the
Freeman
VOL. 35, NO. 8 • AUGUST 1985

Anyone wishing to communicate with authors may send first-class mail in care of THE FREEMAN for forwarding.

the Freeman

A MONTHLY JOURNAL OF IDEAS ON LIBERTY

FOUNDATION FOR ECONOMIC EDUCATION

Irvington-on-Hudson, N.Y. 10533 Tel: (914) 591-7230

THE FREEMAN is published monthly by the Foundation for Economic Education, Inc., a nonpolitical, nonprofit, educational champion of private property, the free market, the profit and loss system, and limited government.

The costs of Foundation projects and services are met through donations. Total expenses average $18.00 a year per person on the mailing list. Donations are invited in any amount. THE FREEMAN is available to any interested person in the United States for the asking. For foreign delivery, a donation is required sufficient to cover direct mailing cost of $10.00 a year.

Additional copies, postpaid: single copy $1.00; 10 or more, 50 cents each.

THE FREEMAN is available on microfilm from University Microfilms International, 300 North Zeeb Road, Ann Arbor, Mich. 48106.

Reprints are available of "A Page on Freedom," small quantities, no charge; 100 or more, 5 cents each.

Is It Fair?

MANY think we can decide fairness by looking at how things are. We can't. Fairness depends on how they got that way.

Advocates of a faulty doctrine called "comparable worth" say it is unfair that women in certain jobs are paid less than men in other jobs these advocates deem equally valuable. Some American auto makers say it is unfair that the Japanese can sell their cars for less than American counterparts. Advocates of income redistribution say it is unfair for wealthy people to accumulate more wealth than others.

But these inequalities are not necessarily unfair. They *might* be, of course. Suppose the women are paid less because the men have a union which forces employers (through violent strikes) to pay them above-market wages. That would be unfair. Or suppose the Japanese can sell their cars for less because the U.S. government imposes quotas on the number of American cars sold. That would be unfair. Suppose wealthy people receive more income than others because the government gives them other people's money. That, too, would be unfair. Each of these situations would be unfair—not because of their inequality, but because *they occur through force.*

On the other hand, if the wages are freely negotiated and agreed upon, if Japanese cars sell cheaper because Japanese auto workers produce more for less pay, if the rich make their money by providing a desired product at an affordable price, all is fair no matter how unequal. We might not choose those outcomes, but they are fair.

Process determines fairness—fair process, fair outcome. If a process involves force and legal privilege, its outcome is unfair, though equality itself. But as long as a process is free and peaceful, its outcome is fair.

This is why the market process—free, peaceful exchange—embodies economic justice.

—*Howard Baetjer Jr.*

John Davenport

The Anti-Apartheid Threat

ACCORDING TO LENIN the road to the communization of Europe lay through the heart of Africa. Today this dictum could be amended and sharpened. The road to destabilizing Africa's major economy, namely South Africa itself, and cutting it off from the West lies straight through the financial markets of Wall Street, the American universities, and the halls of Congress.

The spearhead of this attack on South Africa is the anti-apartheid lobby which aims to strike down all customs and laws making for the separation of the races. To this end liberals and communists demonstrate outside the South African Embassy in Washington and its consulates throughout America. Excited students parade across our campuses to force trustees to sell off South African securities. Meanwhile, Congress strongly favors legislation which strikes at the heart of South African sovereignty not to mention constitutional rights of American citizens.

The thrust of this Draconian legislation is to bludgeon South Africa into changing her racial ways by limiting U.S. bank loans to her government, prohibiting purchase of gold Krugerrands, and, worst of all, snuffing out new direct corporate investment in the country. Paradoxically, it has been black South African leaders who have seen the dangers of this approach. When Senator Kennedy visited South Africa he found to his astonishment that it was blacks who hooted him down. In a powerful article in *The Wall Street Journal,* Chief of the Zulus, Mangosuthu Gatsha Buthelezi, warned against this disinvestment policy. The cutting edge for social change, he argued, has been the presence of American corporations. Anything which decreases U.S. investment in South Africa, now running to two and a half billion dollars, must drag down the living standards of blacks no less than whites.

But as matters have turned out the anti-apartheid lobby is not much interested in raising black living standards. The attack on South Africa

John A. Davenport is a former editor of *Barron's* and former member of the board of editors of *Fortune*.

has been programmed by such outfits as TransAfrica and by radicals who have again and again favored Soviet interests in Cuba, Central America, and the Middle East. But this claque never could have achieved overwhelming influence in the House and strong support in the Senate had not Liberals succumbed to a perverse delusion. This delusion is that the United States has a *right* to impose its social ideals on South Africa by intimidation and ostracism.

Yet American experience, starting from the priceless inheritance of a common language and law but entailing long years of slavery and bloody civil war, offers a poor guide as to the road South Africa can or should travel. South Africa is not America. It is a sovereign state but one that embraces 4.5 million whites, nearly one million Indians from India who would not return if paid to do so; some three million Coloureds, product of early mixed marriages, who most closely resemble our American blacks, and finally seventeen million Bantu speaking a variety of tongues who retain strong tribal affiliations. Perhaps half of these live in the increasingly autonomous homelands; the other half in close association with whites in the country's urban areas.

In this strange mixture of cultures and subcultures the weeds of apartheid, an ugly word for separateness, took early root though its outward manifestations have changed over the years. Americans visiting South Africa no longer encounter those degrading signs of petty apartheid that used to disfigure Jan Smuts Airport. Job reservation for whites in the mines and factories has been undermined by that very investment which our American legislators are seeking to snuff out. What remains is a complex system of laws determining where each race can live. These surely do conflict with personal liberty. In the good society legislation *ought* to be color blind.

Yet even the most sanctimonious Congressman should have exhibited a measure of prudence before trying to tear up the country's social fabric. The people of Soweto, the sprawling black township in the shadow of Johannesburg's skyscrapers, may rightly resent the fact that while by day they can mix freely with the whites, they must return to Soweto by nightfall. Yet these same residents would be even more resentful if tribes from the hinterland invaded their township in search of better housing.

It is fatuous to believe that if all past laws were torn up tomorrow, peace and harmony would prevail. The result might well be wars between black and black such as have swept other areas of Africa. Time, education, and the kneading forces of a market economy may make forced apartheid obsolete. Bellows from Washington will not contribute to this desired end.

Similar reflections concern the broadening of the franchise where the world owes South Africa a debt for refusing to go along with the mania of majority rule and "one man one vote once." Admittedly the color bar is an offensive and clumsy way to limit the follies of doctrinaire democracy. Far better to knit minimal educational or property requirements into the franchise as obtained in the infancy of the United States.

This approach was embodied in the Rhodesian Constitution of the sixties. Perversely the West turned its back on this hopeful experiment and today Rhodesia, renamed Zimbabwe, languishes under the one-party tribal rule of Mugabe.

South Africa has watched this denouement with increasing cynicism. It has given Indians and Coloureds a place in its Parliamentary structure and is now reaching out toward some kind of power-sharing with the Bantu, while avoiding majority rule. Bishop Tutu regards these moves as mere "crumbs from the white man's table." Others may see them as windows of opportunity.

The critical question however for Americans is a simpler one. It is whether at 9,000 miles remove the U.S. has the wisdom or indeed the will to manage and dictate South African affairs. This the more so because in the case of most other nations we have learned to curb our innate idealism.

Americans have not forgiven China for slaughtering millions in its "cultural revolution," but we nonetheless are doing big business with China. We do not seek to tear down India's caste system, though it may be a palpable cause of much misery. The very banks which under proposed legislation would be prevented from lending money to South Africa are today pouring money into East Germany which is fomenting discord in Southwest Africa (Nambia). Why single out South Africa for special treatment when she has remained loyal to the West and resisted Communist subversion and Soviet dictation?

The truth is that in the name of morality America is waging an immoral war of aggression on South Africa. The President has a Constitutional duty to veto sanctions or threat of sanctions against that country and should powerfully reassert America's enduring strategic interest. That interest lies in seeing to it that South Africa's vast store of mineral wealth remains in friendly hands. It is also to see to it that the sea routes around the Cape of Good Hope are properly defended. In the furor over apartheid it is easy to forget these imperatives. We may be sure the Soviets are making no such miscalculation.

E. Barry Asmus
Donald B. Billings

American Economic Progress

THE English Industrial Revolution of the late eighteenth and early nineteenth centuries created new technologies, production processes, and machines of both marvel and miracle. Many became available to the rest of the world following the War of 1812. But it was the American entrepreneur who successfully borrowed, adapted, and applied these new ideas in the United States. Complemented on the American continent by the rich endowment of land and resources and a limited but literate population, but unencumbered by vestiges of feudal restrictions, the technologies begun in Great Britain were utilized by the industrious people of this new nation.

In addition, the presence of a political and social environment which rewarded work, encouraged savings and investment, and in large part left individuals alone in the pursuit of their own interests, also contributed importantly to the transformation of the American economy. A crucial ingredient in that advance was a set of economic institutions which provided the impetus for individuals to better their own condition: private ownership of the means of production, voluntary exchange in open and free markets, and a price system which assigned resources to their highest and most valued uses.

The benefits attributed to the "open qualities of American society" produced a willingness to consider and adapt new and better ways to get things done. In this environment, the propensity to "truck, barter, and exchange" was encouraged, and "the uniform, constant, and uninterrupted effort of every man to better his condition," in combination with the richness of the American conti-

---

Dr. Barry Asmus is an economist and national speaker living in Phoenix, Arizona. Dr. Don Billings is Professor of Economics at Boise State University.

This article is taken from their book, *Crossroads: The Great American Experiment*, published in 1984 by University Press of America. Reprinted by permission of the publisher.

nent's natural environment, generated the most remarkable increase in wealth and progress mankind had ever experienced. Viewed as a long term process of raising living standards, competitive capitalism in the nineteenth century was eminently successful.

From a Feudal System to One of Private Property

In contrast to the success of private property arrangements in the nineteenth century, it is interesting that in the earlier phases of the British colonization of the eastern seaboard, attempts were made to transfer communal arrangements of land ownership to America. The Virginia Company, for example, tried to establish a structure of property rights reflecting the late feudal system of Europe. Such efforts at common ownership discouraged individual motivation, however, and gave settlers little incentive to better their own condition. The Virginia Company was eventually dissolved, and a system of private property rights in the land, a system of "freeholds," came to dominate American agriculture.

Following the successful revolutionary break with England, the new nation sought to establish the institutional arrangements necessary for economic growth. This would involve, as Adam Smith had said, securing the property rights of individuals, extending the market so that specialization might be encouraged, and insuring that gains in productivity might become part of a self-sustaining process of economic expansion. Fundamental decisions were made which increased and encouraged the role of the private sector of the economy and left relatively few functions for government.

As an example, a significant consequence of the constitutional convention in Philadelphia in 1787 involved the prohibition on tariffs between the several states. Drawing on the ideas of Adam Smith and his *Wealth of Nations*, free trade was encouraged among the United States. The relevant market was thus extended and future economic expansion was assured. The provision in the new Constitution for a patent system further strengthened private property rights, thereby encouraging inventions and entrepreneurship. The increased security of individual rights to property in combination with provision for the enforcement of private contracts laid the basis for a large and continuous increase in production and wealth. Since rights were protected and enforced, business risk was limited to that arising from the vagaries of the market, exclusive of government changing the legal environment. Thousands upon thousands were willing to take a chance at reaching the golden ring.

This constitutional period set the stage for the economic revolution which would follow in the nineteenth century. As stated in the highly acclaimed *American Economic Growth*: "In short, the whole structure of the institutions and the legal enactments of this period, was designed to encourage the growth of the private sector by reducing transaction costs, with the supplemental result of shifting the private-public mix in favor of the former." Government was largely restrained to protecting property rights and private individuals were allowed to work and produce.

The rise of competitive capitalism in the United States had its important beginnings in those early years of the Republic. The emphasis on private property and, therefore, private initiative was also stimulated by a massive shift of resources from public lands to the private sector, culminating in the Homestead Act of 1862. The slow transition to an industrialized America and the pace of economic growth was quickening in the early decades of the nineteenth century.

Civil War Interrupts Economic Progress

The coming of the Civil War represented a dramatic interruption in this economic progress. It was an especially important watershed period. Some industries, mostly in the North, such as woolen textiles, shoes and boot manufacturing, sewing machines, and farm machinery were stimulated by the hostilities. Other industries were contracting. According to Dudley Dillard and other economic historians ". . . the Civil War was a major disrupting influence to American life and retarded, perhaps, as many economic activities as it stimulated." Based on available statistics on employment and the value of output by economic sector, it is apparent that the Civil War separated an agricultural America from the industrial economy that followed.

After the Civil War, progress began again. One author has called that period until the eve of World War I "the most rapid and striking transformation of a major social order in the history of mankind." Other writers and historians have characterized this time as the "Gilded Age" or the "Age of Excess." In any case, the United States was propelled to the rank of being the wealthiest country and having the highest standard of living in the world. While progress was uneven due to cyclical changes in the level of economic activity, the real material standard of living, as measured by the real earnings of nonfarm employees, showed an accelerating advance. Not only did real wages rise significantly, but at the same time the work day was becoming shorter.

The average work day in manufacturing and mechanical establishments was 11.5 hours in 1850, 9.8 hours in 1900, and down to 8.5 hours in 1920. Dorothy Brady, in *American Economic Growth*, observed that ". . . the refinements that households with modest means were introducing into their homes in the 1830's and earlier, became available to the poor. By the 1870's such articles as beds, bedding, chairs, tables, dishes, knives, and forks were considered indispensable even to the poor." And these material gains, it must be remembered, occurred before labor unions were at all significant as a portion of the American labor force.

Unprecedented Growth

Historically, we must remind ourselves, economic progress has been very slow throughout the world. Generations and even centuries would pass without noticeable differences in the standard of living. This so-called "Age of Excess" in the United States, and the earlier Industrial Revolution in Great Britain, represented an unprecedented break with the past. Per capita income was doubling every 30 years, and Americans came to expect a constantly improving economic life. The die was cast, there was no turning back. The agricultural revolution in America was giving way to an industrial revolution. By the late 1870's, employment in non-agricultural occupations exceeded employment in agriculture. Between 1860 and 1910, the percentage of the labor force engaged in agriculture fell from about 60 percent to approximately 30 percent. Today it is less than 3 percent. The value of output in the manufacturing sector surpassed that of agriculture during the decade of the 1880's.

