and conveniences in their lives, even though particular producers or consumers may never recover, as in the case of buggy manufacturers when automobiles arrived or workers who lose their jobs and are too old to be retrained.

Schumpeter's ideas have won many adherents, although he never explained the exact linkage between innovation and the business cycle. Schumpeter's magnum opus on the subject, the two-volume Business Cycles, described a short, intermediate, and long cycle (the last being the celebrated Kondratieff Wave of fifty to sixty years). The cycles overlapped; especially foul conditions resulted whenever all three cycles hit bottom at the same time.

Paul Krugman, the Keynesian economist, has called Schumpeter's book "turgid, almost meaningless."[275] But other economists, for example, Finn Kydland and Edward Prescott, real business cyclists who jointly won the Nobel Prize in 2004, have also expressed the view that innovation among other factors may create "shocks" which lead to boom or bust, although they have not followed Schumpeter's particular scheme.

Austrians agree with Schumpeter that entrepreneurs play a vital role in the economy in general, but disagree that innovation per se sets the business cycle in motion. In addition, Austrians such as von Mises and Hayek regard equilibrium as an economic goal, one that we strive after but never quite reach, while Schumpeter, like most other classical economists, thought of equilibrium as an economic norm, a state that can and should be achieved. Although this difference may seem merely theoretical, it is of profound importance. The mathematical approaches that now dominate economics depend upon the conceptual possibility of reaching equilibrium. If the Austrians are right, mathematical economics represents a wrong turn toward an intellectual dead-end.

Appendix G
The US Federal Reserve System

In monetary theories of the business cycle, whether Keynesian, monetarist, supply side, or Austrian, central banks play a dominant role. It is vitally important to understand how they work, and the best way to do that is to look at the operations of a particular central bank, in this case the US Federal Reserve.

Historical Background

The framers of the US Constitution gave responsibility for money to the national government rather than to the states. Since money was primarily gold, this responsibility was expected at the time to be limited. In time, however, the Federal Government exercised more and more control. Extensive paper money was issued during the Civil War, gold was supplemented at times by silver, the nineteenth century gold standard was abandoned during World War One (in favor of paper money backed by gold), private ownership of gold was outlawed by the Roosevelt administration in April 1933, and the official link between the dollar and gold was finally severed in 1971 by the Nixon administration, although private citizens could again own bullion. The de-linking of money and gold put the US on what is called a fiat money system.

Many people thought that the outlawing of private ownership of gold (and concurrent devaluation of the dollar in terms of gold) in the 1930s would be ruled unconstitutional by the Supreme Court. But in a February 1935 decision the Court held that Congress has full power, "To regulate the currency and to establish the monetary system of the country."[276]

As a general rule, however, Congress does not directly regulate the currency. In 1913, it delegated that power to a Federal Reserve System that came into being the following year, just prior to World War One and the collapse of the nineteenth century gold standard for global money.

Organization and Duties

The Federal Reserve System (often called the Fed) consists of a Federal Reserve Board in Washington D.C. and twelve regional Federal Reserve Banks. Board members, presently called governors, are appointed by the president for fourteen year non-renewable terms, subject to confirmation by the Senate. The board's chairman is appointed by the president every four years, again subject to Senate confirmation, and is arguably the most powerful person in the United States, or at least the second most powerful after the president.

One of the Federal Reserve System's duties is to supervise banks, and much of this is carried out by the regional Federal Reserve Banks, each led by a president. Monetary policy, which principally focuses on the level of short-term interest rates and the quantity of money in the economy, is largely determined by an Open Market Committee led by the board chairman and comprised of the seven board members, the president of the New York Federal Reserve Bank, and four other presidents chosen in rotation from the other eleven regional banks.

Operations

The Open Market Committee has a choice. It can try to fix the price of money (technically the price of credit), that is, the level of short-term interest rates. Or it can try to fix the quantity of money (technically the quantity of credit). This is true of any market. One can usually fix price or supply but not both. The 2008 TARP (Troubled Assets Relief Program) legislation, however, gave the Fed new powers to pay interest on its deposits, which could enable it to fix both the price and supply of money, albeit with difficulty.

In other countries, arguments rage about whether the central bank should try to fix interest rates, the price of the country's currency on global markets, or money supply. But in the US, the argument has largely centered on interest rates versus money supply, and the Fed has generally focused on interest rates.

The interest rate that the Fed most directly controls is the Fed funds rate, the rate the banks charge each other for inter-bank borrowing. But, by controlling this rate, the Fed can generally set short-term interest rates in general. The way the Fed controls the Fed funds rate is by buying and selling notes, bonds, repurchase agreements, and other securities. When it buys, it uses Federal Reserve checks, which draw upon nothing and thus create new money. Buying securities from banks directs this new money to banks. This in turn "liquefies" the banking system, reduces the Fed funds rate, and also creates additional reserves to support bank loans. Banks multiply this new money by being able to lend $10 for each $1 of reserves, and the new money is further multiplied as it moves from bank to bank.

The Money Multiplier

We have already covered some of this ground in Appendix D, but will give a somewhat more complete account here, since the multiplier is such an important part of what the Fed is and does. Assume that person A deposits $1,000 in a bank. The bank keeps $100 for reserves and lends $900 to person B. Since person A still has $1,000, but person B now has $900, the total amount of money in the system has almost doubled. Wealth, of course, has not increased, because the $900 is a debt which must be repaid, but credit has increased the money supply to $1,900. If person B then deposits his or her $900 in another bank, that bank may keep $90 for reserves and lend out $810, which will increase the money supply further. All told, the money supply may increase through this process by as much as ten times (based on a 10% reserve).

The so-called money multiplier (referring to bank credit) must be distinguished from the Keynesian multiplier. The Keynesian or fiscal multiplier assumes that government can multiply spending throughout the economy by borrowing and spending funds over and above what it has received in taxes. Whether the

Keynesian multiplier exists is doubted by many economists, and virtually all economists agree that there are circumstances under which it would either not be operative or not be desirable. The money multiplier by contrast undoubtedly exists, although there is debate about how it works.[277]

Open Market Operations

In the example above, we have considered only private depositors, borrowers, and banks. In this simple case, reserves are obtained solely from depositors. Credit (and money) levels rise or fall solely based on private demand, without any intervention by government. But bank reserves legally consist of Federal Reserve deposits (what the bank has on account with the Federal Reserve) as well as vault cash.

When the Fed buys securities from banks with its fictitious checks, it does not pay the bank directly. Instead it increases the bank's deposit account at the Fed. As these deposits increase, reserves increase with them, and banks can then lend more.

In the parlance of the trade, when the Fed puts new money into the system by buying bank securities with fictitious checks, and this new money circulates through banks, it is "high powered" because of the multiplication effect.

In most cases, putting aside all the complexities, it is as if the Fed had simply "printed" new money and given it to banks to lend, thus expanding money and credit. The Fed can also do the reverse by selling securities, which will take money out of circulation, thereby contracting money and credit.