The massive and rapid transition to a fully industrialized economy was assisted by the building of the transcontinental railroads. While railroad building involved a curious "mixture of government paternalism," it was essentially a laissez faire philosophy that marked public policy. Government was careful not to offend the strident individualism of the post-Civil War period. In order to stimulate and accelerate the pace in the construction of a transcontinental rail connection with the West, more than 130 million acres of land adjacent to railway right-of-ways were granted to railroad companies between 1850 and 1871. For example, the Union Pacific received 20 million acres, while the Northern Pacific acquired 42 million. Nevertheless, and in spite of these land-grant subsidies, the actual construction of the railroads was with private money and was carried out through the entrepreneurial skills of the Vanderbilts, Goulds, Hills, and Morgans. Capital was more generously available in part because of the decline in the federal debt during this period. On the eve of the Civil War there were roughly 30,000 miles of track, by 1890 there were 170,000 miles, and by 1916 there were 250,000 miles. The railroad construction boom created a truly integrated national market for the products of American farms, mines, and factories. Indicative of this growth in markets was the growth in ton-miles of freight hauled. In 1859 railroads carried 2.6 billion ton-miles, by 1890 the figure had exploded to 80 billion ton-miles.

Specialization

Since more geography meant expanded markets, economies of scale could be attained by specialization in production and distribution. Mass production techniques were encouraged by the new national market, and assembly line principles of production were employed by a number of industries. Automobile companies adopted the "process experiments" conducted by the slaughterhouses and grain mills. The "disassembly" of pigs in slaughterhouses during the first decade of the 20th century provided the guidelines followed by Henry Ford's assembly line in the second decade. The "rationalization of the work process" permitted larger volumes of production and lower costs than would have otherwise been possible. In 1916, the Ford Motor Company sold more than one-half million Model T's at a retail price of less than $400 and shipped them all across the country on the radically improved and integrated national transportation network. Ford's experiment, which relied on an industrial system that used "the principles of power, accuracy, economy, system, continuity, speed, and repetition," made available to the growing middle class the automobile: America's great "freedom machine." Henry Ford literally placed a steering wheel in the hands of every working person in America. This is a feat which most industrialized countries of the world have still not totally accomplished.

The Great Entrepreneurs

In the process of rationalizing techniques of production, the great entrepreneurs of the Gilded Age brought to the American people ever greater quantities of consumer goods at continuously lower prices. Since an essential input to most, if not all, of the new industries was steel, it was Andrew Carnegie who, through his entrepreneurial leadership and production techniques, filled the void and brought remarkable results. Writes William Greenleaf:

> Carnegie's unrelenting insistence of cost-cutting through progressive technology reduced the price of a ton of steel from $65 a ton in 1872 to $20 a ton in 1897.

> Between 1889 and 1900, Carnegie boosted his annual steel output from 322,000 tons to 3 million tons. During that time his profits increased eight times over, reaching $40 million in 1900.

Rising productivity also meant higher real wages for steel workers. In the process of searching for entrepreneurial profits, Carnegie's efforts generated large increases in the output of steel at drastically lower prices, but higher wages for those in the industry. Unfortunately, the clearly beneficial results of Carnegie's cost cutting efforts are still viewed by many as selfish profiteering. This is a most unfortunate twisting of the facts.

John D. Rockefeller was another "Robber Baron" who, with the assistance of entrepreneurial partners Samuel Andrews, Henry Flagler, and his brother William Rockefeller, led the race in petroleum refining and distribution. This competitive race, in which Rockefeller set the pace for a while, revolutionized the average American's life and standard of living. The Rockefeller organization began refining petroleum products in 1865. By 1870, Rockefeller's share of total refined output was 4 percent, and at that time there were approximately 250 independent refiners. By 1880 the Rockefeller share was more than 80 percent, and the number of independent refiners had fallen to less than 100. The decrease in numbers was encouraged by the generally deflationary movement in prices during the 1870's, and by the economies of large scale production associated with the introduction of destructive distillation (petroleum "cracking"). The myth of predatory pricing, as the source of Rockefeller gains, has been soundly refuted by John S. McGee in a 1958 article in *The Journal of Law and Economics*. In actual fact, rival refineries were frequently purchased by the Standard Oil Company at "outrageously" high prices. One George Rice in 1882 literally tried to "bribe and blackmail" Standard Oil into paying a price for his refinery which was inflated by a factor of ten.

Standard Oil

For economic growth and American living standards, however, we are interested in the implications of the competitive forces for costs of production and consumer prices. During the period in which the Rockefeller interests were supposed to have monopolized the petroleum industry, Dominick Armentano has captured the flavor of what was in fact going on:

> Between 1870 and 1885 the price of refined kerosene dropped from 26 cents to 8 cents per gallon. In the same period, the Standard Oil Company reduced the average costs per gallon from almost 3 cents in 1870 to 0.452 cents in 1885. Clearly, the firm was relatively efficient, and a

good share of that efficiency was transmitted profitably to the consumer in the form of lower prices for a much improved product.

As costs and prices continued to fall into the twentieth century, Standard Oil experienced a progressively less important and less secure position. Fuel oil, lubricating oils, and gasoline began to replace the kerosene age; new crude supplies were discovered in the Southwest and California; and additional integrated petroleum companies entered the competitive oil business. Standard's share of crude supply fell from 34 percent of total market supplies in 1898 to just 11 percent in 1906. On the eve of the government antitrust suit against the Standard Oil Company in 1911, its share of the petroleum products market was 64 percent, down from a high of 88 percent in 1890. The per gallon barrel price of refined oil, which had been 9.33 cents in 1880, declined to 5.91 cents in 1897, and continued to decline into the twentieth century.

Yet in the face of these facts, on May 15, 1911, the United States Supreme Court ruled that the Standard Oil Company had "unreasonably" conspired to restrain trade, and, therefore, was in violation of the Sherman Antitrust Act of 1890. The socially beneficial effects of lower prices, and very large increases in the production and consumption of petroleum, was apparently not considered at all. The accepted meaning of monopoly—the restriction of output and higher prices—was to be turned on its head. Standard Oil was to be dissolved for increasing output and lowering prices. This case is just one example of where government chooses to interfere with economic activities regardless of the actual situation. In our own time, government agencies find fault with IBM for increasing production and lowering the price of processing information through innovation. If the price is too high, then government charges monopoly. If the price is too low, government charges unfair competition. What about the same price? Then, of course, the government charges price fixing. The government rule seems to be: no matter the price, it is suspect.

Competition and Government in the Gilded Age

In fact, the conventional wisdom that the American economy in general was controlled by giant monopoly trusts around the turn of the century is itself incorrect. As the railroad tycoon James J. Hill said in 1901: "... the trust ... came into being as the result of an effort to obtain ruinous competition." According to the economic historian Gabriel Kolko, monopoly during this period "... was the exceptional and not routine characteristic of most industries, and the use of the term 'monopoly' or 'trust' by defenders of the status quo, was based more on wish-fulfillment than on economic reality." Kolko quotes from an issue of *The Iron Age* in 1900 which sadly summarized the difficulty encountered in short-circuiting the competitive process:

> Experience has shown that very few of the promises of the promoters of consolidation have materialized. That some of them are satisfactorily profitable is undoubtedly true ... Others are less so, some are conspicuously unprofitable, some have dissolved, and more will have to dissolve within the next two or three years.

The pressures of the inherently competitive open market system required that those wishing to protect themselves from new and potential competition had to turn to government for aid and protection. But imagine the kind of world we would have if business was generally successful in hiding behind government. Instead of solving problems through individual initiative, people would be encouraged to lobby, demonstrate, coerce, threaten, and use government power to their own ends. In most cases, government action is synonymous with monopoly and the naked use of power. Seldom can a company maintain a monopoly position for long without the mantle of government protection. Profits attract entry. The life of the incumbent is quite uneasy, and they must constantly be looking over their shoulder for potential competitors. However, through licensing, controls, import restrictions, tax credits, depletion allowances, and other devices, government can successfully impede rivalry, and, hence, reduce or eliminate competition. In reality, government is controlled by powerful special-interest groups, and it is these minority interests that, without exception, work at cross-purposes to the private interests of the average citizen. It is this movement to state enforced monopoly which Gabriel Kolko has termed "The Triumph of Conservatism."

In general, then, most historians have this thing backwards. Seldom have antitrust laws ever been used against a firm that was restricting production and raising prices, but almost always the firms that get prosecuted are the ones that expand production and lower prices. The result is that they get a larger market share. The question is: Should that be construed as bad? Suits are brought against these firms because they attract and hold customers day-after-day, and conduct transaction-after-transaction in markets where new entrants are always a realistic possibility. In the final analysis, these firms are merely being responsive to the consumer because they recognize that the consumer is king. As an example, and contrary to popular assumptions, the Interstate Commerce Commission was not created to regulate a natural monopoly. It was lobbied in the Congress by influential eastern railroad interests as a means of enforcing their price fixing agreements and other cartel-type behavior; enforcement which had proven to be impossible in the free and open market place. Kolko summarizes this more realistic perspective:

> Despite the large number of mergers, and the growth in the absolute size of many corporations, the dominant tendency in the American economy at the beginning of this century was toward growing competition . . . As new competitors sprang up, and as economic power was diffused throughout an expanding nation, it became apparent to many important businessmen that only the national government could rationalize the economy . . . ironically, contrary to the consensus of historians, it was not the existence of monopoly that caused the federal government to intervene in the economy, but the lack of it.

The Great Transformation

On the eve of World War I, after a century of remarkable progress in the United States, economic growth and its benefits for raising the standard of living were evident for all to see. It was a time during which capitalism (cynics call it "Social Darwinism"), was given a chance, the role of government in economic affairs, while substantial in some instances, was quite limited in scope. Living standards, longevity, and economic opportunity grew to levels unimaginable merely a hundred years earlier. Though progress was uneven, and some people grew fabulously rich, it was in part the poor who experienced the greatest improvements. By the end of the nineteenth century, America's poor enjoyed material living standards significantly higher than most of the world's population.

Something indeed must have been right in America. If not in the view of many historians and their social theories, then in the actions of the "teeming millions" who immigrated to the United States by voting for competitive capitalism with their feet. The truth was out that America offered economic opportunity and political freedom. Between 1860 and 1890, more than ten million immigrants came to America to seek their fortunes. During the period between 1895 and 1915, on the average, more than one million immigrants a year came to the United States. Thomas Sowell, a contemporary economist, documents in his *Race and Economics*, the important degree to which these immigrants, mostly carrying just the clothes on their backs, were largely assimilated, within a generation or two, into the mainstream of American economic life.

The great increase in wealth and economic progress in the nineteenth century, which was shared by most if not all Americans, can largely be attributed to the revolutionary ideas of John Locke, Thomas Jefferson, and Adam Smith. They redefined the relationship of sovereign individuals to their government, and clearly demonstrated the socially beneficial results of a system of natural liberty. Political and economic freedom, after all, go hand-in-hand, and they produced living standards which even Karl Marx recognized would occur.

But "capitalism" in many quarters is, nevertheless, perceived to be morally unacceptable. While agreeing to its material advantages, academicians, pastors, parlor groups, people in the media, and other word merchants, believe capitalism is unworthy of compliment or retention. Even in the face of Stalin and Mao, the gulag and bureaucracy, and repeated socialistic failures worldwide, the dream lives on that there exists a better system than capitalism. Perhaps there is. But history, and especially the United States and its economic system during the nineteenth century, shows clear and overwhelming evidence that private ownership and limited government produce a system of natural liberty that allows man more freedom, economic opportunity, and a better chance to improve himself than any other system known to man. Though falling far short of utopian dreams, it would seem far ahead of whatever is in second place.

BIBLIOGRAPHY

Armentano, Dominick. *Antitrust and Monopoly: Anatomy of a Policy Failure.* New York: John Wiley & Sons, 1982.

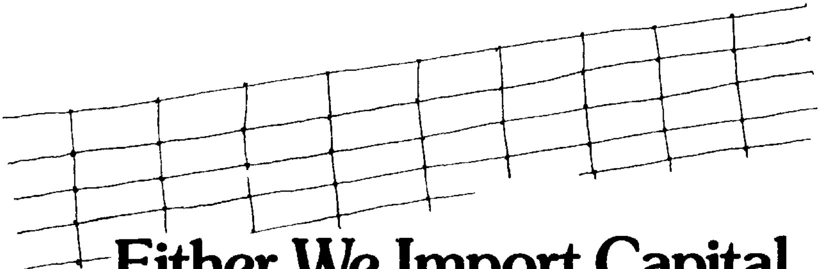
Davis, Lance; North, Douglas C., et. al. *American Economic Growth: An Economist's History of the United States.* New York: Harper & Row Publishers, 1972.

Dillard, Dudley. *Economic Development of the North Atlantic Community.* Englewood Cliffs, N. J.: Prentice-Hall, 1967.

Greenleaf, William, ed. *American Economic Development Since 1860.* New York: Harper & Row Publishers, 1968.

Kolko, Gabriel. *The Triumph of Conservatism: A Reinterpretation of America's History, 1900–1916.* New York: Free Press, 1977.

Gustavo R. Velasco



Either We Import Capital or We Export People

Gustavo R. Velasco (1903-1982) was a prominent lawyer, banker, economist and professor in Mexico. Speaking there before the Fourth Industrial Congress in 1957, he warned against a local Chamber of Commerce proposal to inhibit foreign investments in Mexico. He said this could halt the entrance of new capital, lead to less domestic production and force many Mexicans to leave their country in search of a livelihood.

Persisting restrictions against capital movements into Mexico and the steady and continuing stream of people across our southern border reinforce the logic and urgency of Velasco's warning.

THE true victim of the protectionist measure being considered will not be foreign capital. Capital will go to more sensible and less hostile countries than Mexico, to countries where it will be able to employ labor profitably and productively. The true victim of the measure will be the economic progress of Mexico. In the very real and true sense of the word the victims will be the millions of our fellow countrymen whom we shall be forcing, by this antiforeign sentiment, either to emigrate or to live in misery, without the hope that they or their children will be able to attain human dignity.

What distinguishes a poor country such as Mexico or China from a country like the United States or

---

Translated from the Spanish and slightly condensed by Bettina Bien Greaves.

Canada is *not* racial superiority, natural resources, good intentions or luck. What makes the labor of the American worker or the Canadian farmer more productive is that they work not just with their hands or with antiquated tools: they work with equipment and machinery. In other words, they work with the aid of capital. The best and most efficient way to improve the power of the Mexican workers, to increase production and to raise our standard of living, is through capitalization.

The Need for Saving

If domestic capital, savings, could bring about the miracle of compounding our efforts and multiplying our output, we would have no reason for being concerned about foreign investments. Unfortunately, however, precisely because of our poverty, the portion of the population that saves is extremely small. In view of the lack of savings and of Mexico's great need for capital, public and private domestic investment are quite inadequate. Yet, the population of Mexico is increasing at such a rate every year, every day, that a much higher rate of investment is necessary just to keep us from going backward—let alone to achieve progress. The only way to speed up economic development, the only hope for the millions of the less fortunate of our fellow countrymen is to take advantage of all available resources. In other words, precisely because the problem is so great, we should not only increase domestic capital as much as possible, but we should also protect foreign capital. The dilemma is clear: *Either we import capital or we export people.* Either we permit foreign investors to cooperate in the enormous task which confronts us, or we deny our laborers the opportunity to perform useful and beneficial work in their own country.

In Mexico today, we still have not attained the income per capita that France or England had at the beginning of the 19th century. In other words, the truth is that we are more than 150 years behind the times economically. If we depend on our own resources, our people will not, not even in a hundred years, approach the standard of living now enjoyed in the United States and Canada.

The real problem of foreign investments does not consist of the harm they may cause to an established producer. All new competition, domestic or foreign, may do injury to those producers who believe they may relax their efforts. A free economy is essentially dynamic. Nothing in it is sure except that producers must constantly earn the favor of consumers. The daily plebiscite of the market determines who satisfies the needs of the consumers best or cheapest. Their interests must prevail, for the ultimate purpose of the economy is to serve the general welfare. Consequently, when producers try to protect themselves from competition by means of a law, they thwart the plebiscite of the consumers, a plebiscite which is much more democratic and truthful than a political election. Moreover, they presume thereby to set their own individual interests above those of the majority.

In addition to being improper and immoral, this protectionist proposal itself would lead to general impoverishment. No one denies that the industrialist who obtains a special privilege, such as the exclusion of competitive foreign products, will benefit. But this will be at the expense of consumers. They will have to go without some article they would have preferred which will not then be produced. Or they will have to purchase some domestic product at a price that is higher than it would have been if the producer had faced greater competition.

For the community in general, not only is there no advantage at all from such legislation, but there is a net loss equal to the amount of production which is prevented. Like all restrictionist measures, the elimination of domestic or foreign competition imposes an economic cost. The result is not progress but retrogression, not abundance but scarcity.

Foreign capital has not been primarily responsible for political instability in the many countries that could be mentioned. To cast blame is a convenient way to avoid confessing the truth to ourselves. During the first 70 years of our political life, we had hardly any foreign investments here in Mexico. And yet we had continuous riots, insurrections and revolutions. We do not suggest that there is a cause and effect relation, but it was precisely when the country opened its doors and when it developed economically that it finally tired of its convulsions, attained peace and some measure of economic progress.

Erect a Wall

With respect to the preservation of our culture, the grounds on which many argue for restriction, we should note that the real threats come, not from the establishment of new factories, but rather from contacts outside the country. To be consistent, the advocates of the restrictionist measure under consideration should propose that books, magazines and travellers be kept out of Mexico. They should also recommend that radio waves be blocked, as in Russia and her satellite countries, because they bring us the music and the language of other peoples.

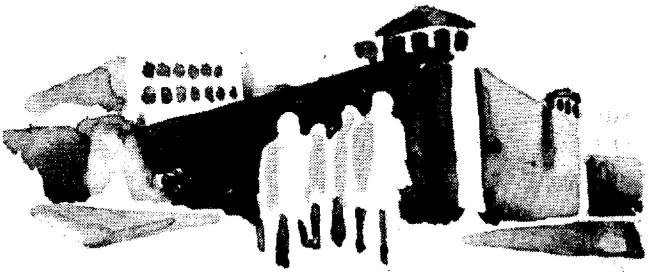
Whoever believes that the way to preserve our culture and traditions is to erect a Chinese Wall around the country shows very little faith in their vitality. It is only our poverty which prevents us from building more schools in which that half of our people who now have no schools might learn to read and write. It is only our poverty which prevents us from establishing libraries and museums, conserving the monuments and artistic treasures left us by our indigenous and Spanish ancestors.

If the United States can radiate its culture beyond its borders, this is due above all to its vast economic wealth. He who lacks vitality because he does not have the proper food or because he is weakened by disease can hardly think about the purity of his language or the conservation of his country's temples. We proudly and energetically defend our Mexican heritage. We should even increase and enrich it. But we should not confuse these two problems. We should recognize that the foundation on which the defense of Mexican culture must rest is the economic prosperity of the country.

Patriotism, and the nation's best interest, do not call for the policy of discrimination and repudiation now being proposed. If the problem is correctly stated and analyzed from the point of view of the general economic and cultural interest of Mexico, the conclusion is precisely the opposite of that recommended in this proposal. Either we permit foreign investors to cooperate in the enormous economic task which confronts us, or we deny our laborers the opportunity to perform useful and beneficial work in their own country. Once again, *either we import capital or we export people.*

Charles H. Logan

Competition in the Prison Business



A specter is haunting American corrections—the specter of free enterprise. To be clear at the beginning: no entrepreneurs are challenging the state's monopoly of penal *authority.* However, there are those who believe that the actual day-to-day business of imprisonment should not be left entirely in the hands of government employees. It is one thing to believe that only the state has a right to imprison someone. It is another matter entirely to believe that only the state can run a prison in a fair, humane, effective, and economical fashion. The first belief is a matter of political philosophy; the second is an empirical proposition. Given the dismal performance of the state in running its prisons, many people now are willing to entertain, and to test, the proposition that private enterprise can do it better.

Mr. Logan is Associate Professor of Sociology, University of Connecticut at Storrs.

The Fruits of Monopoly

What do we normally expect in a business that is protected from competition? More often than not, we find unmet demand, low quality, and high cost. Precisely these conditions now characterize the prison business. Rising crime rates and more punitive public conceptions of justice have increased the demand for imprisonment. Supply, however, has not kept up with demand, so prisons and jails have become seriously overcrowded. The Bureau of Justice

Statistics reports that in 1983, state and federal prisons operated, on the average, at about 110 per cent of capacity. In 15 states, 21,420 prisoners were released early because of overcrowding. Over 8,000 other prisoners, in 18 states, were held in local jails because of prison crowding. In a recent survey of corrections officials, police, prosecutors, public defenders, court personnel, and probation and parole officials, a majority of all but the public defenders identified overcrowding as the number one problem of the entire criminal justice system. This was in response to an open-ended question (no prompting or choices offered) and for most groups this problem was far ahead of the nearest contender.

The strain on quantity also affects the quality of imprisonment. Corrections departments have been forced to double-cell and to house the overflow of inmates in tents, gymnasiums, corridors, recreational rooms, and basements. San Quentin, built to hold 2700 but currently housing 3900, must, to insure security, confine most of its prisoners to their cells continuously, allowing them to emerge only for meals and showers. Courts have begun to declare these conditions intolerable. As of 1983, 41 states and the District of Columbia either were under court order to remedy prison conditions or were the subjects of litigation.

However, it is much easier to order reforms than to pay for them. Calculations of the cost of constructing a new prison range as high as $125,000 per bed, but are highly variable. The U.S. Department of Justice, using 1982 dollars, cites average construction costs per bed of $26,000, $46,000, and $58,000 for minimum, medium, and maximum security prisons, respectively. Since they are based on a systematic survey of all states and are specified by prison type, these may be the best figures to use for average costs nationally.

Cost Overrun

Most estimates of construction cost are probably too low, because they ignore such considerations as land purchase, site preparation, overruns, hidden costs, and financing cost (for example, if construction is paid for by a 20-year bond at 10 per cent interest, the real cost will be triple the original figure). Moreover, construction cost is only the beginning; operating cost adds yearly to the burden. As with construction, figures on operating cost vary widely, running from $4,000 to $30,000 per inmate per year. The most common figures are in the mid-teen thousands, as represented by the American Correctional Association's figure of $15,000 and the federal prison system's estimate of $13,000.

The cost of constructing and operating prisons has been rising faster than the general level of inflation. This is not surprising; cost is predictably less restrained where the government has a monopoly over imperative services. If current conditions of demand and supply persist, we can expect the cost of imprisonment to continue its upward course. However, two recent developments may deflect this course somewhat. First, taxpayers are beginning to resist. Perhaps the public is aware that it does not get from the penal system full value for its tax dollar. This should put pressure on the government to be more efficient. Second, private entrepreneurs are beginning to offer an alternative. Where demand for a service outstrips supply and where current prices seem unreasonably high, conditions are ripe for competition and the emergence of new sources of supply. We should therefore not be surprised to see this occur.

Despite long-standing and widespread dissatisfaction with the quality, quantity, and cost of imprisonment, it still comes as a shock to most people to learn of the rise, at the beginning of the 1980s, of a new source of supply in response to this unmet, or poorly met, demand. Nonetheless, a number of entrepreneurs, many with prior governmental experience in corrections and other areas of criminal justice, recently have come to believe that they can build and run prisons at least as effectively, safely, and humanely as the state, but with greater efficiency. This would lower the cost to taxpayers while allowing a profit for themselves.

The Private Prison Pioneers

Actually, virtually all aspects of corrections (food services, medical services and counseling, educational and vocational training, recreation, maintenance, security, industrial programs, and so on) are already subject to private contracting on a piecemeal basis. What is new is the idea of running entire, secure institutions completely under private contract. These facilities are usually, but not necessarily, built and owned by the companies that manage them.[1]

The first such facility dates to 1975, when RCA Services Company, a subsidiary of Radio Corporation of America, established the Intensive Treatment Unit, a 20-bed, high security, dormitory style training school for delinquents at Weaversville, Pennsylvania. The second did not appear until 1982, when the State of Florida turned over the operation of the Okeechobee School for Boys to the Eckerd Foundation (created by the founders of a drugstore chain). In 1983, a prison for youthful offenders near San Francisco was contracted by the U.S. Bureau of

Prisons to Eclectic Communications, Incorporated.

Most recent of all have been contracts for the private operation of secure institutions for adults. By the end of 1984, the U.S. Immigration and Naturalization Service (INS) had contracts with two private companies for the detention of illegal aliens (including facilities for families). One of these, Behavioral Systems Southwest, has been setting up and running detention centers for the INS since 1983. They run facilities totaling 350 beds in Arizona, California, and Colorado and have proposed additional centers in New Mexico. The other INS contractor, Corrections Corporation of America, constructed and opened a $5 million, 350-bed detention center in Houston in 1984 and has been awarded a contract for another facility in Laredo, Texas, to open in 1985 with an expected daily population of 175.

At the local government level, adults are also being held in several privately owned and operated facilities. Corrections Corporation of America owns and runs a 250-bed, medium security correctional facility for Hamilton County, Tennessee. Southwest Detention Facilities owns and runs jails for counties in Texas and Wyoming and is negotiating for similar facilities in Colorado and New Mexico. So far, however, I have learned of only one currently operating commerical prison for convicted adult felons: in 1984, Palo Duro Private Detention Services opened a 575-bed medium security prison for convicted immigration offenders, under contract to the U.S. Bureau of Prisons. These inmates are in the custody of the U.S. Bureau of Prisons because they have been convicted and sentenced to prison terms. The illegal aliens held for the INS are in temporary detention, mostly pending deportation.

States have been slow to follow the federal lead, perhaps partly because of statutory impediments, but private companies are prepared to sign contracts with one state or many. Buckingham Security Limited, a Pennsylvania-based company incorporated in Connecticut, has plans to site and build a 720-bed maximum security prison near Pittsburgh. They have letters of intent from several states to contract for the care of protective custody inmates. These inmates consume extra resources and cause many problems within their original prisons, but are not so troublesome when removed to separate facilities.

Cost Advantages of Private Prisons

What does it cost to build and run prisons in the private sector? It is difficult to give a definite answer to this question even in the public sector, where experience is long and data are plentiful. Early figures on private costs must, therefore, be regarded with caution, but they appear to support an expectation of savings.

At an annual cost per inmate of $40,000, RCA's Weaversville Intensive Treatment Unit is much more expensive than the other institutions. From independent descriptions of the programs and facilities, it seems likely that much of the cost reflects high quality and small size, combined with the special needs of hard-core juvenile offenders. One expert (James Finkenauer, a criminologist at Rutgers) has described Weaversville as "better staffed, organized, and equipped than any program of its size that I know."[2] The Florida School for Boys at Okeechobee, at $14,588 annually per inmate, is comparable in operating cost to the American Correctional Association's estimate of $15,000 for state-run institutions.

Other available cost figures vary considerably. The lowest is $14 a day, per inmate, which Behavioral Systems Southwest charges the INS to detain illegal aliens in a series of converted and lightly secured motels. This is low by any standards, but the $24/day charged to the INS by Corrections Corporation of America for the same service may be an even better deal, since it covers construction of a new facility. The Hamilton County contract with CCA does not include basic construction, but the $21/day fee includes a commitment to spend up to $1 million in renovation during the first year of the four-year contract.

Behavioral Systems Southwest compares their $14/day charge to a current INS cost of $40–$50/day, while Corrections Corporation of America claims their $24/day charge is one-third less than it would otherwise cost the agency (which would compare it to $36/day). Palo Duro Private Detention Services charges the U.S. Bureau of Prisons $45/day for medium security imprisonment, which they say is 25 per cent less than the projected cost if that agency provided the service itself. Southwest Detention Facilities has offered to build and run a regional prison at a fee of $54/day for three counties in New Mexico that currently spend $78/day to house each of their prisoners.

Even the high security prison proposed by Buckingham Security Limited would be competitive at $24,000 per year (about $66/day) per inmate, since that figure includes construction. Buckingham Security's estimate of $15 million to construct a maximum security prison with 720 beds works out to $20,833 per bed, a steal compared to the U.S. Department of Justice average figure (cited above) of $58,000 per bed for a maximum security prison. Corrections Corporation of America built their

350-bed detention center in Houston for $5 million, or $14,286 per bed.

What these figures suggest is that claims from the private sector of ability to build and run prisons at lower cost are at least plausible and worth putting to the test. The data are too limited and too crude to support any firm or categorical conclusions yet, but they are enough to show that a *prima facie* case for commercial prisons must be taken seriously. Pending further data, the case for (or against) private prisons rests mainly on *a priori* arguments, only a few of which can be considered here.[3]

A Priori Arguments for Privatization

Perhaps the strongest presumption in favor of private contracting of imprisonment is to assume that it would be similar in success or failure to the private contracting of other public services. We know that these other contracts are not always successful. However, E. S. Savas, in *Privatizing the Public Sector*,[4] points out that the most rigorous and comprehensive research (of which there is little so far) supports the general superiority of private over public provision of such diverse services as solid-waste collection, electric power, fire protection, transportation, health care, education, social services, protective services, and a number of others.

Obviously, imprisonment differs from these other activities in important respects, but not necessarily in ways that relate to efficiency and cost. Besides, if a prison system is broken down into its various separate activities, there are only a few aspects that do not have counterparts in both the public and the private sector. Therefore, evidence of successful private delivery of other public services warrants the presumption that it would be feasible for imprisonment also

Personnel is probably the major area where savings could be expected with private contracting. Businesses, for economic reasons, tend to hire and retain approximately the number of employees that they truly need. Governments, for political reasons, frequently employ too many or too few. Retirement programs, sick pay, fringe benefits, and (for blue collar workers) salaries are generally more generous in the public sector, as the Grace Commission has documented. This is because wages and benefits are not subject to the direct discipline of market forces in the public sector, at least not as much as they are in the private.

Profit-and-Loss versus Bureaucratic Incentives

Costs other than personnel are also more likely to be held down by commercial prisons, as a result of the intrinsic economic incentives found in profit-making companies but absent from government agencies. Public service institutions tend to be both inefficient and ineffective, not so much because they are public rather than private, but because of the way they are financed. Profit-and-loss incentives differ fundamentally from bureaucratic incentives.