When the Fed buys bonds directly or indirectly from the government with its ficticious checks, it is said to "monetize [the government's] debt." In that case, government has borrowed from itself, which is equivalent to "printing" more money, but is less likely to be noticed by the press and public.

If the Fed were to set specific money supply targets, it would generally buy securities to increase the monetary base* and thence the money supply and sell them to decrease it. In practice, this has proved to be nearly impossible, because it is too difficult to define what money is, much less monitor how much of it there is on a real-time basis. A dollar bill clearly is money, but what about short term money market investments such as treasury bills? Might not even the equity in our homes count as money, since it can be turned into cash almost overnight through a home equity loan? What about common stocks? These do not seem to be money, but can also be turned into cash readily. On balance, a realistic definition of money today would at least include all debt as well as the broadest government measures of money per se such as "MZM" or "MOM."

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* Currency held by the public and banks plus bank deposits at the Fed.

If the Fed targets short-term interest rates, it is usually using these as a kind of proxy for money supply. After all, if rates fall, it means that there is more credit (and money) available, since price falls as supply increases. Conversely, if rates rise, it means that the supply of credit (and money) has fallen. By extension, if the Fed announces that it wants the federal funds rate to fall, it usually means that the Fed will be buying securities (with its fictitious checks) to create more bank reserves, credit, and money. If it wants the federal funds rate to rise, it will do the reverse.

These are good rules of thumb, but no more. Sometimes, the Fed will announce a cut in the federal funds rate, but keep selling securities; or an increase in the rate, but keep buying. It may also allow the rate to drift significantly above or below its stated target. Indeed, the Fed only began to reveal its target in 1994. Prior to that, it generally had a target, but refused to disclose it.

Recall, also, that other countries' central banks may use open market operations, the buying and selling of securities, for other reasons. For example, assume that a country sells much more abroad than it buys. As the foreign currency floods into the country, it will be exchanged for the local currency. Since the demand for the local currency will increase relative to the supply, its price would be expected to rise. A central bank can prevent this by "printing" additional local currency, but only at a risk of triggering local inflation (because the supply of money may grow faster than the supply of goods). To avoid or reduce the inflation, the central bank may sop up or "sterilize" the new money by selling government bonds. In this case, the open market operations are not directly tied to interest rate targets.

In the US, regional Federal Reserve Banks put in requests for a higher or lower federal funds rate based on their local conditions. The Open Market Committee meets every six weeks and decides. During some periods, there is much dissent among the members. During other periods, the chairman has been dominant, or consensus has otherwise been achieved.

The Fed and Capital Markets

Whatever federal funds rate is selected, the impact of the decision may be amplified in a variety of ways. For example, if rates are lowered, this may stimulate the home mortgage market, and thus home purchases, but low rates may also be greatly amplified by mortgage subsidies offered by quasi-government agencies such as Fannie Mae and Freddie Mac, as demonstrated all too well during the housing bubble of 2002–2007.

If the Fed signals that it can be relied upon to keep rates low for a period of time, this will encourage banks, along with investment funds known as hedge funds and other financial institutions, to borrow billions of dollars in the money market (short-dated securities), which are then invested in the bond market (longer-dated securities). Because bonds normally offer a higher interest rate than money market securities (a spread), the hedge fund can earn a large profit with the borrowed funds. The important point from a macro-economic perspective, however, is that the Fed has encouraged large-scale purchases of bonds, which should lower bond rates relative to where they would have been. By encouraging the carry trade, as it is known on Wall Street, the Fed has gained a degree of control over long- as well as short-term interest rates, and it has said it may expand its control over long rates by other means as well.

The power of the Fed does have limits. If official short-term interest rates fall, that does not mean that consumer rates will necessarily follow. Credit card interest rates, for example, may rise with the federal funds rate, but then not fall. In general, they are almost always very high. Other factors may thwart the Fed as well. For example, the stock market may fall just when the Open Market Committee wants to stimulate the economy. When stocks fall, stock owners feel poorer, and they spend less. Or the value of dollar may rise, which will reduce exports, and thus reduce employment opportunities.

Contrarily, the Fed may so strongly influence the stock and currency markets that they further amplify whatever the Fed is doing. In the 1990s and early 2000s in the US, stock and bond markets seemed to be much more concerned with likely Fed actions than with fundamental economic indicators. If economic growth statistics looked weak, the market tended to mark up stocks and mark down bonds, the opposite of what might be expected, because of anticipation that the Fed would ease, that is lower, short-term interest rates. If growth quickened, the market similarly tended to mark up bonds and mark down stocks, again the opposite of what would have been expected. The ability of the Fed to move markets has become increasingly important as the years have passed, because less and less business financing is done through banks, and more and more through markets.

The Fed has other "traditional" tools at its disposal besides the federal funds rate and open market operations, but rarely chooses to use them. It can raise or lower the loan reserve requirement for banks. It can raise or lower the discount rate, the interest rate charged banks that are too weak to borrow in securities markets and therefore come to the Fed as a "lender of last resort." It can change margin requirements, the amount of collateral demanded when customers borrow from brokers. But, in a world of derivative securities such as futures and options, speculators can generally get all the leverage they want, and impecunious plungers can often get it on exactly the same terms as powerful financial institutions.

The Fed's Mission

Congress has delegated control of money and banks to the Fed, and this broadly defines its mission. Beyond that, the picture is somewhat murky. Congressional debate leading up to the Federal Reserve Act of 1913 suggested that proponents of the new institution expected it to make the money supply elastic, that is, to ensure that the money supply grew at least as fast as the real economy, if not faster. The underlying theory, much disputed by "Austrian" economists in particular, is that an inelastic money supply will cause deflation, and deflation will hold the economy below its full potential. Another objective of proponents was to stabilize the banking system and prevent bank failures by providing both a regulator and "lender of last resort."

After the nineteenth century gold standard collapsed and paper (fiat) money became the norm, the idea arose that the Federal Reserve would guard against the issuance of excessive paper money, would keep currency from being too elastic, and would thus prevent inflation. Hopes were expressed that the governors of the Fed would operate in a more objective way than Congress, would put professional expertise above partisanship, and could be relied on to take a long, not a short, view of what was best for all Americans.

During World War Two, and to some extent during the Cold War that followed, it was assumed that the Fed's principal job was to finance the government that was protecting us from our enemies. In addition, in 1946 Congress passed a law making the government and the Fed responsible for maintaining "full" employment as well as keeping prices stable. The controversial Phillips Curve, developed by a disciple of Keynes, suggested that these goals were incompatible, that more employment must lead to rising prices, stable prices to less employment. A similar idea was contained in Milton Friedman's "NAIRU" (non-accelerating inflation rate of unemployment), which tried to identify a level of employment that is compatible with stable prices. These concepts have been hotly debated, but a majority of economists now agree that any incompatibility between employment and inflation goals only applies to the short-term, not to the long-term. So it all depends on how the Full Employment Act is interpreted.