Entrepreneurs are motivated, under conditions of competition, to provide maximum satisfaction at minimum cost. Bureaucrats, in contrast, are rewarded not so much for efficiency, but in direct proportion to the sizes and budgets of their agencies. Budget-based organizations are thus motivated to grow and to spend. Their money is based on promises, intentions, and efforts, and not strictly on results.

There is another reason why it tends to be inefficient for a governmental unit to attempt to supply all its own services. Economies of scale vary greatly by the type of service and by the size and nature of the area being served, but as Robert W. Poole, Jr. notes: "The one arrangement *least likely* to be most efficient is for all the services to be provided at the scale defined by the size of the city" (or county, or state).[5] For example, nearly all cities need some jail services, but it may require a multi-city contract to meet efficiently the needs of small cities, while a large city can operate more efficiently by using multiple contractors to meet its varied needs (e.g., high and low security, male and female inmates, juveniles and adults, detoxification units, etc). Moreover, economies of scale can change, sometimes rapidly, due to technology or market forces; private vendors can respond to these changes more readily than can political entities.

Other Benefits

So far, I have addressed only the fiscal advantages of commercial prisons, but certain other potential benefits are no less important. One goal of contracting is to inject into the public sector some of the greater flexibility that is often found in the private sector. Flexibility is especially important in the administration of public policy, where concentration of decision-making magnifies the consequences of ignorance, uncertainty, and error. Policies regarding imprisonment, for example, contain implicit or explicit projections about trends, distributions, and patterns of crime and punishment. Even where broad trends are discernible, however, it is beyond the powers of social science to make highly accurate and reliable forecasts.

Because of the scale on which it operates and the ponderous way in which it moves, government is much more dependent than is private enterprise on the long-term accuracy of projections. Of course, the private sector must also be able to predict, if it wishes to make a profit, but it can make better use of short-term (and therefore more accurate) predictions because it can generally respond more quickly to changes in information.

A market in corrections would share in the general advantages of markets over all forms of central planning. The advantage most relevant here is that competition isolates and minimizes the consequences of erroneous predictions, while central planning magnifies them. If a state launches a major prison construction plan and hires an army of civil servants on the basis of a long-term projected trend that does not materialize, or that unexpectedly reverses itself after a few years, the cost will be monumental. If several competing contractors are responding continually to projected needs, it is unlikely that they will all make the same mistakes at once.

Some contractors will predict better than others, or be able to respond more quickly to altered predictions. These companies will survive and prosper by being able to meet the changing needs of the state more effectively. The less successful companies will have to absorb and thereby contain the cost of their inaccurate predictions. In contrast, when the state has a monopoly on the prison business, it can simply pass on to taxpayers the full cost of its errors. Thus, the state has less incentive to avoid errors in the first place.

Speedy Response

This presumption of flexibility and speed of response on the part of private prison contractors is not just a matter of faith; concrete examples can be cited. In 1975, the Attorney General of Pennsylvania ruled that even hard-core delinquents could not be incarcerated in facilities with adult offenders. Faced with the need to immediately relocate all affected juveniles, and having no suitable facilities available, the state turned to RCA, with whom they already had a contract for educational programs for delinquents. In ten days, RCA set up the Weaversville Intensive Treatment Unit, a heavy security facility with 20 beds and 30 staff members. In this case, RCA was able to convert buildings already owned by the state; other contractors have built their own or remodeled existing private structures, such as motels, to make them secure.

While a spokesman for the Federal Bureau of Prisons reports that it takes two or three years to site and build[6] and other sources report that it takes five years or more to build secure facilities, private contractors claim to be able to design, finance, and build a prison in as little as six months. Corrections Corporation of America financed, built, and opened its 350-bed detention facility for the INS in just seven months.

Contracts allow government agencies to experiment with new programs without long-term commitment of funds or of tenured civil service staff. Thus, vested interests in these programs do not accumulate inside the agencies. This avoids the tendency toward bureaucratic self-perpetuation that ordinarily makes public programs difficult even to alter, let alone to eliminate. Of course, advantages of flexibility for the public agency translate into insecurity for the private contractor.

If the vulnerability of a contract is an advantage to one side, it is a disadvantage to the other. However, this problem is intrinsic to all private contracting. To survive and succeed, a contractor must be able to solve this problem in a variety of ways: by providing service that is too good to give up; by accurately anticipating and being ready to meet the shifting needs of different clients; by holding down the administrative cost of hustling from one contract to another; by cultivating multiple clients; or by other techniques that must be the stock-in-trade of any competitive contractor.

Flexibility Promotes Justice

The flexibility of private prison contracts can also enhance justice. Public concerns over justice and punishment have led to reforms in many components of the justice system. Abolishing parole, limiting judicial discretion, banning or restricting plea bargaining, and other such reforms, are supposed to curb abuses and to make punishment more uniform and just. One objection to these reforms is the fear that they will produce further and more dangerous overcrowding of prisons. Therefore, attempts have been made to reintroduce discretion through mechanisms for diversion, sentence reduction, emergency release, and "early community reintegration."

The search for these new discretionary mechanisms, which are designed to forestall or to relieve the pressures of overcrowding, rests on a faulty assumption: that prison flow can and should be fine-tuned by the state, while prison capacity remains virtually fixed. A penal system primarily concerned with doing justice, however, makes just the opposite assumption: prison flow should respond to crime rates, which are largely beyond the control of the state; therefore, prison capacity must be flexible.

At least at the margins, then, the prison system should be able to expand and contract as the shifting demands of justice require. Flexibility at the margins will tend to maximize the supply and minimize the cost of imprisonment. Commercial prisons, with efficient management, multiple vendors, and renewable, adjust-able contracts, offer an increased prospect of achieving this marginal flexibility.

Government Should Foster Competition

Public employee unions will no doubt offer many reasons why government services, including imprisonment of criminal offenders, are best handled by civil servants under direct employment and administrative management by the state. They may be correct, much of the time, in this assertion, but they should be made to uphold their claim in open competition. No longer should they be permitted to foreclose the question through monopolization by fiat.

Competition is as important to the processes of government as it is to those of private enterprise. As a mechanism of evaluation, accountability, and control, it is unmatched. How do we know—and how can we be sure—that the government is running our prisons in the most just, humane, effective, and efficient manner possible? A very good test is to see whether private enterprise can do it better.

Competitive private contracting introduces a market test of price that is absent under governmental monopoly, and it provides a new basis for comparison of all programs, both public and private, on dimensions other than cost. Many of the component activities of the penal system are already subject to competition among private vendors. Why not do the same for the administration of entire prisons? The ultimate legal authority for imprisonment must, by definition, remain in the hands of government, which means that a high degree of regulation will always be necessary. With that proviso, however, rigid legal obstacles to the private administration of prisons should be removed.

—FOOTNOTES—

[1]Information on the programs described below comes from the following sources: Kevin Krajick, "Punishment for Profit" *Across the Board*, 21, March 1984, pp. 20–27; Kevin Krajick, "Prisons for Profit: the Private Alternative" *State Legislatures*, 10, April 1984, pp. 9–14; Philip E. Fixler, Jr., "Behind Bars We Find an Enterprise Zone" *The Wall Street Journal*, November 29, 1984, p. 34; *The Hartford Courant*, April 1, 1984; *The Philadelphia Inquirer* April 16, 1984; and telephone inquiries.

[2]Cited in Krajick, "Punishment for Profit."

[3]For an extended list of *a priori* arguments both for and against privatization of public services generally, see E. S. Savas, *Privatizing the Public Sector: How to Shrink Government* (Chatham, N.J.: Chatham House Publishers, 1982), pp. 89–91.

[4]*Ibid.*, pp. 93–111.

[5]Robert W. Poole, Jr., "Objections to Privatization" *Policy Review*, 24, Spring 1984, p. 107.

[6]Cited in Krajick, "Punishment for Profit."

Charles Dykes

The Ultimate Source of Wealth

"Is Saudi Arabia rich? Is Mecca Muslim? one might respond."[1] With this seemingly trivial question, George Gilder introduces a subject of profound importance: *the nature of wealth.* And when Gilder points to history as showing that "the most prosperous countries—from Phoenicia to Venice, from England to Japan, from Hong Kong to Singapore—have been domains rich not in 'natural resources' but in human freedom and rights to property,"[2] he opens up an even more profound matter: *the source of wealth.*

What, then is "wealth"? For the economist, wealth is anything having economic value measurable in price. For most people, wealth means great amounts of worldly possessions. For nearly everyone, wealth is synonymous with money.

From the perspective of history, however, it is instructive to note that money has not always been the chief symbol of wealth as it is today. The concept of wealth has varied in different periods of history. For example, wealth in the medieval era was not thought of primarily as the possession of large amounts of money or material possessions, but in having power over other people. Still later, wealth came to mean the ownership of large tracts of land and great houses.

The Industrial Revolution again transformed the idea of wealth. Wealth no longer was viewed primarily as the possession of landed property, but the ownership of the means of production—e.g., factories,

---

Mr. Dykes is a businessman, free-lance writer and enthusiastic advocate of the free market.

looms, mines, railroads. Then insidiously, over the last 150 years, the idea of wealth has changed from the ownership of the means of production to the possession of money.

Is Saudi Arabia rich? She is, if "rich" means money. But is Saudi Arabia wealthy? Warren Brookes remarks "that most, if not all, of the economic mistakes we have made (and continue to make) over the last generation have resulted from a fundamental misconception about the nature of substance or wealth," and insists that if our economy is to be re-established on a sound basis we must have "a more correct understanding of what wealth really is and (perhaps more important) what it is not."[3]

Adam Smith vs. Karl Marx

Among economic thinkers over the past 200 years, there have been two dominant schools of thought on the nature of wealth. According to men like Adam Smith and J.B. Say, wealth is primarily a matter of the human spirit, "the result of ideas, imagination, innovation, and individual creativity, and is therefore, relatively speaking, unlimited, susceptible to great growth and development." The other dominant school, represented by such men as Thomas Malthus and Karl Marx, believes "wealth is essentially and primarily physical and therefore ultimately finite."[4]

George Gilder makes clear his conviction that wealth is basically a product of the human spirit and not of natural resources. He argues, moreover, that "riches"—i.e., money—is not the same thing as wealth. "Wealth consists," he writes with reference to Saudi Arabia, "in assets that promise a future stream of income. The flows of oil money do not become an enduring asset of the nation until they can be converted into a stock of remunerative capital—industries, ports, roads, schools, and working skills—that offer a future flow of support when the oil runs out." In the 16th century Spain became "rich" much like Saudi Arabia, flooded by money in the form of silver from the mines of its colonies in Latin America. "*But Spain failed to achieve wealth*, and soon fell back into its previous doldrums, while industry triumphed in apparently poorer parts of Europe" [My emphasis]. Gilder is certain the oil-rich nations of today will achieve wealth when they "transform the transitory streams of income from oil into capital goods at home with a yield for the future."[5] Is wealth, then, "the *consequence*, possessed by the oil-rich lands . . ., or the *cause*, manifested for centuries, for example, by relatively barren islands like Japan and Great Britain, and now by Hong Kong and Taiwan?"[6]

One cannot undertake a serious examination of the subject of wealth without at the same time clearly understanding what economists call *capital.* While wealth and capital can be distinguished, they cannot be separated. Capital is a form of wealth. It is a unique form of wealth, however, in that its function is the production of additional wealth. Capital is wealth in the form of tools or resources which are employed to generate a greater quantity or quality of various kinds of wealth.

Productive, Static, Transcendental and Human Capital

It is possible, in the context of the United States in the waning years of the 20th century, to distinguish at least four kinds of capital. The first, *productive capital,* is the conventional form—i.e., any tool or resource used to create additional goods or services for sale in the marketplace, for example, seed corn used to produce corn, a carpenter's tool chest, a writer's typewriter. Productive capital is usually capable of being measured in terms of monetary value.

Second, there are those who speak of *static capital.* It differs from productive capital in that, while it has tangible value, it is not employed in the production of additional wealth; for example, a diamond, or a rare stamp.

Third, it is possible to speak of a new kind of wealth which is not capital at all in the usual sense, something called *transcendental capital.*[7] This new form of capital is a product of political or legal coercion by which an individual or a group "enjoys returns on the capital owned by someone else."[8] There is the taxation of the productive and provident for the purpose of subsidizing through government transfers the lazy and improvident. Politics in our time has become as powerful a means of achieving personal wealth as innovation and productivity; and that means is the possession of transcendental capital claims.

Fourth, in the free world "the major productive resource is personal productive capacity—what economists call 'human capital.'"[9] *Human capital* includes things like character, knowledge, skills, creativity, health, imagination and liberty. Michael Novak rightly protests that when the classical economists discussed "the components of economic wealth—land, rents, capital, and labor—they nearly always overlook the most important ingredient: practical intelligence and the organization of personal life." "The cause of wealth," Novak believes, "lies more in the human spirit than in matter."[10] While productive or physical capital increases the productive capacity of a people by putting the tools or resources with which to work in their hands, human capital makes possible more efficient tools, or superior resources, and organizes more effective means of utilizing both physical and human capital to achieve desired ends.

Thomas Sowell argues that human capital is ultimately decisive for the economic performance of a nation or people. Throughout history men have seen the destruction of their physical wealth by war, persecution or natural catastrophe, but armed with substantial human capital they not only have survived but regained their former prosperity. It was human capital, not natural resources or luck, which enabled Germany and Japan to emerge from the rubble of World War II to become the economic powers they are today. The same is true of Chinese immigrants who left their homeland and arrived in new lands impoverished and uneducated. In these new lands they have frequently been victims of persecution and have often been excluded from occupations deemed desirable by the host country's majority. Yet almost everywhere, they have ended up achieving astonishing economic success.

Capital Deteriorates

"Visible physical capital—factories, power dams, oil refineries—is always in a process of deterioration," writes Sowell, "whether at a slower or a faster rate. Financial assets likewise are constantly being consumed in order to live. Wealth in both forms will have to be replaced, even in the normal course of events. What war or expropriation does is to speed up this process of wealth's exhaustion and its need for replenishing. But the real source of wealth in both normal and abnormal times is the *ability* to produce—human capital—not the inventory of goods, equipment, or paper assets in existence at a given time."[11]

The person or people possessed of substantial human capital is characterized by a strong future-orientation. That is, they are willing to delay present satisfaction in order to enable either themselves, their children, or someone else to enjoy greater satisfactions at some later time. The future-oriented father is concerned to develop his children's potentialities to the full, and toward this end he stresses the values of hard work, self-discipline, initiative, honesty and unselfishness.

Living in the Present

By contrast, the present-oriented person "lives from moment to moment . . . things happen *to* him, he does not *make* them happen. Impulse governs his behavior, either because he cannot discipline himself to sacrifice a present for a future satisfaction or because he has no sense of the future. He is therefore radically improvident: whatever he cannot consume immediately he considers valueless."[12]

Family life and the rearing of children are crucial arenas for human capitalization. "Human capital," writes Victor Fuchs in this context, "refers to the development in the child of a healthy body and mind, general and specific skills, and other qualities that will help determine how well the child will fare later in life. The development of these traits typically requires *investment* by parents and society—that is, an expenditure of resources when the child is young in the expectation of a return to the child, parents, and society when the child matures."[13]

Economic Progress

Economic achievement and progress, thus, depends largely on human aptitudes and attitudes, and upon the political, social and economic institutions and arrangements which derive therefrom. Alexis de Tocqueville, in his book *Journeys to England and Ireland* (1833) sums up in a powerful statement the transcendent importance of human capital for the life of nations and individuals. He writes, "Looking at the turn given to the human spirit in England by political life; seeing the Englishman, certain of the support of his laws, relying on himself and unaware of any obstacle except the limit of his own powers, acting without constraint; seeing him, inspired by the sense that he can do anything, look restlessly at what now is, always in search of the best; seeing him like that, I am in no hurry to inquire whether nature has scooped out ports for him, and given him coal and iron. The reason for his commercial prosperity is not there at all: it is in himself."

—FOOTNOTES—

[1]George Gilder, *Wealth and Poverty* (New York: Basic Books, 1981), p. 47.

[2]George Gilder, *National Review*, "The Disease of Government," December 31, 1980, p. 1569.

[3]Warren T. Brookes, *The Economy in Mind* (New York: Universe Books, 1982), p. 12.

[4]*Ibid.*

[5]George Gilder, *Wealth and Poverty*, p. 48.

[6]*Ibid.*, p. 49.

[7]James Dale Davidson, *The Squeeze* (New York: Summit Books, 1980), p. 41.

[8]*Ibid.*, p. 43.

[9]Milton and Rose Friedman, *Free to Choose* (New York and London: Harcourt Brace Jovanovich, 1980), p. 21.

[10]Michael Novak, *The Spirit of Democratic Capitalism* (New York: Simon and Schuster, 1982), pp. 102–103.

[11]Thomas Sowell, *The Economics and Politics of Race* (New York: William Morrow and Company, Inc., 1983), p. 249.

[12]Edward C. Banfield, *The Unheavenly City* (Boston: Little, Brown and Company, 1968, 1970), p. 53.

[13]Victor R. Fuchs, *How We Live* (Cambridge: Harvard University Press, 1983), p. 52.

John K. Williams

A Piece of Street Wisdom

One of the illusions of our age is that wisdom is most likely to be found in the writings of the learned and the deliberations of *academia*. That this belief *is* an illusion is demonstrated if, in imagination, we take a tour of Athens as it was in the fifth century B.C.

Scholars we can find aplenty. The historian Thucydides is penning a volume which, he claims, "is not . . . designed to meet the taste of an immediate public, but [to] last for ever."[1] The philosopher Socrates is raising questions destined to haunt the human mind for millennia. The dramatist Sophocles is writing plays which audiences, in the year 1985 A.D., will still find awesome.

Yet in the streets of Athens ordinary people are doing what ordinary people ever have done and ever will do. They haggle in the market, discuss the weather, and make wagers on sporting events. They boast of their triumphs, lament their tragedies, and devise their schemes. They tell one another jokes and pass on the latest gossip. Occasionally they spice their conversations with snippets of street wisdom, quoting proverbs they drank in with their mothers' milk.

One such proverb might puzzle us. "Ah, well," one Athenian sighs, "the avenging gods are shod with wool." "True, true," nods his neighbor, and the conversation proceeds. And we wonder. "What," we ask, "does this saying mean?" "The avenging gods are shod with wool."

Actually, the saying enshrines a dramatic change in Greek thought, a change explored by Gilbert Murray in his magnificent little volume,

The Reverend Doctor John K. Williams has been a teacher and currently does free-lance writing and lecturing from his base in North Melbourne, Victoria, Australia.

Five Stages of Greek Religion.[2] The Greeks once believed that the avenging gods were swift and furious, riding in fiery chariots and announcing their entry into human affairs by ear-shattering thunder. They exacted vengeance with a blazing sword the visibility of which brought fear to the hearts of erring mortals.

The proverb questions this picture. The avenging gods, it affirms, are slow, deliberate, silent. No thundering sound or blazing sword signifies their presence. Their footfall is as soft as a whisper or a sigh. There is no noise, no spectacle, no chase, no headlong pursuit. For the feet of the avenging gods are shod with wool.

It would be superficial to dismiss the saying because we no longer believe in the avenging gods of Greek mythology, be these gods drawn by galloping steeds or shod with wool. Indeed, the Greeks themselves did not take the inhabitants of Mount Olympus too literally. What they believed and what the folk-saying we are considering affirmed, is that life is consequential. Actions have consequences which, while not always obvious, are inescapable.

They saw it in nature. A sapling, struggling toward the sky, is injured. It continues to grow, but the injury it incurred has consequences. The grown tree is crooked. The unintended injury has undesired consequences.

So, affirmed the ancient Greeks, with human life. The actions we sow determine the harvest we reap. That this is so is not, they held, entirely to be regretted. If a growing sapling could not bend its trunk to an injury, it could not bend its roots around rocks and seek out nourishment. If error did not carry the consequences of error, truth could not carry the consequences of truth. Unless folly brought the consequences of folly, wisdom could not bring the consequences of wisdom. If actions defying the laws of nature did not lead to disaster, actions in accordance with these laws could not lead to blessing. Indeed, were the world capricious rather than consequential, knowledge and partial control of the world would be impossible. Or so the ancient Greeks believed.

Actions Have Consequences

No sphere of human activity more displays the reluctance of human beings to acknowledge the consequential nature of their world than does the economic sphere. Again and again men and women have learned to their dismay that actions defying economic laws lead to disaster, but it would seem that our species suffers what educationalists pretentiously call a "subject-specific learning difficulty." National leaders, laughingly called statesmen, launch a war against economic reality, then desperately seek for scapegoats when the nation they have so ill-served suffers the consequences. Social reformers, all too many of whom wear clerical collars, proffer for the remediation of real and imagined social ills the snake-oil nostrums of yesteryear. The mistakes of the past are repeated in the present. It is tempting to ask with Bob Dylan, "When will they ever learn?" Dylan's assurance that "the answer, my friends, is blowin' in the wind" I do not presume to understand, but I do know that, in the words of Scripture, those who "have sown the wind" sooner or later "shall reap the whirlwind."[3]

Many today *have* "sown the wind." Many today act as though the laws of economics could be defied. Yet if we listen we can hear a soft footfall. If we look we can see the pale shadows of ghostly figures just behind us. For the avenging gods, shod with wool, are in pursuit.

The Creation of Wealth

First, we have ignored the process whereby wealth is created. We have acted as though wealth could be created by political edicts. For most of humanity's history men and women have so acted, hence examples of such behavior are legion. Let us consider, however, the cluster of writings, edicts and policies, usually known as mercantilism, which directed the economic life of most European nations during the seventeenth and eighteenth centuries.

Rigorous laws, designed to achieve the goal of an export surplus, controlled imports. Maximum wage laws allegedly kept the cost of production low. Governments dictated the cost of material goods. The children of the poor were trained so that they could labor in industries judged important by bureaucrats. In the France of Louis XIV state officials decided what industries were to be created and where in France or her colonies they were to be located. Self-styled experts dictated, to take but one example, what patterns were to be woven in the state-owned tapestry works at Aubusson, it taking some four years of intense negotiation between weavers and state officials before backwarp could be introduced into fabrics. Rules laid down between 1666 and 1830 for the textile industry filled in excess of two thousand pages.

The situation in the United States of America was only slightly less bizarre. The distant ruler who, in the words of the Declaration of Independence, had sent "hither swarms of Officers to harass [your] people" included among those officers not a few whose task it was to ensure that such commodities as tobacco, beaver pelts, pig and bar iron, and whale fins were traded only with Great Britain. Hats and woolen goods were not to be exported from one of your provinces to another. The story is well told by John Chamberlain in his volume, *The Roots of Capitalism.*[4] As an unrepentant Anglophile I draw my only comfort from the knowledge that attacks on George III and his policies penned in your nation were exceeded in thoroughness only by an attack penned in Great Britain by Adam Smith.

Fruits of Mercantilism

But what were the fruits of the economic system coordinated by political edicts we call mercantilism? They were the same as the fruits of *any* economic system so coordinated. Life, for the masses, was poor, nasty, brutish and short. The United Kingdom, France and your country were cursed by recurrent famines. Life expectancy at birth was, in the France of 1800, twenty-four for males and twenty-seven for females. In 1780, over 80% of French families spent at least 90% of their income solely on bread. A few people, admittedly, prospered, but the many did not, and this unhappy situation was perpetuated by a plethora of brutally enforced laws establishing and maintaining a rigid system of caste, class and privilege.

The disastrous consequences of mercantilism were no accident—indeed, the disastrous consequences of any economic system coordinated by political edicts are no accident. For such economies ignore a simple but unalterable truth. *Human beings are not omniscient.* The knowledge of any person is fragmentary, imprecise, and imperfect.

The point is perhaps best made by considering first the situation of a small, primitive tribe. Its way of life has remained unchanged for generations. Members of the tribe know, by and large, what skills the tribe possesses, what needs the tribe has, and what material resources the tribe enjoys. *Given* this knowledge, tribal elders or all members of the tribe meeting together can lay down rules specifying how the tribe is to use what it has to acquire what it wants.

But consider the problem facing a large and complex society. Skills are dispersed through literally millions of people, and constantly change as new technologies evolve. People want many different things. The material resources available are distributed globally and are characterized by ever-altering relative scarcities. No individual or set of individuals, however wise or however benign, conceivably could collate and synthesize the totality of information so widely dispersed and so subject to change.

Yet this information, wondrously, is available, and economic decisions—decisions as to how a people can best use what they have to acquire what they want—can be made by reference to this information. Friedrich A. Hayek puts it succinctly and puts it well. "Each individual can rarely know the conditions which make it desirable, for him as well as for others, to do one thing rather than another, or to do it in one way rather than another. *It is only through the prices he finds in the market that he can learn what to do and how.* Only they, constantly and unmistakably, can inform him what goods or services he ought to produce in his own interest as well as the general interest of his community or country as a whole. The 'signal' which warns him that he must alter the direction or nature of his effort is frequently the discovery that he can no longer sell the fruits of his efforts at prices which leave a surplus over costs."[5] Simply, changing relative money prices encode information about people's changing wants, changing technologies, and changing relative scarcities of raw materials, otherwise unavailable.

Why Socialism Fails

This is why economics coordinated by political edicts do fail and must fail, misallocating resources and thereby spawning destitution and the human suffering destitution entails. This is why, as Ludwig von Mises compellingly argues, socialist economies cannot succeed.[6] This is why, to make the general specific, Tanzania, which once enjoyed thriving agricultural bases but socialized these bases in the name of agrarian reform, is today utterly dependent upon foreign aid for the most basic of foodstuffs. This is why, in socialist nations, men and women are not able to use what they have to acquire what they want, including food for their bellies and shelter for their bodies.

The point is *not* that their rulers are heartless or evil, deliberately issuing edicts which misallocate resources. Rather, the point is that economic reality has been defied. The most obvious of truths has been forgotten. People are finite, fallible creatures. The only means whereby finite, fallible beings can, in a large and complex society, obtain the information necessary if they are to use what they have to acquire what they want, has been ignored. And the avenging gods, shod with wool, inexorably overtake those who presume to defy reality.

Yet let us not pretend that these gods, slowly and silently, are not pursuing us. We may not totally have abolished a market economy, but we have severely fettered it, thereby distorting the information changing relative money prices encode. Tariffs. Quotas. Subsidies. Minimum wage laws. A plethora of regulations controlling industry. We have not utterly ignored economic reality, but we have infringed its laws. And the consequences are inescapable, their cost to human well-being incalculable. For the avenging gods cannot be deterred from their task.

At the heart of economic reality is the thinking, valuing, choosing and acting being we call "man" or "woman." If we are to discover the law-abiding processes defining economic reality, our focus must therefore be upon this being. Should we pretend otherwise, thinking and writing and acting as though abstract fictions are concretely real, whereas flesh and blood people are irrelevant to our concerns, we invite error and the pursuit of the avenging gods.

The general fallacy informing such a pretense was called by the philosopher A. N. Whitehead "the fallacy of misplaced concreteness."[7] Contemporary philosophers prefer to see the fallacy as an instance of what they call a "category mistake."[8] In a paper entitled, "Redigging Old Wells,"[9] I suggest that social scientists are peculiarly prone to this error. A summary statement of the argument I develop in that paper may, however, here be appropriate, although I urge any person wishing to follow up the point carefully to read Friedrich A. Hayek's volume, *The Counter-Revolution of Science.*[10]

The Priority of the Particular

Imagine that ten people are castaways on an island. Innumerable relationships between these people are formed. For some purposes it may be useful to refer to the "community" or the "society" existing on the island, but these expressions do not signify some single existing entity distinct from the ten individuals and the relationships between them. Rather, the expressions are a useful shorthand whereby we refer to the individuals and their relationships. If one of the ten individuals acquires a monopoly of coercive power, and starts ordering his nine companions around and exacting tribute from them, no mysterious eleventh "thing" called the "state" has magically come into existence. All that exists is one bullying ruler, nine bullied victims, and the relationships between these sets of individuals, relationships characterized by coercion.

Admittedly, the term "society" is frequently used to include institutions and customs no living individual created. This indicates, however, that the term "society" can designate the predecessors of an existing generation and the heritage these people passed on to their successors. As G. K. Chesterton somewhere observes, a particular generation is but "the small and arrogant oligarchy of those who merely happen to be walking about." The ten castaways on our imaginary island doubtlessly bring into their present skills and practices inherited from the past. The crucial point, however, still holds. Terms such as "community" and "society" and "state" do not refer to concrete, existing "things" somehow distinct from individual human beings and their relationships.

When economists forget this, mischief is afoot. For the economist who deals in the abstractions called "aggregates" is ever in danger of losing from his sight the thinking, valuing, choosing and acting individual. He is thus in danger of departing from reality.

As a case in point, consider the seemingly self-evident proposition that an increase in the marginal tax rate will be followed by an increase in tax revenues. The assertion seems perfectly obvious—*but only if individual people and their possible responses to an increased marginal tax rate are ignored.*

Tax Models

To make this point, I shall refer to two "tax rate-tax revenue" models elaborated by Professors A. Laffer[11] and P. Gutmann.[12] I do so with some hesitation, for the models—the so-called Laffer Curve and Gutmann Curve—*themselves* can lure us into committing the fallacy of misplaced concreteness. The models are *not* photographs of reality or even portraits of reality; at best they are like cartoons featuring characters such as Uncle Sam and John Bull. Unlike a diagrammatic representation of, say, Boyle's Law, which enables us to make specific predictions about the behavior of gases, the diagrams we shall consider *cannot* be used as a basis for precise prediction. Yet, *given that we exercise due caution*, the Laffer and Gutmann Curves can assist us in understanding a vital truth.