What the Fed Watches

"Fed watching" is a thriving activity on Wall Street, but the Fed must also watch the economy. Since economy watching is a daunting task, it is essential to decide which data series matter most, which matter less.

The most useful series would have predictive power, would enable masters of the data to foretell the future. But this idea is no better than a fantasy. Statistics not only fail to forecast the future; they take time to gather and interpret and therefore cannot even describe the present, only the past. It is certainly better to know the past than to know nothing, although some series are so flawed or doubtful in their construction that they may be worse than nothing. The series to watch, their relevance, their construction—all of it is subject to intense debate and dispute.

If one is charged by law to foster employment but also to control inflation, as the Fed is, the obvious place to start would be with employment and inflation statistics. The most comprehensive series on employment, the payroll survey conducted by the government's Bureau of Labor Statistics, focuses on larger businesses and thus misses the smaller and new businesses where the greater portion of the new jobs are to be found. The much smaller household survey picks up all businesses, but the statistical sampling is limited. If one is interested in wage gains, the BLS also has data, but only on hourly workers, so the vast white collar sector of the labor market remains an unknown.

The BLS also produces the Consumer Price Index (CPI), the primary measure of inflation. The techniques used to construct the index are endlessly dissected and criticized. There are reasons to think it overstates inflation and other reasons to think it understates it, with the balance shifting from period to period. The Fed itself can influence the very measure it is watching, since, for example, lower interest rates can boost home sales, higher home sales can depress rents, and rents are used to define home costs in the index. An alternative to the CPI is the Personal Consumption Expenditure Deflator (PCED) produced by the Bureau of Economic Analysis.

Apart from inflation indexes, which are backward looking, the Fed can look at commodity prices (especially the kind of industrial commodity prices tracked by the Journal of Commerce [JOC] Index) and industrial capacity utilization. The underlying assumption is that economic growth in a period of low commodity prices, plenty of production capacity slack, and above average unemployment will be noninflationary, because it will not lead to a bidding up of production factors.

A few analysts look at one commodity, gold, because they believe its price tells them whether money supplies are too tight or loose, and thus the rate at which prices will change. The Fed can also derive inflation forecasts from the futures market, from a comparison of inflation adjusted bonds with other bonds, and from the shape of the yield curve, that is, from the relationship of bond prices and yields to each other as maturities lengthen.

Apart from consumer price inflation, there is also asset inflation to consider, as measured by stock, bond, commodity, and real estate assets. As we saw in a prior chapter, some economists and even some central bankers believe that asset bubbles are so destabilizing that monetary policy should be used to deflate or, even better, prevent them. But other central bankers demur, and say that monetary policy should confine itself to consumer prices or to some combination of consumer and currency prices.

Currency prices must be a dominant consideration for countries that borrow in currencies other than their own. The US (as the possessor of the premier reserve currency) has always borrowed in dollars, and has thus not had to worry about having to repay loans in a depreciated currency. Even so, some financial analysts have argued that the stability of the dollar abroad should be a primary goal along with stable consumer prices. In any case, the Fed must at least pay close attention to the balance of payments, because a payments surplus tends to import inflation from other countries while a payments deficit tends to import deflation. The reason for this is that a surplus balance of payments increases the money supply (more money is coming in than leaving) while a deficit decreases it (unless sellers finance the sales).

Assuming that stable consumer prices are desired, how should that be defined? If the target is zero percent inflation, might that not produce deflation as often as inflation, and is deflation not to be avoided at all cost? We will not reprise the arguments pro and con this position, but simply note that the US Fed since the 1930s has voiced a strong aversion to deflation, especially during the aftermath of the bubble of the 1990s. This in turn has led some Fed board members to want to target inflation, that is, to target no less than one, two, or three percent inflation in any given year, so that there will be a cushion against deflation. The European Central Bank has in fact adopted such a policy, and specified two percent inflation as the target. Economist Paul Krugman has suggested three to four percent.[278]

Critics respond that inflation targeting is contradictory, because it applauds productivity gains in industry, but responds to them by flooding the economy with new money to bring prices back up. Or, if certain economic sectors are lagging in productivity (e.g., healthcare, housing, education in the US), it underwrites their price increases by expanding the money supply.

Appendix H

Global Monetary Systems and Institutions

In most countries, the finance minister is nominally in charge of international finance including the all important price of the country's currency. In the United States, this means the secretary of the treasury. In reality, the chairman of the central bank has much more control over a currency's international price because the central bank can raise or lower interest rates (thus strengthening or weakening demand from foreign buyers) and also "print" more or less money (thus increasing or decreasing supply).

Even central banks, however, can only do so much. A central bank may try to control the price of money (actually the price of credit) as represented by interest rates or it may try to control the quantity of money. Alternatively, it may try to control the global price of the country's currency or the size of its global monetary reserves. But it is necessary to choose, because it is only possible to control one variable at a time.

As noted in the prior appendix, the US Federal Reserve has generally chosen to concentrate on domestic short-term interest rates and to raise or lower them for almost exclusively domestic reasons. In 1987, markets became persuaded that the Fed would make an exception and raise interest rates specifically to support the dollar. As a result, the US bond market, and then the US stock market, plunged, until it became clear that the Fed would not proceed further along those lines.

The global monetary system that forms the backdrop for all this is negotiated between leading countries. During the past century, systems have come and gone and generally not lasted for more than a generation or two. We will focus on different types of systems, the pros and cons of each, and will conclude with a word on global monetary institutions.

1. The Classic Gold Standard

Assume that gold is money or that any paper money can be redeemed on demand in gold. The dollar is defined as some fraction of an ounce of gold, the pound as some other fraction, and so on. In effect, there is one world currency although it is denominated in dollars, pounds, and other currencies.

If the United States imports more than it exports, gold will leave the country in payment. This might be offset if gold is flowing in for investment reasons. If not, the amount of gold (that is, money) will fall, and as gold (money) becomes scarcer, interest rates will tend to rise. As interest rates rise, economic activity will tend to fall. As economic activity falls, so will imports. At some point, gold (money) flows into and out of the country will again match and a working equilibrium will be restored. Similarly, if banks create too much credit (and thereby expand the money supply and reduce interest rates), gold will flow out of the country seeking higher rates. This will reduce the money supply, raise rates, and restore a working equilibrium. We will now consider arguments for and against a classic gold standard.

For Classic Gold Standard:

The great advantage is that the system is self-correcting: governments find it hard to manipulate. Economic downturns may be sharp, but are usually short-lived. Prices and interest rates may also rise and fall but tend to be stable over the long run. In some respects, this system makes life easier for developing countries, because a universal currency means that entrepreneurs are not saddled with uncertain local currencies and local currency debts as they are today.