The Laffer Curve purportedly shows that increases in the tax rate cannot generate a rise in government receipts indefinitely. A zero tax rate means no government revenue. A 1% tax rate results in some government revenue. A 2% tax rate almost certainly leads to greater government revenue than does a 1% tax rate. Yet a 100% tax rate produces tax revenue approaching that resulting from a zero tax rate—namely, zero revenue. At some point, an increase in the marginal tax rate results in an individual choosing leisure rather than paid employment, and if sufficient individuals do this, tax revenue drops.

Put it this way. A person earns $100 a day. On Monday he is taxed at the rate of 20%, retaining $80 from his original $100. The cost of leisure—the cost of not engaging in paid employment and instead walking in the park, visiting friends, listening to the music of Mozart, and so on—is a forgone $80. On Tuesday a 40% tax rate applies, the individual retaining only $60 from his earnings. The cost of leisure has thus dropped, the individual forgoing only $60 if he chooses not to go to work. On Wednesday and Thursday the tax he pays rises to 60% and 80% re-

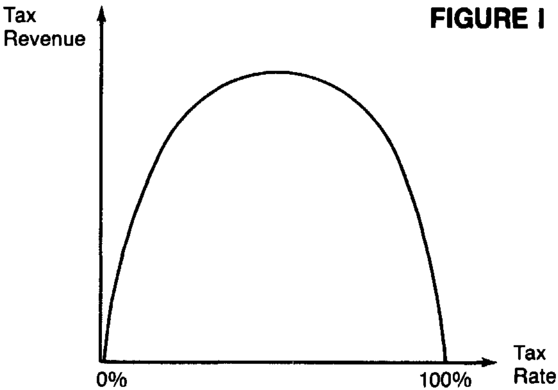


FIGURE I

spectively of his earnings. By Thursday the cost of leisure is temptingly low, being merely $20 forgone. On Friday a 100% tax rate applies. The cost of leisure is now zero—save, perhaps, for whatever pleasure an individual derives from his work and the company of his working companions. Simply, at some point an increase in the marginal tax rate will so decrease the cost of leisure, that many people will choose leisure rather than paid employment. Tax revenues thus drop. Hence the Laffer Curve (Figure I).

I repeat that this tidy diagram ridiculously oversimplifies complex reality. It might suggest that if governments were smart enough, they could discover a tax rate which, at all times and places, maximizes government revenue. Clearly, this is nonsense. The point at which the cost of engaging in paid employment—that is, forgone leisure—becomes so high that what is forgone by not working is less valuable to an individual than the joys of his leisure activities, varies from person to person and, in the case of a specific individual, from time to time. What the Laffer Curve dramatically displays is that an increase in the marginal tax rate can so reduce the cost of leisure that an individual may rationally change his pattern of behavior in a way that reduces tax revenue. A consideration of the relationship between the marginal tax rate and tax revenue that ignores the thinking, valuing, choosing and acting individual is absurdly simplistic and misleading.

The Gutmann Curve depicts another possible human response to increasing marginal tax rates. Instead of choosing leisure rather than paid employment, individuals may choose to transfer their productive activities from the "legal" economy to the so-called "subterranean" economy. Gutmann suggests that three distinct phases in the relationship between the "legal" economy, the "subterranean" economy, tax rates and tax revenues, can be specified. Given a low marginal tax rate, the totality of goods and services people cooperatively produce—a totality, incidentally, which is *itself* a fiction we must handle with care—will involve both a legal output and an illegal output, but a relatively small illegal output. As the marginal tax rate climbs, the ratio of legal output to illegal output changes, more individuals deciding to switch their productive activities to the "subterranean" economy. Since typically an illegal activity is less efficient than an open market exchange, the total productive output of a community drops. Finally, a limit is reached: given the institutional structures obtaining, no further economic activities can be transferred from the "legal" economy to the "subterranean" economy. Hence the Gutmann Curve (Figure II).

Again, my warning message: Diagrams depicting a relationship between abstractions are an economic health hazard! Yet the diagram *does* depict a very real choice individuals can make when confronted with an increase in the marginal tax rate. The Gutmann Curve, like the Laffer Curve, suggests that a government may threaten its own well-being—and, indeed, the well-being of an entire community—by increasing marginal tax rates. A decrease in government revenues does not in itself disturb me; indeed, I deplore attempts to "sell" the Laffer and Gutmann Curves to governments by the lure of increased government revenue. I *am* disturbed by a decrease in the number of goods and services a community produces and provides,

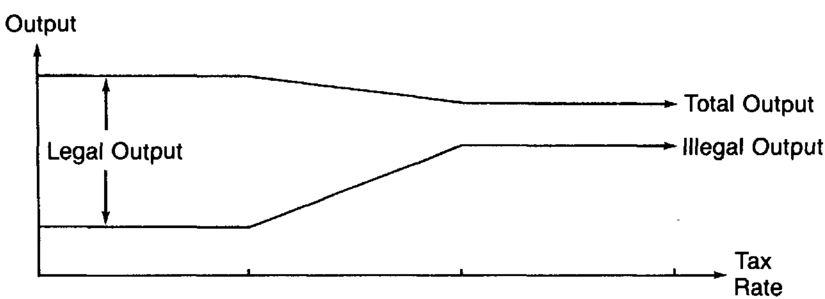


FIGURE II

for this affects the material well-being of all people—save, perhaps, government officials. Certainly, a decrease in the number of goods and services available to a community is disastrous from the point of view of the poorest.

Marginal Tax Rates Affect the Marginal Dollar

I have but touched on the consequences of tax policies dictated by theories which, focusing upon aggregates, ignore the real world of flesh and blood people. I make one further point. Marginal tax rates affect, by definition, the marginal dollar. Now the marginal dollar is important, for it is that dollar which an individual is most likely to save and to invest. Put it this way. An individual wins the lottery and, after tax, has $100,000 at his disposal. He is tempted *either* to invest that sum and add, let us say, $10,000 *per annum* to his income stream, *or* to blow the lot on a luxury cruise. The cost of the cruise is considerable: a forgone $10,000 *per annum*. A marginal tax rate of 50% reduces the cost of the cruise to a forgone $5,000, for the income derived from investing $100,000 at 10% *per annum* is taxed at 50%. The marginal tax rate of 97% which obtained in pre-Thatcher Britain reduces the cost of the cruise to a mere $300 forgone *per annum*. Extravagant consumption is thus encouraged, and *capital formation is discouraged*. And this is disastrous, for capital formation is the *sine qua non* of economic growth. Jeopardize economic growth, and human beings suffer—again, particularly the poorest.

My primary claim, however, is simple. The rules defining a fascinating game with abstractions and aggregates, and the laws defining economic reality, are *not* identical. If the rules defining a game are applied to the real world, an invitation has been extended to retribution. And the invitation is accepted. The avenging gods, shod with wool, set about their slow and silent task.

The People's Money

Money matters. By "money" I mean merely an economic good sought by all or nearly all members of a community and used primarily for present or future exchanges, units of the economic good "money" being exchanged for services and other goods. The discovery of money was a momentous discovery, for without it the cooperative activities of the division of labor and free exchange could not have gone beyond rudimentary forms. Indeed, if any person doubts that money matters, that person should ponder the recent obscenity that was Pol Pot's regime in Cambodia. By abolishing money and its uses, Pol Pot and his henchmen devastated an economy and forced men and women humbly to beg from state officials what they needed to survive.

As the title of a recent volume affirms, money today, in most developed and seemingly secure nations, is in crisis.[13] Indeed I urge you to read the volume in question: *Money in Crisis*, edited by Barry N. Siegel. Within its pages "economists from such diverse perspectives as monetarism, Keynesianism, rational expectations, supply-side economics, and the Austrian school" proffer a variety of proposals with a single objective, namely, "to make monetary institutions strictly accountable and devoid of political and bureaucratic influences." This cover description of the book accurately indicates the book's contents.

In a very real sense, however, money has always been in crisis. The long history of money can be read as an ongoing war between rulers and the ruled. It is no accident that money controlled by the masses through the market was once called "the people's money" as against money controlled by political rulers and their associates.

It is not my purpose to narrate the fascinating albeit depressing story of the battles between a "people's" money and a "ruler's" money. All I wish to affirm is that the laws of economics, the precepts of high morality, and the blessings of individual liberty, lead to the injunction, "Put not thy monetary trust in princes." A people who so place their trust shall be pursued and overtaken by the avenging gods.

A Choice from the Market

How best to secure money not subject to "political and bureaucratic influences" can be debated and today is hotly debated. My own conviction is that we should, with Friedrich A. Hayek, agitate for the de-monopolization of money and choose a gold currency from whatever rival currencies result. By a 'gold currency,' I mean simply coins made from gold and carrying information as to the maker and weight of the coins *and* notes the issuers of which must, by law, on request convert into whatever weight of gold the notes specify. While personally choosing such a currency from whatever currencies the free market makes available, I would keep an interested eye upon alternative forms of currency available. Who knows in advance what new discoveries individuals might make?

I stress this openness to alternatives simply because some advocates of the case for gold attempt to utilize for their own purposes the strategy so brilliantly deployed by Lord Keynes, namely, ridiculing the views of opponents. There is nothing objectionable in this: *reductio ad absurdum* is a legitimate form of argument, even when spiced with humor. What *is* objectionable is the suggestion that people *could not value* rare pieces of paper carrying certain words, or that walking gold is "scientific" whereas valuing printed pieces of paper is "magical." People can value anything. Of course paper money has no intrinsic value, but neither does gold. The "value" of any good is not some "thing" inhering in the good, but a relationship between an appraising mind and a good appraised.

A Reasonable Doubt

At this point, permit me a second personal aside. I am second to none in my admiration for Ludwig von Mises. I do not believe, however, that Mises is honored if his admirers fail to do what he invariably did, namely, be prepared to question any claim. Frankly, I have some worries with Mises' "regression theorem," at least as sometimes stated.[14] Crudely, the theorem can be understood as asserting that units of money can be exchanged for services and other economic goods *if and only if* what first functioned as money had a nonmonetary use. It *must* be possible to trace back the monetary use to a nonmonetary use. I see no absurdity in asserting that an extraordinarily intelligent human being *could* have realized that some substance all people in a community would accept in an economic exchange would serve a very useful function. I see no absurdity in asserting that this individual might specify some rare substance, hitherto regarded as utterly useless, as an ideal candidate for a currency. I see no absurdity in asserting that the case for using this substance as money might be accepted by a community. The happy coexistence of such intellectual perspicuity and such persuasive prowess in a single individual is absurdly unlikely, but it is not logically impossible or empirically impossible.

The point is possibly pedantic. Maybe it is sufficient to say that we are ill-advised to overstate the case for a gold currency or to assert that individuals in a money-creating-and-providing free market *could* not create and provide a paper money somehow protected from the cupidity of those providing it and from political and bureaucratic influences. How such could be done I know not and that such will be done I believe not. But the free market again and again has done what many said was impossible. Hence my option: the demonopolizing of money, my own choice from whatever currencies the market provides of a gold currency, *and* my ongoing observation of the success or failure of non-gold currencies.

Milton Friedman's advocacy of a constitutional amendment proscribing the arbitrary inflation of the currency by government fails to convince me. First, unless people thoroughly understand why money matters, an amendment passed today could be revoked tomorrow. Second, an acceptance of "non-arbitrary" inflation, whether under a 2% rule or a 5% rule[15] or any other rule, overlooks the effect of *any* inflation upon the *relative* prices of goods and services. Friedman's arguments against a gold currency have, I submit, been anticipated and answered in Ludwig von Mises' volume, *On the Manipulation of Money and Credit.*[16]

Money Matters

Similarly, Friedrich A. Hayek's advocacy of the de-monopolization of money,[17] divorced from the prudential advice that one should choose from any alternatives proffered a gold currency, does not satisfy me. While not saying that competition between rival paper currencies *could* not discover means for securing a non-inflatable currency, I would not, and the pun is intended, bank upon such a possible discovery. During your nation's history different states issued their own paper currencies, and these currencies, in a very real sense, competed.[18] This precedent, so to speak, does not provide grounds for optimism.

My main point, however, is simply that money matters. If men and women entrust their nation's monetary system to rulers who can inflate the currency, the avenging gods make ready to strike. And there is no protection from their vengeance. Advertisements promising men and women that an investment in gold will protect them "from inflation"—and that *should* read "from the effects of inflation"—are utterly misleading. The effects of inflation are not identifiable with the decreasing purchasing power of a nation's monetary unit. The entire communication system that is the free market in a free society is distorted by inflation, and that distortion can become so grotesque that a market economy ceases to function. There *is* no protection from the wool-shod, avenging gods.

Conclusion

It would be pleasant if economic reality were not as I have depicted it. But our desires must be adjusted to reality, for reality will not adjust itself to our desires.

Yet I remind you of what I said earlier. If error did not contain the consequences of error, truth could not contain the consequences of truth. Unless folly brought the consequences of folly, wisdom could not bring the consequences of wisdom. If actions defying the inexorable laws of economic reality did not end in disaster, actions complying with those laws could not result in blessing.

I remind you also of what that blessing involves. Men and women freed from the horrors of destitution. Men and women, their material needs satisfied, freed to create beauty bringing delight to their souls and to seek truth bringing joy to their minds. Men and women freed to foster and to nourish the warm and intimate relationships that make human life holy. Men and women freed to dream dreams of an even greater future and to struggle to make their dreams come true. All that, and so much more, is involved in the blessing we seek.

So maybe the avenging gods are but angels in disguise. Maybe, by visiting upon us the consequences of error and folly, they lure us back to the pathway of truth and wisdom. Maybe they wish us well, not ill. For the pathway from which we stray and to which they so insistently redirect us, is the pathway leading from a city doomed to crumble and which nothing can save to a city our forefathers in the fight for liberty founded, and which we, under God, are called upon to complete.

—FOOTNOTES—

[1]Thucydides, *The Peloponnesian War*, trans. Rex Warner (Harmondsworth: Penguin Books, 1972), p. 48.

[2]G. Murray, *Five Stages of Greek Religion* (London: Watts and Co., Thinkers' Library Edition, 1935), pp. 72–8.

[3]Hosea 8:7.

[4]J. Chamberlain, *The Roots of Capitalism* (Indianapolis: Liberty Press, 1976), pp. 39–41.

[5]F.A. Hayek, *1980s Unemployment and the Unions* (London: Institute of Economic Affairs, 1980), p. 28.

[6]L. von Mises, "Economic Calculation in the Socialist Commonwealth," in *Collective Economic Planning* ed. F.A. Hayek (London: Rutledge & Kegan Paul Ltd., 1935), pp. 87–130; *idem., Socialism* (Indianapolis: Liberty Press, Liberty Press Edition, 1981), pp. 95–130.

[7]A.N. Whitehead, *Process and Reality* (New York: Macmillan, 1929), p. 11; *idem., Science and the Modern World* (New York: Macmillan, 1929), p. 75.

[8]G. Ryle, *The Concept of Mind* (London: Hutchinson, 1949), pp. 16–18.

[9]J.K. Williams, "Redigging Old Wells," *The Freeman*, June, 1985.

[10]F.A. Hayek, *The Counter-Revolution of Science* (Indianapolis: Liberty Press, second edition, 1979).

[11]A.B. Laffer, "Government Exactions and Revenue Deficiencies," *Cato Journal*, 1 (Number 1, Spring 1981), pp. 1–22.

[12]P. Gutmann, "The Subterranean Economy," *Financial Analysts Journal* (November-December, 1977), pp. 26–34.

[13]B.N. Siegal, ed., *Money in Crisis* (San Francisco: Pacific Institute for Public Policy Research, 1984).

[14]Mises, *Human Action* (Chicago: Regnery, 1966), pp. 408–11, 610f.; *idem., The Theory of Money and Credit* (New York: The Foundation for Economic Education, 1971), pp. 97–123.

[15]Friedman, *The Optimum Quantity of Money* (Chicago: Aldine, 1969), pp. 46–8.

[16]Mises, *On the Manipulation of Money and Credit* (Dobbs Ferry, N.Y.: Free Market Books, 1978).

[17]F.A. Hayek, *Choice in Currency* (London: Institute of Economic Affairs, 1976); *idem., Denationalization of Money: The Argument Refined* (London: Institute of Economic Affairs, second edition, 1978); *idem.*, "The Future Monetary Unit of Value," in Siegel, *op cit.*, pp. 323–35.

[18]E. Groseclose, *Money and Man* (Norman: University of Oklahoma Press, 1976), pp. 180–93.

Dennis Bechara

The Myth of National Industrial Policy

CALLS have come in recent years for a new industrial policy as a certain cure for economic stagnation. Between 1969 and 1976, the Northeast and Midwest sections of the country lost about a million manufacturing jobs. It was common to refer to some of the more blighted areas as the "rustbelt" of America, foreshadowing ominous things to come. Although the recent economic rebound has in some ways muted the urgency, the call for government planning is still very much with us.

Demands for a new industrial policy no longer originate solely from academic circles. Prominent business leaders are espousing such a solution to our economic evils. Lee Iacocca, for instance, asks for the implementation of a "rational" industrial policy. In fact, he has stated that, "Any debate over whether the [United States] should have an industrial policy is outdated and way off course. We already have one but it's all messed up. The real issue is, should we have a *rational* industrial policy." In a sense, he is right. We have a hodgepodge of Federal policies that affect investment decisions in a significant fashion. Whether these policies could ever be "rational" is, of course, a debatable point.

Mr. Bechara is an attorney in Washington, D.C.

Two Variations of a Theme

Two names are commonly associated with the proposal for a national industrial policy—Felix Rohatyn and Robert Reich. Rohatyn acquired national prominence when he became the chairman of the Municipal Assistance Corporation (MAC), an off-budget enterprise created by the State of New York, which issued $10 billion in bonds. MAC was credited with saving New York City from bankruptcy, and Rohatyn, as its chairman, basked in the so-called success of the rescue operation. He became affectionately known as "Mr. Fixit."

New York City by 1975 had borrowed $724 million to cover current expenses. Its short-term debt amounted to $4.5 billion. MAC was devised as a way of financing the short-term debt and averting outright default. MAC was able to function only with the backing of the federal government. This was achieved by measures that guaranteed to the capital markets that even if the City of New York defaulted, the taxpayers would cover the bonds. New York City was saved from bankruptcy by the spreading of its risks to the national level.

Rohatyn's proposed national industrial policy is to revive a scrapped agency called the Reconstruction Finance Corporation (RFC) which would target decaying industries and regions and inject them with much-needed capital. Rohatyn also calls for easy credit by the Federal Reserve System to encourage the expansion of the housing and construction industry. The new RFC would not be vulnerable to public pressure, according to Rohatyn, because it would make its investment decisions behind closed doors, after consultation with appropriate business, labor and government representatives. As part of the conditions for granting financial assistance, the RFC would require certain policy and management changes, and it would obtain a share of equity in the enterprise. Thus, dying industries, such as steel, textiles, rubber and automobiles would be favored and strengthened by the RFC.

Robert Reich, a Harvard Professor, proposes to favor industries with potential future technology. In contrast to Rohatyn, Reich's version of the RFC would conduct its deliberations in public and would welcome the participation of all segments of society.

Interestingly enough, Reich and Rohatyn criticize each other's proposals. Reich feels that Rohatyn's closed-door RFC represents a dangerous concentration of power and a threat to our democratic institutions. Rohatyn's criticism is that an open-door RFC would only lead to politicized decisions. Both criticisms are valid arguments against the creation of an RFC.

Credit Is Earned

The unfettered market extends credit according to the profitability of an enterprise. If a business venture seems headed for failure, the credit markets either charge higher borrowing costs or simply do not grant any further financial assistance. On the other hand, if an enterprise has a probability of success, credit is allocated to it. This is a healthy phenomenon, because profitable enterprises are rewarded by the credit markets and unprofitable industries are penalized. A profitable enterprise is one that has correctly judged desires of consumers and thus is allocating resources in the most efficient way. An unprofitable enterprise, on the other hand, is one that has failed to adjust to consumer demand and misallocates resources.

By granting financial assistance to dying industries, the proposed RFC would, in effect, lower the rate of economic growth because resources would be allocated to inefficient uses. In addition, the RFC would be the lender of last resort. Industries whose prospects are so bleak that they cannot obtain further financing from the private markets, would flock to the RFC seeking assistance.

The funds granted to these poorer risks would crowd out more deserving users of funds. This may happen either because interest rates go up as a result of government operations, or, because one borrower obtains actual physical capital goods—let's say tractors on farms—at the expense of others. So we would be allocating resources to those poorer risks, who would either fail, or produce inefficiently. Therefore, it is not just a mere re-allocation of capital that is involved in an industrial policy. Also involved is the reduction in the country's wealth.

There is no guarantee that government is any better equipped than the credit markets to judge what will be the technology of the future. A few years back, France and England joined in a common government enterprise to develop a new airplane that would be the fastest in the world. The result was the Concorde, a massive white elephant that is no longer in production. The test of profit and loss is the crucial one to determine what industries have potential for growth, and the credit markets are better equipped to judge this.

Under Socialism

The incentive to be careful in allocating credit would be removed if credit were socialized, because government is not under the constraint of having to turn a profit. Other considerations, such as "the public interest," are prone to political manipulation. On July 25, 1983, Senator Proxmire, when discussing the desirability of instituting a national industrial policy, wondered how resources would be allocated, and he answered the question in this fashion:

> Money will go where the political power is . . . It will go where the union power is mobilized. It will go where the cam-

paign contributors want it to go. It will go where the mayors and governors as well as Congressmen and Senators have the power to push it. Anyone who thinks government funds will be allocated to firms according to merit has not lived or served in Washington very long.

In addition, it is easy to envisage dying industries, with their lobbyists, Congressmen and labor unions influencing an RFC and persuading it to grant further economic assistance. The so-called "new" or "promising" industries that Reich would like to aid would simply not have the political clout that the established industries already have. An RFC would provide a further incentive for groups to engage in rent-seeking behavior. Political considerations will enter into play in the allocation of capital, and those firms that are economically efficient but politically unpopular, will suffer the consequences.

Government Allocation Distorts the Economic Message

To the extent that the proposed RFC channels resources to industries less favored by consumers, we distort the economic information which is essential to entrepreneurs. Where the relative profitability of industries is forcibly altered by the government, the wrong signals are sent to entrepreneurs, and further malinvestments take place. An RFC could only perpetuate inefficient firms at the expense of the efficient ones.

In fact, this is happening right now. If we look at the activities of the federal government, we observe that there are over $30 billion in direct loans and over 150 agencies that guarantee loans to different groups in the country. All of this activity amounts to approximately $100 billion a year. Economist Herbert M. Kaufman of the University of Arizona studied the effect of Federal loan guarantees and his conclusion should not surprise us. For every $1 billion in Federal loan guarantees, between $736 million and $1.2 billion in private investments that otherwise would have taken place is crowded out.

In addition, the current tax code provides a series of incentives and deductions that skew production and the allocation of resources away from where the market would have put them. For example, by fiscal 1986, the combined tax breaks provided to people and businesses will be in the neighborhood of $400 billion. It has been estimated that in 1983 alone, the wealthy legally avoided paying taxes on more than $35 billion of income by placing investments in such qualifying ventures as oil drilling, avocados, dairy farms, real estate and other tax-sheltered enterprises. This is one of the reasons Lee Iacocca is correct when he states that we already have an industrial policy.

There is no question that a substantial segment of our economy is directly influenced by considerations that are outside the free market.

History of the RFC

Perhaps a better way of understanding the proposals for a national industrial policy is to study the actual record of the much-trumpeted Reconstruction Finance Corporation.

The RFC was established on January 22, 1932, as part of Herbert Hoover's programs to combat the Depression. Its purpose was to provide financial assistance to a number of institutions, public and private, in order to promote economic recovery. During the first few months of its existence, the RFC refused to divulge to the public the names of the institutions that were being considered for or which were granted financial relief. It was feared that the public would lose confidence in any corporation that received funds from the RFC, perceived as the lender of last resort. Congress, however, revised this policy and mandated that the RFC's activities become publicly known. It soon became evident that loans were granted on the basis of political considerations, as shown by the following:

(a) $90 million to the Central Republic Bank of Chicago, whose "honorary chairman," Charles G. Dawes, was the past president of the RFC.

(b) $14 million to Union Trust Company of Cleveland. Its chairman was the treasurer of the Republican National Committee.

(c) $12.3 million to the Guardian Trust Company also of Cleveland. Atlee Pomerone, president of the RFC, was a director of this company.

(d) $7.4 million to the Baltimore Trust Company, whose vice chairman was a Republican Senator.

(e) $13 million to the Union Guardian Trust Company of Detroit, a director of which was Roy D. Chapin, Secretary of Commerce.

Aside from banks and trust companies, over the years the RFC provided financial assistance to insurance companies, mortgage companies, credit unions, agricultural credit corporations, railroads, and eventually even to topless bars and massage parlors! Over 13 years, the RFC distributed more than $35 billion. Although some apologists of the RFC claim that when it ceased operations it left a surplus of $500,000,000, a closer analysis reveals an $11.5 billion loss due to loans that defaulted and were otherwise written off.

Did the RFC achieve its goals? If we consider unemployment as a reliable indicator, we have to conclude that the RFC failed. In 1931 unemployment stood at 8 million. By 1939 there were 9 million people unemployed. Unemployment declined only after Pearl Harbor. All the RFC achieved was to misallocate resources. Capital was diverted from more efficient uses to less efficient, but politically more savvy uses. No one will ever know how much investment was crowded out by the RFC, but if the study by economist Kaufman is an indication, the effects were substantial.

Japan

One of the shining examples utilized by many proponents of a national industrial policy is Japan. According to this version, Japan's economic miracle is due to the guidance provided by the Ministry of International Trade and Industry (MITI). Therefore, all we have to do is set up our own MITI and permanent economic recovery will be with us. Before we do that, it would be instructive to analyze just what MITI has done in Japan. Is the Japanese miracle due to MITI's omniscience? Or is it due to a policy of limited government and laissez-faire?

At the end of World War II, Japan was devastated militarily and economically. Two of its cities, Hiroshima and Nagasaki, were obliterated by atomic bombs. Food was scarce, and only 16 per cent of Japan's land is arable. In 1947 more than half the Japanese population was engaged in farming. Although lacking capital and technology, Japan had a vast amount of cheap labor. So labor-intensive industries began to prosper and produced such items as foodstuffs, textiles, ceramics, and beverages. These export industries in turn brought foreign currency into the country, enabling Japan to acquire foreign technology, managerial expertise and raw materials.

As the evolution continued in the 1960s, capital intensive industries began to emerge, producing such items as automobiles, motorcycles, television sets, radios and cameras. Japan's success in exporting its goods was the result of thousands of private companies which imported cheap raw materials, acquired foreign technology and exported goods. What was the role of the Japanese government and of MITI in particular during this time?

During the 1950s, MITI was convinced that there were no commercial possibilities for the transistor. After all, a change to transistors was simply too revolutionary an idea. So for two years, MITI attempted to prevent Sony from acquiring manufacturing rights from Western Electric. Similarly, MITI felt that Japan's automobile manufacturers could not compete in the world markets. So they attempted to dissuade the manufacturers from getting into the export market. In addition, MITI felt that there were just too many automobile plants in Japan, so it attempted to force all ten firms into merging into two—Nissan and Toyota.

Needless to say, MITI failed to persuade the Japanese business community of the wisdom of its advice. Robert Reich points at the Japanese semiconductor industry as the one example where the government successfully targeted an industry. But, if we take a closer look at the statistics, the U.S. government has been spending 10 times as much money as the Japanese government spends on the semiconductor industry. Therefore, government spending is not the answer to the success of the semiconductor industry. In fact, the Japanese government's share of all research and development (including defense) is amazingly low. In the U.S. it is 48 per cent, whereas in Japan it is 28 per cent.

Not surprisingly, during the 1950s and 1960s, the Japanese government was concerned with rebuilding the nation's infrastructure. Roads, harbors and airports were built. The government balanced its budget during this time, and taxes were kept low. The tax system did not penalize savings, and the share of national income taken by taxes was and still is the lowest among the developed nations. In addition, the devastation of the Second World War took away the power enjoyed by the old bureaucratic elite, the Zaibatsu, and this in turn has spurred competition.

Perhaps the most astonishing fact is that contrary to what the proponents of a national industrial policy contend, most loans recently issued to business in Japan have come from the private sector. There has been, in other words, no massive financial targeting of industries by the government. In fact, the industries that have received government financial assistance have been politically powerful, but economically weak.

Farmers receive a substantial amount of protection in the form of outright subsidies and import restrictions. Coal mining has benefited from low interest loans. Yet output has decreased from 54 million metric tons in 1962 to 19 million tons in 1978. The shipbuilding industry also received low interest loans. Yet it is operating at 35 per cent capacity and, after 1977, 46,000 workers had to be laid off. Petroleum refining, petrochemicals and aluminum have also received government aid. None of these industries, however, is responsible for the outstanding rate of growth experienced in Japan. Rather, the "secret" of Japan's success may be reasonably attributed to the government's policy of keeping spending under control, and of providing a favorable business climate.

Is it true that in spite of having a general policy of favoring free enterprise, we are nevertheless experiencing a de-industrialization of our economy? A brief review of some of the statistics will be revealing.