For or Against, Depending on One's Viewpoint:

The money supply can only be increased by finding and processing new gold. Governments cannot expand or manage it.

Against Classic Gold Standard:

Countries with gold reserves and mining potential are unduly favored.

2. The Gold Exchange System

This system prevailed in various forms from the end of World War One to August 1971. After World War Two, it was known as Bretton Woods (for the conference site where its terms were negotiated by Harry Dexter White, representing the US, Lord Keynes, representing Britain, and others).

Under Bretton Woods, the value of the US dollar was fixed in relation to gold. (In technical jargon, gold was the numeraire and a dollar the unit of quotation.) All other currencies were fixed (pegged) relative to the dollar, although subject to revaluation by their respective governments. Central banks would keep reserves of gold and dollars, and could demand at any time that the US buy back the dollars in exchange for gold at the fixed rate. The pros and cons of this system were hotly debated while it lasted.

For Gold Exchange Standard:

This arrangement recognized the unique role of the dollar as a kind of international currency, one that had become the world contract standard, the major settlement currency, the pricing instrument for global commodities such as oil, the major bank clearing and travelers' currency, the main refuge for people afraid to hold their local money, and so on.

For or Against, Depending on One's Viewpoint:

The arrangement allowed monetary authorities to expand world currencies indefinitely on a fixed base of gold. In theory, the US would not over-expand its currency, thereby exporting inflation to the world, because other countries could stop it by demanding gold for dollars. Since the amount of outstanding dollars was far larger than the American gold reserves, a drain of gold would eventually force the US to stop printing money.

Against Gold Exchange Standard:

In practice, other countries were very reluctant to demand gold, because this meant that their currencies would become "sounder" than the dollar, that is, would appreciate relative to the dollar. This would not only reduce the value of their considerable dollar reserves. It would also make their goods harder to sell abroad, which would in turn increase domestic unemployment, which might lead disgruntled voters to throw out governments. Eventually France under President de Gaulle demanded gold in the early 1970s. The US eventually refused to comply and the Bretton Woods system collapsed.

For Gold Exchange Standard:

It is sometimes argued that the world's finance ministers should have prevented the collapse of Bretton Woods by the simple expedient of accepting a French proposal to devalue the dollar relative to gold. At the time, each dollar's value was fixed at 1/35 an ounce of gold (an ounce of gold was valued at $35). If the value of gold had been set at, hypothetically, $70 an ounce by international agreement, the US would then have been able to continue exchanging gold for dollars whenever demanded by foreign central banks.

Against Gold Exchange Standard:

At the time, it was objected that this re-valuation of the dollar against gold would humiliate the US and reward France for its "trouble-making," since France had large gold reserves. France replied that the US had been the trouble-maker by printing too many dollars, importing far more than exporting, and generally not living up to its obligations as the reserve currency country. Apart from concern about "rewarding" France, there was also opposition to "rewarding" the Soviet Union and South Africa, two large gold producers, by increasing the value of gold in dollars.

3. Floating Rates

During the 1950s and 1960s, economist Milton Friedman criticized the fixed rate Bretton Woods system and proposed that currencies should be bought and sold on a free market basis. This suggestion was dismissed as impractical. But when Bretton Woods collapsed and negotiations to repair or replace it with another fixed rate system failed, floating rates came into being (in June 1973) more or less by default.

The float was never "clean," that is, governments continually intervened by buying or selling currencies in order to manipulate their prices. But there was a widely shared presumption in the early years that currency markets were getting too big for government interventions to continue, that markets would therefore become "less dirty" over time. As Steve Forbes, editor of *Forbes Magazine*, put it in 1992, "Today, thanks to high technology, . . . [private money] traded over computer lines will overwhelm any resources governments can muster. Democracy is coming to international finance."[279]

As it turned out, this presumption proved to be incorrect: the float became ever "dirtier." In any case, we will consider the pros and cons of a "clean" free market in currencies.

For Floating Rates:

If the chief purpose of prices in an economy, in this instance the world economy, is to convey information about supply and demand, then nothing accomplishes this better than a free market. In addition, the transparency of a free market makes it more difficult for governments to intervene, i.e. to distort prices for political reasons.

Against Floating Rates:

Floating rates create unnecessary complication and uncertainty for business owners and managers. Unanticipated currency swings may be large enough to wipe out anticipated profits on an investment or for a year of operation. In a survey of chief executive officers of the world's 1400 largest companies, currency instability was cited as the third highest concern, right behind global competition and over-regulation.[280] Companies do employ a variety of marketable financial hedges to reduce currency uncertainty, but the hedges, like all financial transactions, cost money.

The case against floating currencies was summarized by Robert Kuttner, then economics correspondent for the *New Republic*: "A market system needs a stable stage on which to play."[281]

Robert Bartley, generally regarded as an individual of the Right in politics, unlike Kuttner, who is regarded as of the Left, agreed, "What the world economy needs is the monetary stability that allows free markets to work."[282]

For Floating Rates:

According to this viewpoint, both Kuttner and Bartley are wrong. Marxists have traditionally argued that free markets of all kinds are needlessly complicated, inefficient, costly, duplicative, and so on. After the collapse of Communism, the world generally recognized that free markets are more, not less, efficient, whatever their costs. The idea that free markets are better, but that they somehow require unfree currency markets as a foundation is completely illogical. Currencies represent prices, critically important prices, and prices cannot do their job of communicating information and organizing production if fettered and distorted.

It may sound persuasive to say, along with Steve Forbes, a defender of Bartley, that, "Changes in the value of money are just as disruptive as changes in the number of inches in a foot or minutes in an hour would be."[283]

It is true that time, distance, and price are all measurements. But time and distance measurements are logical and helpful only if inert, while prices are logical and helpful only if allowed to change freely. Currency cartels and price controls, like other cartels and price controls, are economically destructive.

Against Floating Rates:

As we have noted, the classic gold standard provided automatic remedies for a situation where a country's banking system created too much credit (and thereby artificially expanded the money supply and reduced interest rates) or where a country was importing too much relative to exports without offsetting capital flows. A floating exchange rate system also provides remedies, but they are not automatic and can be easily thwarted by government action.

In theory, if the US "prints" too many dollars and inflation results, international currency buyers will push down the value of a dollar to ensure that a pound of copper (or something else) costs the same whether bought in dollars, pounds, or other currencies. This is called the purchasing power parity theory. It might work quite efficiently if we only used world markets to buy or sell goods or services. In reality, however, we also use world markets to buy and sell currencies, bonds, stocks, and other investments. These financial flows tend to swamp the volume of trade in goods, and in the process swamp purchasing power parity.

It is also unrealistic to expect free markets to discipline governments that mismanage their currencies, because so many factors enter into currency valuations. The answer to the question: what makes floating currencies rise or fall?—is a very complicated one. In the long run, free currency prices, like other free prices, simply reflect people's subjective valuations. But all else being equal, one would expect a strong currency country to:

- not inflate its domestic prices
- not import more than it exports, thereby avoiding a deficit in its trade account (relating to goods) or current account (relating to goods, agricultural products, services, foreign investment income, corporate profits earned abroad and repatriated, et al.)
- borrow overseas from private investors rather than from governments or central banks consistently grow its economy
- save and invest a good share of its earnings
- become more and more productive (high productivity growth)
- offer higher real (inflation adjusted) interest rates than other countries
- promise political stability
- display military strength, or other assurances of national security etc.

In real life, countries tend at any given time to have some of these factors working for them and some against them, and markets will weigh the factors differently depending on circumstances and perceptions. Even factors that seem positive for a currency may, on closer inspection, prove to be equivocal. For example, expectation of strong economic growth typically strengthens demand for a currency. But growth increases imports, which negatively affect the trade balance, which may weaken currency demand. Whether economic growth has increased currency demand on balance at a given moment can only be a matter of conjecture.

When governments step into this complicated picture and start misbehaving (for example by "printing" too much of their currency), markets may react with a wave of selling. But, then again, they may not. Consequently, floating rates may or may not enforce financial discipline.

It is especially difficult to enforce discipline on a reserve currency country such as the US, because that country can always borrow in its own currency. Non-reserve countries more often than not must borrow in other, "stronger" currencies. If their own money falls in value relative to the borrowed currency, the real cost of the loan increases, sometimes dramatically. This is an inducement to arrange the nation's financial affairs in a manner designed to keep debt manageable, but it can also be a recipe for dire and unnecessary economic suffering.

4. One World Money

At various times, during the Bretton Woods negotiations and especially after the collapse of Bretton Woods, there have been proposals for a single world money other than gold, that is, for a world fiat (paper) currency. This money would presumably be issued by a designated global institution such as the International Monetary Fund and would either exist along with national monies or eventually replace them.

For One World Money:

Most of the arguments against a floating rate system are arguments for a single world money. As Robert Bartley, echoing economist Robert Mundell, has concluded, "Ideally, the [global] economy ought to have one money, with one central bank, perhaps. [In the meantime], a system of truly fixed exchange rates would simulate a world money. . . ."[284]

Against One World Money:

This is not possible. Even if it were possible and eventually adopted, political considerations would swamp economic ones, with ruinous results. A world monetary authority would never be independent of global politics, its decisions would be thought to favor some nations at the expense of others, and the system could not last.

Most importantly, the main restraint on a country's desire to "print" ever more money is concern about what this will do to the value of its currency. A world central bank would have no such worries, would "print" and inflate beyond all bounds, and would ultimately bring the world economy down.

5. Dollarization

An alternative to adopting a new world currency would be for everyone to agree on the use of an existing currency. In the past, this has usually meant dollarization.

Dollarization in turn may take a variety of forms. A country other than the United States may simply adopt the dollar as its currency. Or, it may:

- promise to exchange its local currency for a dollar whenever demanded
- disband its central bank and adopt a "currency board" charged with issuing currency when and only when a dollar is available in reserve to meet an exchange demand
- peg its currency to the dollar and take whatever steps are necessary to support the peg.

All of these approaches have been tried by various countries and have given rise to intense debate among economists.

For Dollarization:

Economist Steve H. Hanke has strongly favored currency boards and full dollarization for many countries as a way to avoid the tendency of governments and central banks to "print" money and inflate with abandon.

Against Dollarization:

Milton Friedman, the "father" of floating rates, just as intensely opposes pegs, currency boards, and dollarization. He believes that they are both ineffective (conditions vary too much among countries) and unrealistic (countries will not give up their sovereignty to the US Federal Reserve Bank).

6. Managed Floating Rates

As we have noted, floating global currency rates have been ever more tightly managed by governments since their formal inception in 1973. Intervention often takes the direct form of buying and selling currency on the open market. Alternatively, it may take the form of fiscal or monetary policies designed to influence foreign exchange buyers and sellers.

Proponents of management do not necessarily agree on how it should be done. One debate is whether leading countries should try to cooperate and coordinate their interventions or should separately pursue their national interest as they see it. In the 1980s, governments generally assumed that coordination was desirable and tried to negotiate guidelines in the so-called Louvre Accord. Unfortunately, the Accord skirted the touchy issue of what individual countries would do when markets drifted away from agreed-upon parities. Before long, a much-publicized spat developed between the US secretary of the treasury and the German finance minister, a spat that roiled world financial markets and ended the British chancellor of the exchequer's hope of establishing, "A more permanent regime of managed floating."[285]

An even more intense debate concerns whether or not currency "managers" should aim for a stable currency.

Stability in this context may mean over time, against a basket of other currencies, against gold, or some other measure. A very different approach is to aim for the lowest possible currency price as a way of reducing the price of export goods and thus stimulating foreign sales and domestic employment. A deliberate attempt, covert or overt, to reduce one's currency price is usually referred to as devaluation.

For and Against Devaluation:

Politicians who support devaluation may simply want to win votes and stay in office. But they may also sincerely believe that the best way to bolster flagging economic demand is to devalue the currency. Of course, if all countries are intent on managing their currencies down in order to boost exports, no one country is likely to benefit from this particular maneuver. In economic jargon it becomes a zero-sum game.

Another complication is that devaluation does not stimulate domestic employment at once. When a currency price falls, imports become more expensive immediately, which raises costs for everyone (including exporters), while exports become less valuable, which initially creates a more negative trade balance.

What happens thereafter is uncertain. Proponents of devaluation say that there is a J curve: export income and employment will decline for a short while, then rise steeply as volume increases. Others say no: the J curve is a fiction. As the price of imports rises, other domestic prices will rise with them. In the blink of an eye, the revenue gains from additional exports will be offset by more domestic inflation. Real (inflation adjusted) national income will not improve.

To make matters worse, as opponents of the J curve tell it, the inflation arrives quickly; the export volume gains may take as long as several years to follow. In the meantime, liquid international capital will not be happy with the devaluation, and will have taken flight to other, more reliable shores, leaving behind capital scarcity and higher interest rates. Although exchange controls have been used by some governments to prevent capital flight, either domestic or international, they further alienate investors and may jeopardize foreign investment for a long time.

The classical arguments against devaluation are hotly disputed, especially by the staff of the International Monetary Fund, which has often prescribed lower currency prices for failing third world economies. But as Paul Volcker, former US Fed chairman, has noted, "A depreciating currency ordinarily means that imports cost more and the exports earn less foreign currency. In other words, the nation is poorer, not richer, and that's not something to jump with joy about."[286]

To which Morgan Stanley chief economist Steve Roach adds, "I have looked at economic history back to the Babylonian era, and there has never been a country that has prospered on the back of a weak currency."[287]

To some degree, of course, terms such as devaluation and weak currency are in the eye of the beholder. If a government intervenes to slow or block the appreciation of its currency, that is technically not a devaluation. Indeed, it could be called an effort at stabilization. But if not a devaluation in name, it is still a devaluation in spirit. In either case, the motives are similar: a desire to maintain or grow employment through export.