The Changing Pattern of The American Economy

A common observation among the proponents of a national industrial policy is that the economy has shifted away from manufacturing. Non-agricultural employment has increased from 60.6 million in 1965 to 90.8 million in 1980. The manufacturing sector has, during this same period of time, fluctuated between 18.5 and 21 million jobs. Between 1969 and 1975, about a million manufacturing jobs were lost. Yet, 3 million manufacturing jobs were created between 1975 and 1979. Some of the manufacturing industries contracted as a result of the recent recession, but manufacturing employment has subsequently stabilized. Fears that our manufacturing sector was on the verge of extinction were unfounded.

The importance of the manufacturing sector, however, has declined during this same period of time. In 1965, 30 per cent of all non-agricultural employment was in manufacturing, whereas in 1980, it was 22 per cent. The growth in jobs has occurred in the service and the governmental sectors. But this does not mean that we are fast becoming a nation of janitors. The share of manufacturing jobs in Japan, Germany and England has fallen even more sharply than in this country.

Although the reasons for the contraction of the relative share of manufacturing jobs are varied, they do not defy logical analysis. One reason is that some industries, like the steel industry, paid exorbitantly high wages to its unionized labor force at a time when their productivity was declining. The average wage rate for a Japanese automobile worker is half what his American counterpart earns.

Paradoxically, many employees have voluntarily left the manufacturing sector and joined better-paying jobs in the service sector. The service sector created 9 million jobs in the decade of the 1970s. Of these, about 8 million were in the professional and business service area. In addition, the growth of the service sector has been made possible by the entry in the market of many part-timers, such as teenagers and the elderly, who seek temporary assignments that demand few skills. Clearly, there is a need for these jobs. However, there is no danger that the manufacturing sector is about to disappear. Even if the manufacturing sector were in the decline, that in and of itself is insufficient to justify an industrial policy.

Conclusion

As we have seen, the proposals for a national industrial policy are founded upon a misunderstanding of basic economic issues. The role of the price system; the allocation of resources; supply and demand—these are all crucially important issues that we must understand if we are to prevent one economic folly from being implemented on top of another. As Friedrich Hayek once said, the fundamental problem in economics is that knowledge of all the relevant circumstances "never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess."

This is the fundamental reason all central planners, from the 5-year plan in the Soviet Union to national industrial policy, are bound to fail. Understanding why this is so is an important step. This is why it is so crucial that groups, such as the Foundation for Economic Education, exist. As each one of us strives to improve his understanding of the market order and its moral underpinnings, we shall approach a more just and freer society.

IDEAS ON LIBERTY

Voluntary Cooperation

To suggest that America's greatness lies not in trying to frame national goals and purposes, but in making it possible for millions of individual Americans to realize *their* goals and purposes is not to intimate that America is devoid of ideals or lacking in the capacity for voluntary cooperation. Quite the contrary. The American pioneer, by his very way of life, was more self-reliant than the European peasant who was dependent for his livelihood on the local country squire in England, or nobleman in France.

But, in the case of an Indian raid, the lives of the pioneer and his family might depend on the willingness of his neighbors to come to his help. There was also cooperation in building cabins, in clearing woods, in husking corn. And this tradition of voluntary mutual aid finds expression in the very different conditions of modern life, in the service club that looks after handicapped children, in the alumni group of a small or medium-sized college that raises funds for scholarships for the students who have followed them and whom they wish to help.

WILLIAM HENRY CHAMBERLIN,
"America is Many Million Purposes"

The Wealth of America

In his *From Adam Smith to the Wealth of America* (New Brunswick, N.J., Transaction Books, 237 pp., $29.95), Alvin Rabushka has written one of the really searching books of our time. But its title, though apt as an indication of the validity of principle, is somewhat misleading. Taken literally, it implies a straight line process in history. But the sad truth is that Adam Smith lost caste in England at the very peak of his success. His principles took hold in America in the nineteenth and early twentieth centuries, but they went out of vogue in the depression of the Thirties.

If that were all there was to it, Rabushka might as well have called his book *The Decline of the West.* Both Britain and America have been throwing their wealth away. But it so happened that several geographically small countries on the rim of eastern Asia (Hong Kong, Taiwan, Singapore, South Korea) decided to follow the path of economic freedom, a phenomenon which is now teaching us to have a new look at things. Rabushka devotes part two of his book to the Oriental experience. With rebirth in mind he might better have called his book *The Phoenix.* Or even, *There'll Always be an England—Somewhere.*

Certainly we in the West have been honoring Adam Smith's laissez faire philosophy in the breach. But there is a lesson in Rabushka's story. The lesson is that it can take fifty years for a common sense proposition to take over. When Adam Smith wrote *The Wealth of Nations* England was in the grip of the mercantilist philosophy. The younger William Pitt was fascinated by Smith's work, but the war with Napoleon kept him from doing much about it.

"In the aftermath of the Napoleonic Wars," so Rabushka writes, "Britain paralleled the contemporary United States." The list of regulations in the British statute book covered all sorts and conditions of work. There was a stiff tariff wall around manufactures, and the corn laws were regarded as an absolutely necessary crutch for agriculture. The export of machinery was banned and skilled artisans were denied the right to emigrate. The Navigation Acts stipulated that all seaborne trade going in and out of British ports should be carried in British ships. The ships themselves had to be built in British yards. There were restrictions on joint stock companies, and foreign trade was in the hands of royally-chartered monopolies. A huge public debt, the legacy of the eighteenth-century wars, consumed half of all public spending.

Says Rabushka, "the government's heavy-handed approach to the economy reflected mercantilist thinking and practice embellished by wartime controls . . . The British economy was a mixture of deliberate economic decisions of her rulers to achieve specific national goals and a collection of ad-hoc taxes and measures solely reflecting urgent wartime needs for more revenue or economic protectionism." Sounds very much like Washington, D.C., today.

The Cotton Industry

It so happened that the British controllers in 1815 had overlooked the cotton industry, which was just coming into existence. There were hundreds of regulations to prevent growth in silk and woolen manufacture. But the cotton industry had, for a moment, the unchecked advantage of the nascent industrial revolution. It began to show its heels to silks and woolens.

Adam Smith had been a long time dead when the British really began to heed his words. And it took a full half century, from 1815 to 1865, before the economic reform had been completed. Some great men were involved in it. Rabushka doesn't give enough credit to the evangelists of free trade, John Bright and Richard Cobden. His heroes are William Huskisson, Sir Robert Peel and William Gladstone. Huskisson started the ball rolling by the tariff reform of 1825, with reduction in the duties on rum, fabrics, minerals and manufactured goods. In 1832 the first important electoral reform brought manufacturing representatives into the House of Commons.

Sir Robert Peel continued the tariff reduction crusade, but he had to compromise by accepting a not too onerous income tax in order to keep the budget balanced. The Corn Laws persisted, and Peel, as a Tory, didn't dare go too strongly against the landed aristocrats who insisted that agriculture should not be left to the mercies of the international market. But the potato famine in Ireland changed the intellectual climate a bit. Despite the opposition of the Duke of Wellington, who said "damned rotten potatoes put Peel in his fright," the Corn Laws were finally repealed.

A Stimulus to Trade

Then came the Gladstone budget of 1860, with a total abolition of duties on dairy products and cuts on timber. The favor to imports had a magical effect on exports. "The export trade of 1860," says Rabushka "was the largest on record, having risen in value to 136 million pounds from the 1859 figure of 130 million."

Modern supply side theorists would be fully justified in claiming that the history of England between 1815 and 1865 proves the case for the Laffer Curve. Money continued to pour into the exchequer in steadily increasing amounts with each round of tariff reductions. The lower the tax rate, the bigger the tax volume. But Britain's increase in wealth, coupled with the new electoral laws that extended the franchise to all males regardless of property qualifications, was its own undoing. The Fabians, with their philosophy of redistribution, set the new intellectual climate in the Eighties and Nineties, and the Welfare State was the end result.

Rabushka more or less drops the British story at this point. He continues to accentuate the positive by switching to what happened after 1946 in Hong Kong, Taiwan, Singapore and South Korea, where the British experience of the 1815–1865 half century has repeated itself. Rabushka's penultimate chapter, entitled "What happened to the American Dream?," is pure melancholy. The final chapter, "Recipe for Prosperity," calls for a return to Adam Smith's principles.

With the fifty-year struggle in Britain in mind, Rabushka obviously doesn't think anything is going to happen overnight. But "Ronald Reagan," he says, "has taken a modest first step, perhaps no more than that of William Huskisson . . ." Some modest reforms, he says, have been achieved. And the "determination and success of three giants in nineteenth-century Britain gives cause for optimism in our country. As the intellectual currents increasingly demonstrate the flaws in big government and the benefits of the market economy, politicians . . . will find the attractions of more economic freedom irresistible. On this view, the future is not so black."

AN AMERICAN IN LENINGRAD
by Logan Robinson
(W.W. Norton & Co., New York, New York 10010), 1982
320 pages ▪ $17.50 hardback

Reviewed by Bill Anderson

LOGAN ROBINSON, a New York City lawyer and Harvard Law School graduate, has written an enjoyable and informative book on his experiences in the Soviet Union, first as an exchange student at the Civil Law Faculty of Leningrad State University (Lenin's alma mater) from 1976 to 1977 and later as a tourist returning to the U.S.S.R. in the fall of 1980.

A well-written and fast-paced book, *An American in Leningrad* gives much insight into daily life in the Soviet Union through a collection of anecdotes detailing the author's adventures (and misadventures) in dealing with the omnipresent bureaucracy, standing in long lines to purchase shoddy merchandise (when it was available), and making friends with local citizens despite the KGB and the built-in paranoia of the Russian culture. Robinson's accounts are laced with humor as he describes his many brushes with Soviet bureaucrats whose main duty, it seems, is to make life as difficult as possible for anyone needing their official approval.

For example, the author cites the difficulties of obtaining the necessary faculty signatures to allow him to travel in other parts of the U.S.S.R., although he admits that his being an American gave him a distinct advantage over his counterparts from the Soviet Union as well as those from Eastern European and Third World nations who were also studying in Leningrad. And part of the reason for his relative success in winning "victories" over the bureaucratic system, Robinson writes, was his determination not to leave his American values and forcefulness at home.

Although he is not an economist, Robinson picks apart the inefficiencies of the Soviet economy with the logical scalpel worthy of a Milton Friedman, pointing out just why the communist system fails. The author gives an excellent example in his account of a small, private industrial goggles factory in Leningrad. Because of the eye injuries occurring in Leningrad factories due to a goggles shortage, some workers fashioned industrial goggles of their own. They recognized the growing demand for their products and were soon filling orders from state factories, an illegal activity in the U.S.S.R. punishable by death. For a while, the state's desperate need for goggles outweighed the gravity of the workers' "crimes," but when the factory became "too" successful, the authorities closed in on the operation, shutting down the enterprise and jailing its owners. The end result, Robinson writes, is that once again goggles came into short supply and eye injuries rose in Leningrad.

The fascinating part of that story, he narrates, is that it was told to him by a Soviet lawyer who herself believed that state crackdowns on private enterprises were wrong-headed at best and harmful at worst. The lawyer's attitudes, it seems, mirrored the attitudes of others Robinson met in the U.S.S.R. In fact, he writes that he found only one (that's correct) believing Marxist-Leninist in all his travels in the ideology's birthplace. Unfortunately, the lone adherent to the Russian civil religion happened to be his faculty advisor.

An American in Leningrad contains many other anecdotes as well, including Robinson's brief tour with the Nitty Gritty Dirt Band as he served as the band's translator during part of its Soviet tour, a tour made humorous by the bumbling antics of the KGB as it tried, in grade-B movie style to harass the band and its Russian fans.

For those who wish to gain more insight into the U.S.S.R., its economy and its people, this book is must reading.

MAKING THE FUTURE WORK
by John Diebold
(Simon & Schuster, Inc.,
1230 Avenue of the Americas,
New York, N.Y. 10020), 1984
466 pages ■ $18.95

Reviewed by William H. Peterson

THOSE who well anticipate and define the issues, according to legal lore, usually win the arguments. John Diebold is one who not only foresaw the postwar sweep of automation—indeed he coined the word—but who has long been adept at spotting and honing issues and hence winning arguments. Diebold sharpens national if not global questions and probes the fit (or misfit) of many of America's institutions with the dynamics of the 1980s.

Generally he finds these institutions out of tune with the times—i.e., a drag on progress. Accordingly he comes up with ways of "closing the gap between what our society can achieve—and what we do achieve."

Examining that gap, Mr. Diebold analyzes on the basis of structure, function, process and management such institutions as the federal regulatory bureaucracy, Congress, organized labor, commercial banking, corporate America, the "lawyering" industry, the media, and public education.

Well, what about education? He notes that the school industry spends about 85 per cent of its budget for salaries, 10 per cent for buildings, less than 5 per cent for books and papers, and under 1 per cent in research on how children learn and its own efficacy in educating them. He worries about educational monopoly—about requiring a child to attend a particular school regardless of its goals, methods, and curriculum. He therefore asks for more choices in education and comes out for the voucher plan, for possibly even for-profit corporate-run schools. He writes: "An IBM school or a General Electric school is not outside the realm of possibility."

What about the media, which Mr. Diebold thinks is indeed the Fourth Estate? He decries its generally short-term outlook, its penchant for creating crises by focusing attention on isolated generally pictorial events to the exclusion of stories that cannot be told in pictures or a few paragraphs. Television news gets especially rapped for sensationalism. Example: Three-Mile Island, which Walter Cronkite hyped up at the time as "a nuclear nightmare. . . the worst nuclear power plant accident of the atomic age." Even now the incident is still described as a "disaster," comments Mr. Diebold, even though the only human harm known for sure as attributable to the accident was caused by anxiety, not radiation.

What of the "lawyering" industry? Mr. Diebold criticizes the U.S. legal system for becoming in many ways a roadblock to making the future work and even "a roadblock to justice." He criticizes, for example, the government antitrust attorneys who tried to subpoena IBM documents that would have taken 62,000 man-years to produce at a cost of $1 billion. He complains about the more than 600,000 lawyers in America as against 15,000 in Japan. He thinks humorist Russell Baker has a possible cure—we export one lawyer to Japan for each Japanese car imported here.

So this incisive book goes, with hardly any institution spared. More and more corporate leaders are castigated for their short-term vision which in turn is blamed on the "performance" orientation of Wall Street analysts, the SEC requirement of quarterly reporting, the here-and-there behind-the-times teaching of business schools, and the Congressional prohibition manifested in the Glass-Steagall Act preventing banks from taking equity positions in corporations.

To be sure, the anachronizing, the emerging cross-purposes of America's institutions, are complex matters. The status quo is frequently tyrannical, as another critic of our times, Milton Friedman, has reminded us. But the promise of freedom and free enterprise is too great to be short-changed. Better to define issues, raise questions, exercise leadership, engage in dialogue, and perhaps above all, have vision—the long view. These are the marching orders that John Diebold, a modern-day Socrates, hands us in this book.