Throughout the post-World War Two period Japan followed the managed currency path, first refusing to float its currency, then controlling its rise. China subsequently followed suit, long maintaining a peg to the dollar despite mounting pressures to acknowledge its economic success by revaluing upward. These two countries, together with the United States, for many years around the turn of the 21st century formed a de facto managed currency bloc or cartel that was sometimes loosely referred to as "Bretton Woods II."

Global Monetary Institutions

Although the choice of a monetary system lies at the heart of global economics, other, collateral issues are almost as critical. In particular, there is the question of who or what should oversee a global monetary system.

Bretton Woods established two new global institutions, the World Bank and the International Monetary Fund. The former was intended to raise money among rich nations and lend it for development purposes to the governments of poor nations. The latter was meant to assist world finance ministers, support the currency exchange system, and, among other duties, provide member states with temporary reserve financing if they were experiencing balance of payments difficulties (more money leaving the country than entering). We will briefly consider the pros and cons for each.

7. World Bank

For:

This internationalizes at least a portion of foreign aid to poor countries, provides below market loan rates, and is meant to help overcome world poverty.

Against:

Because World Bank loans are made to governments rather than private entrepreneurs, they are often invested unwisely. Sometimes the money has flowed into "show projects" such as unneeded steel mills; or it has fallen into a maw of corruption and ended up in government officials' personal off-shore bank accounts. The World Bank's affiliate, the International Finance Corporation, does make a much smaller amount of loans to parties other than governments.

8. International Monetary Fund (IMF or "the Fund")

For:

By withholding financial assistance, the IMF can often persuade the most profligate and recalcitrant governments to stop spending and accept financial discipline. When countries or central banks run into trouble through no fault of their own, the IMF can act as a "lender of last resort," thereby providing liquidity and helping to stabilize world markets. As former World Bank chief economist, US treasury secretary, and Harvard president Lawrence Summers has said of both the Bank and the Fund, "It would be hard to devise better institutions than these to raise capital to transfer from the richer countries to the poorer countries and to allocate that capital effectively."[288]

Against:

One group of critics holds the IMF to be the agent of a predatory global capitalism, forcing countries to open themselves up to international exploitation in return for loans and rescue packages. A variant idea is that it is a tool of international banks. In his book, *Globalization and Its Discontents*, economist Joseph Stiglitz, a former chief economist of the World Bank, registers a related complaint that the IMF clings to an "Outworn presumption that markets, by themselves, lead to efficient outcomes."[289]

Stiglitz would like to see governance reform to reduce the influence of the rich nations in the leadership of the Fund, increase the influence of poor, especially African nations, promote an emphasis on social justice and redistributive taxation, and stop relying on what he regards as "trickle down" from the rich to help the poor.

This notion of the IMF as a tool of world capitalism is not shared by advocates of free markets. They tend to be equally critical of the Fund, although for entirely different reasons, and charge that it:

- represents an outmoded ideology of central planning
- always demands sharp tax increases of governments, no matter what the problem is, even if tax rates are already insanely high, too high to be collectible
- generally recommends currency devaluation and other "beggar-thy-neighbor" policies, even though these kind of policies always backfire, as they did during the Great Depression
- foolishly condones price controls and other unworkable ideas
- promotes speculation and financial misbehavior by offering a "safety net" to failing regimes and speculators (another example of "moral hazard").

According to this line of thought, the Fund preaches government "responsibility" and "austerity," but ends up creating austerity only for the poor. In any case, as economist Wilhelm Röpke, a champion of free markets, has observed:

> Austerity is bad economics and a false calculation, because it works against people's willingness to work and to save, both so necessary today. But then, this glum philosophy is tailor-made for all planners, collectivists, and "commissars." It gives them an occupation, power, and importance.[290]

Mikhail Gorbachev, the last leader of the Soviet Union, said about the IMF's prescriptions for his country in 1992, "[The IMF program] reminds me of a form of neo-Bolshevism. . . . Stalin [also] . . . invented an artificial model and wanted to impose it on 300 million people."[291]

Economist Milton Friedman, ideologically far removed from Gorbachev, has recommended that, "The IMF be abolished."[292]

Appendix I

Summary Outline of *Are the Rich Necessary?*

Part One: The Central Economic Problem

1. Why Are We Still So Poor?

- Humanity should be rich, but has remained poor because savings have been continually stolen or squandered. Moreover, we keep quarreling about how we might best cooperate.

2. The Appeal of Science

- If economics could be made into a science, it would help us settle the quarrels. But there are reasons why this is not possible.

3. Economic Arguments

- Economics is primarily a form of valuation. As such, it reflects our personal values. We form and express our values by debating them, and this book presents a series of economic debates.

Part Two: The Rich

4. Are the Rich Necessary?—No

- The rich are essentially parasites.
- Wealth causes poverty, without rich people there would be no poor people.
- The problem is not simply that very rich people do not share adequately with the poor. The larger problem is that the rich steal from or exploit the poor, that, as Proudhon said, "property is theft."

5. Are the Rich Necessary?—Yes

- Our economy needs rich people precisely because they are rich.
- There cannot be too much saving if it is invested properly.
- The rich have vital work to do too, and if they shirk it or do it badly, they will lose their money.

- The charge that the rich can only make others richer through a "trickle-down" process is false.
- What would actually happen if the government decided to seize rich people's assets entirely in order to give them to the poor?

Part Three: The Rich in a Democracy

6. Are the Rich Compatible with Democracy?—No

- The rich stand in the way of democracy and often intentionally thwart it.
- We need complete democracy.

7. Are the Rich Compatible with Democracy?—Yes

- Free market arrangements are more democratic than they at first appear.
- To describe rich people as "bosses" is incorrect.
- The acid test for the idea of the business leader as servant is that there must be downward as well as upward mobility. The consumer must be able to give, but also to take away.
- The free market democratic system of one dollar, one vote is actually superior to the political democratic system of one person, one vote. In the final analysis, it is more democratic.

Part Four: Profit-making

8. Are Private Profits Necessary?—No

- Private enterprise pits owners and workers against each other in a ceaseless struggle, a struggle that is ultimately self-defeating for everyone.
- The profit system is inherently inefficient.
- Quite apart from its injustice and inefficiency, the profit system does not give us the goods that we need.
- Even when the profit system produces the right goods, it denies them to those who need them the most, the poor.

9. Are Private Profits Necessary?—Yes

- Prices and profits work together as an indispensable signaling device.
- Profits are also indispensable as a system of positive and negative incentives that are objectively scored.
- At first glance, it might seem that the profit system just produces what rich people want, not what the greater number of people need. But this is wrong.
- It is also understandable that many people think of profits as "stolen" from workers. After all, do not workers' wages come out of

the "skin" of owners and vice versa? Is this not a classic example of a "zero-sum game"? Surprisingly, the answer is no.

- Raising pay in one company will not increase the overall share of "Labor."
- Employee business ownership creates more problems than it solves.
- The kind of macroeconomics commonly taught in schools is misleading: it does not adequately acknowledge the role of profits.

10. Are Private Profits Necessary?—No/Yes

- Profit-driven change is irrational and disorderly.
- **Response**: A price and profit system gives us order, not chaos.

- The pot-of-gold-at-the-end-of-the-rainbow atmosphere of the profit system, with its uncertain, excessive, and largely undeserved rewards, encourages business owners to adopt a short-term, grab it and flee mentality.
- **Response**: On the contrary, the profit system encourages, even demands, a long-term commitment.

- Economic growth requires cooperation. The profit system encourages cutthroat, dog-eat-dog competition, which is the opposite of cooperation.

- **Response**: The profit system both encourages cooperation and channels aggressive tendencies into useful pursuits.

Part Five: Glaring Inequality

11. Are There Alternatives to the Profit System?—Yes/No

- Putting aside purely economic considerations, living with others on a share and share alike basis is simply a better way to live.
- **Response**: Small-scale egalitarian communities are better than a state-run collectivity, but are nevertheless impractical and self-defeating.

12. Should We Accept This Degree of Inequality?—No/Yes

- Income inequality is unjust, and uncharitable. No one should accept it with a clear conscience. The sooner and the closer we can get to equality the better.
- **Response**: Personal incomes are in no sense arbitrary. They are determined by supply and demand, which is a fair and reliable way to evaluate our contributions.

- Milton Friedman's assertion that the development of free markets has reduced inequality, and thus helped the poor, is equivalent to saying that inequality reduces inequality. It is nonsensical.

- **Response**: No, the poor especially benefit from economic growth.
- **Response**: Even if wealth-sharing programs slowed economic growth, we should balance the claims of growth and equity.
- **Response**: If you want economic growth, economic policies per se will not give it to you. Only businessmen and businesswomen can give it to you, and it does not help to undermine and de-motivate them.
- **Response**: Inequality is in fact increasing at an alarming rate.
- **Response**: Global inequality seems to be decreasing. It may be temporarily increasing within developed countries because of the global shifts, but it is hard to say. The data are flawed.

Part Six: Greed

13. Does the Profit System Glorify Greed?—Yes

- Private markets are indeed grounded in selfishness and greed and are thus inherently immoral.

14. Does the Profit System Glorify Greed?—Yes, and a Good Thing

- "Greed is good."

15. Does the Profit System Glorify Greed?—No

- Whether one disapproves or approves of greed, it is quite erroneous to think that markets encourage it. Markets are just technical, and thus morally neutral, mechanisms for human exchange.
- No, the market is not morally neutral, it does express an ethical principle, and that principle is certainly not greed. It is instead rational self-interest, something quite different from greed, and this is by far the best principle on which to organize a society.
- The private market is grounded neither in greed nor in self-interest, but rather in cooperative unselfishness. Adam Smith made a mistake in thinking otherwise, and his mistake has been perpetuated.

Part Seven: Government

16. Can Government Protect Us From the Excesses of the Profit System?—Yes

- A private profit-making economy without government regulation is unbearable.

- Protecting workers is only the beginning of what the community, acting through government, must do.

17. Can Government Protect Us From the Excesses of the Profit System?—No

- Government is not synonymous with community. Like other institutions, it looks upon the world through the lens of self-interest. And because it enjoys a monopoly of coercive force, it has the potential to be the worst predator of all.
- Government is also corrupt.
- A government that is neither predatory nor corrupt can be of immense help to an economy.

Part Eight: Profit-making and Depressions

18. Does the Profit System Cause Depressions?—Yes/No

- The blind selfishness of profit-driven markets is incompatible with employment stability.
- **Response**: The opposite is true.

- Profit-driven economies are inherently prone to depression because workers as a group are not paid enough to be able to afford to buy what they make.

- **Response**: This is false. A business owner who underpays will take the gains and either reinvest them in the economy, to be earned by other workers, or buy luxury goods, which must also be produced by other workers, or pay dividends to other shareholders, who will also either invest or buy. So long as the money is circulating in this way, there should be no failure of demand.

- To achieve employment stability, we need stable prices in our economy. The profit system gives us erratic prices, occasionally stable, but more often rising (inflation) or falling (deflation). Falling prices in particular are a primary cause of depressions.
- **Response**: Prices have nothing in common with weights and distances. We should not want them to be stable. On the contrary, we should want them to fall. Falling prices mean that we can all afford to buy more with the same amount of income. Falling prices are what the market system should be all about, i.e. making people better off as each year passes.
- **Response**: No, falling prices are deadly. If sharp falls in prices could be matched

by sharp falls in wages, then, yes, markets might be able to pull themselves out of depressions on their own. But this is completely unrealistic. Modern workers will not, under any circumstances, accept lower wages. If prices fall dramatically, wages will not fall, profits will collapse, massive unemployment will follow, and depression will persist indefinitely. The best way to keep prices from falling, and thus avert or cure depression, is for the government to increase the money supply by "printing" more money.

- **Response**: Pouring new money into the economy is not the answer. Adjusting wages and other interconnected prices is.

- Keynes was partly right. Government should try to stop a recession from turning into a depression. The best way to do this is to "print" large quantities of new money to prevent prices from falling. It is wrong, however, to recommend monetary stimulus during normal times. In general, the "holy grail" of monetary policy should always be stable prices. (This particular economic advice comes from Milton Friedman and the monetarists.)
- **Response**: Monetarists are inconsistent in their stance toward government. As avowed

free-marketers, they are supposed to be suspicious of government interventions in the economy. Yet Friedman and other monetarists want government to intervene deeply into the economy if deflation threatens and to "print" as much new money as it takes to keep prices from falling.

What to do then during stagflation, when the economy is in a slump and prices are still rising? Keynesians and monetarists disagree. Monetarists would decrease the money supply, while Keynesians would ease monetary policy and cut government spending.

- Supply-side economists think that both Keynesians and monetarists are wrong. They think the remedy for stagflation is tight monetary policy along with easy fiscal policy, i.e., budget deficits. But they agree on the desirability of loose monetary policy to fix a slump without inflation.
- **Response**: There is something perverse about the Keynesian/monetarist/supply-side policy synthesis framework. It is all about using government policy interventions, especially "easy money," to fix a slump. But trying to cure an economic slump caused by easy money with even easier money is like trying to cure a hangover with more alcohol.

- **Response**: It does indeed make sense for government to intervene at the beginning of a slump and to "pour" more money into the economy at that time. It makes sense because this new money can be "drained out" again as soon as the economy recovers.
- **Response**: The idea that government planners will know when to inject or withdraw money and credit is completely fallacious.
- **Response**: Our real objective should be to avoid a slump in the first place. The solution to a faltering boom is never higher or even stable interest rates. It is, on the contrary, lower rates. Lower rates will promote more investment, and more investment will promote more employment.
- **Response**: Keynesian "easy money" policies are not a sustainable solution. The economy becomes so addicted to "easy money" that any interruption, even a tapering off in the growth rate, provokes a crisis. Prices, especially interest rates, provide the all important signals that make economies work. When government intervenes and manipulates these prices, almost always driving them down to "stimulate the economy," market participants can no longer get the information they need to make rational decisions, with the result that the system increasingly fails.

Apart from the perverseness of active monetary intervention, there are other reasons to be suspicious of it. The government injects new money into the economy in a stealthy manner, rather than simply printing new money.

Part Nine: Central Banks

19. Can Central Banks Protect Us from Depressions and Lead the Economy?—Yes

- Without a central bank, there would be no way to control the dangerous excesses of the banking system and otherwise keep the economy on a steady course.

20. Can Central Banks Protect Us from Depressions and Lead the Economy?—No

- The record of the US Federal Reserve has been poor. The country did better before its founding. This should not be surprising. Price-fixing is especially toxic for an economy, and central banks are basically price-fixers. In general, central banks are national economic planners, and national economic planning does not work.

Part Ten: The Global Profit System

21. Does Global Free Trade Destroy Jobs?—Yes

- Free trade destroys jobs, especially good, high paying jobs.
- Left to itself, unrestrained free world trade produces a "race to the bottom" for labor and environmental standards.
- Free trade is ultimately about exploitation.

22. Does Global Free Trade Destroy Jobs?—No

- Free trade produces more and better jobs.
- Global markets are not trashing labor and environmental standards.
- Global free trade is not at all about exploitation.

Part Eleven: Four Economic Value Systems

23. Competing Economic Value Systems

- Economic ideals and related value systems may be grouped under four broad headings: fraternalism, reciprocalism, equalitarianism, and philanthropism. The four types of economic value systems appear and reappear in history. Fraternalism tends to dominate, but all have their passionate proponents.

Part Twelve: Reconciling Opposing Viewpoints

24. Expanding the Nonprofit Sector

- A major expansion of the charitable (nonprofit) sector through tax credits offers a way forward out of the old, bitter, and often sterile quarrels between friends and foes of "big" government around the world.

Appendix A

What is a Fair Price?

- The answer will surprise most people.

Appendix B

What Exactly Are Profits?

- Current definitions are misleading and measurements inaccurate.

Appendix C

What Makes Prices Unstable?

- Greed alone cannot raise prices. Another common idea about inflation is that it is caused by economic "overheating." There is something quite wrong with this logic. Another explanation of inflation is offered by critics of government "intervention" in the economy. Government intervenes in certain industries, notably health care, education, and housing, to ensure that everyone has access. The initial method is to provide financial subsidies. Because these subsidies tend to increase demand without increasing supply, prices rise, so that access is actually restricted rather than improved.

- Milton Friedman famously said that, "Inflation is always and everywhere a monetary phenomenon." Inflation may come from any of three sources: demand, supply, or government engineered money supply changes. But, very often, money does lie at the root of the problem. We must also keep in mind that a change in the quantity of money, as important as it may be, is really less important than people's expectations about where the quantity of money is headed. Friedman's "quantity theory of money" does not turn out to be a reliable tool for forecasting or controlling inflation.

Appendix D

The "Austrian" Theory of Economic Instability

- All banks are technically "insolvent" all the time, because they never keep enough money in their vaults to meet their promise to repay depositors on demand. Building free markets on a foundation of banks that are in some sense "insolvent" all the time is clearly a chancy undertaking. An effort to require banks to maintain 100% reserves against all deposits failed in British courts in 1811 and 1816.
- A fractional reserve bank can "print" new money and thus expand the money supply. In effect, then, the government can print new money on its printing presses. Or government may indirectly "print" money by inducing banks to lend more. The upshot of this is that fractional reserve banking introduces a money supply that may fluctuate sharply.

Keeping Prices Honest

- The continual pouring of new money into the economy and draining of old money out of the economy (mostly the former) by governments and government influenced banks takes an unstable situation and makes it far worse by misleading and deranging the price system. Money supply fluctuations through bank credit especially distort the single most important price in the economy: the price of money itself as reflected in interest rates. Manipulating and distorting interest rates is bad enough. But governments also manipulate and distort international currency prices.

The Boom/Bust Cycle

- Pouring in new money, reducing interest rates, and confusing the price system may produce a temporary boom, but it will sow the seeds of its own destruction. When easy money and credit lead directly to hyper-inflation, governments may finally be forced to stop. However, there are times when easy money and credit are partially offset by deflationary factors such as productivity gains or cheap imports. In this case, inflation is masked and larger and larger economic bubbles inflate.

Laissez-faire Redux

- Two conditions must be met for a real recovery to take place. First, the mistakes of the past must be liquidated. Second, prices (including wages) must fall until they are again in approximate balance with the amount of money in circulation. Government intervention will thwart both liquidation and flexible prices. Whatever government does, the bottom line is that government intervention cannot cure business cycles, because it has caused them in the first place.

Keynes Redux

- Deep-dyed Keynesians, new or old, are especially appalled by the heretical Austrian idea that the seeds of an economic bust may be found in the preceding boom. In their view, booms are good; they do not lead to malinvestment. Both Keynesians and monetarists deny any suggestion that the Federal Reserve set in motion events that led to the Great Depression by "printing" too many dollars during the 1920s boom. This underscores Mundell's comment that, "[So many] years after its beginning, there is no general agreement on the causes of the [G]reat [D]epression."

Appendix E

Did the US Congress Trigger the Stock Market Bubble of the Late 1990s?

- Again, the answer will surprise most people, especially members of Congress.

Appendix F

Other (Non-Monetary) Theories of the Business Cycle

- The business cycle theories reviewed in the body of the book are all monetary in nature. But there are non-monetary theories as well, theories that either complement or contradict the monetary approach. Theory A: The business cycle reflects human nature. Theory B: The business cycle reflects not only human nature, but also the moral failings of the market system. Whenever government lets down its regulatory guard, business owners run amok. Theory C: Business cycles are not any one thing, but reflect a great variety of possible causes. Theory D: Business cycles are caused by the ebb and flow of new technology and other innovation.

Appendix G

The US Federal Reserve System

- In monetary theories of the business cycle, whether Keynesian, monetarist, supply side, or Austrian, central banks play a dominant role. It is vitally important to understand how they work, and the best way to do that is to look at the operations of a particular central bank, in this instance the US Federal Reserve.

Appendix H

Global Monetary Systems and Institutions

- The global monetary system is negotiated between leading countries and tends not to last for more than a generation or two. We focus on different types of systems, the pros and cons of each, and conclude with a word on global monetary institutions.

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