THE FREEMAN

IDEAS ON LIBERTY

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IDEAS ON LIBERTY

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Cover illustration: Randolph Caldecott, from *Old Christmas, from the Sketchbook of Washington Irving.*

PERSPECTIVE

The Christmas Spirit

We get much more out of life than we pay for, because many people give much more than the services for which they are paid. This is the essence of the Christmas spirit, as portrayed by Charles Dickens in "A Christmas Carol."

The well-known French author, Bertrand de Jouvenel, noted that we enjoy "warm hospitality, leisured and far ranging conversation, friendly advice, voluntary and unrewarded services. Culture and civilization, indeed the very existence of society, depend upon such voluntary, unrewarded activities." But such activities very often depend on having time, money, and property. It is the freedom to use private property that enables people to give of what they own.

Dickens contrasted the Christmas spirit of giving, generosity, sociability, and cheer, with the stinginess of dour, greedy, grasping Ebenezer Scrooge. In Dickens' mind, Scrooge was a typical capitalist. But Scrooge was no more a "typical" capitalist than Dickens was a "typical" writer. Moreover, once Scrooge was converted by the Ghosts of Christmas, past, present, and future, it was his private property which enabled him to be generous.

It is ironic that the welfare state, intended to be a system where money doesn't matter, has become a system where only money matters. Many services which used to be provided by family, friends, and volunteers, with no expectation of monetary reward, now depend on taxes and bureaucratic decisions. In a welfare state, the act of "giving" is reduced to a nine-to-five government job.

The Christmas spirit of giving and sharing persists today because capitalism and private property survive. What Dickens failed to realize is that it is having private property and the freedom to use it that permits Christmas giving.

—*BBG*

Efficiency Experts

Are private sector institutions more efficient than government bodies? Yes, by a long shot. At least that is the opinion in most American

households, according to a recent survey publicized in *Newsweek.* Respondents gave "high or very high" efficiency ratings in greatest proportion to competitive enterprises such as supermarkets, banks, department stores, and credit card companies. By contrast, government-provided services such as public schools, the space agency, local transport, and commuter rail generally had the lowest efficiency ratings, with Congress itself holding the dubious honor of last place.

It is no surprise to students of liberty that market enterprises are more efficient than political ones. But it is encouraging that so many Americans recognize the difference.

Logic suggests that schooling, space development, local transportation, and other socialized activities would also be more efficient if turned over to the private sector. Does this survey presage public support for such a move? Let us hope.

—HB

Old Dutch Burying Ground

The Old Dutch Burying Ground in North Tarrytown, New York, dates from the time of the American Revolution. The tombstones of common fieldstone, granite, and slate, tilt at various angles. But many of the inscriptions are sharp and clear.

The dates on the tombstones reveal the ages of the departed. Many lived to ripe old ages, especially the men. Quite a few women died in their prime. But sprinkled among the adults are a substantial number of very young children and infants.

One stone marking the grave of a young woman reads:

Tho the Mother is Dead
And the babe left behind
May it truly be said
That the father proved kind.

But kindness was not enough. Next to this young mother's grave stands a small stone marking the grave of the baby, who died a mere seven months later.

The folks who lie buried in the Old Dutch Burying Ground lived and died before the capitalist "industrial revolution" and also before the "medical revolution" that followed in its wake. In the face of infectious disease, the people of that time were practically helpless; many succumbed before an epidemic ran its course. Operations, often fatal due to shock or infection, were seldom performed, but if they were, the principal method of deadening the accompanying pain was liquor.

A woman's life was especially difficult, not only because of the harsh conditions of daily living but also because of the hazards of childbirth. Men often survived several wives, sired numerous offspring, only to see many die in childhood.

It was the capitalist "industrial revolution" that wrought the difference between those times and now. With capitalist tools and machines, one worker could produce considerably more food, clothing, and shelter than before. As production increased, more people were freed for study and research. In time, their studies and experiments led to the inoculation for smallpox, safe anesthetics, and recognition of the importance of antisepsis, launching what might be called the "medical revolution."

The advancement of medical science lengthened life expectancy, and sharply reduced deaths among young people. In the more recent Sleepy Hollow Cemetery next to the Old Dutch Burying Ground, the tombstones are mostly of adults, and serve as a reminder of the lengthened life spans wrought by capitalism.

—BBG

Freedom Essay Contest: Last Call for Entries!

Deadline for our student essay contest is January 15, 1987. All high school and college students are invited to enter the competition. Cash prizes, as well as seminar fellowships, will be awarded to winners and runnersup. Call or write The Foundation for complete details.

Ravioli and the Economics of Trade

by James Doti

Memories are formed more by discontinuities than continuities in our lives. Because of this, I think, the only Christmas I remember well is a Christmas celebrated away from home, a Christmas spent in Little Italy. It is a Christmas memory whose edges take on more clarity over the passage of time.

December 24, 1955—Christmas Eve Day

My dog Blackie and I look out of a frosted window that separates the cold and crisp Chicago winter morning from the comforting warmth of Grandma's flat. My parents, brothers, aunts, uncles, and cousins will join us tomorrow for a traditional family Christmas celebration, but for now my dog and I are here to keep Grandma company. I don't mind since Grandma and I are tight—a special closeness that comes more easily when one is the youngest of a horde of grandchildren.

Her wizened face is dark, almost swarthy. She wears spectacles with thin silver rims and all manner of long, old-fashioned dresses and shawls, usually black. Her diminutiveness emphasizes the kindly countenance of her face. Many years of dough-kneading have given her stong muscles, but she is old now and often short of breath.

She speaks with a thick Italian accent and I with a speech impediment that renders my English barely intelligible. Yet, we have no problem communicating; our communication does not necessarily require the spoken word. We work with silent efficiency in packing the last of the ravioli that we will bring to market. As I gather the now-dried ravioli which are spread throughout the flat, I savor the rich and sweet aroma of fresh basil and chiminelli.

It is the chiminelli seeds that give Grandma a competitive edge over the other widows in the neighborhood who are also purveyors of ravioli. The source for the seeds is a relative in Grandma's grim little home town of Brienza, Italy—the only area in the world with the proper blend of harsh climate and barren soil that allows the ugly chiminelli bush not only to survive but to thrive and prosper as well. The arrival of Grandma's annual shipment of chiminelli seeds once created quite a stir in the neighborhood when two FBI agents came to question her regarding a possible involvement in drug trafficking. The case was closed when Grandma gave each of the agents a bag of the wonderful tasting pretzel-shaped biscotti that are also distinguished by the anise-tasting seeds.

A chilled wind hits our faces as we pack the last cartons of ravioli on the two decrepit Radio Flyer wagons we use for transport. But Grandma has bundled me up, and I am dressed in galoshes, so except for my face which feels the harsh wind, the rest of me is sweaty and uncomfortably hot.

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As we pull our wagons past Laflin Street and Ashland Boulevard, we make it to Halsted Avenue which will lead us to our destination—South Water Market. Tall buildings and narrow alleys cut sharp angles and make deep shadows. The vibrant and festive street life which envelops the area during summer months is absent now. Table-top Christmas trees seen in several sooty windows and cheap dimestore Christmas wreaths hanging on heavily painted gray-green doors fail to convey any Christmas cheer. Perhaps because the neighborhood is unfamiliar or perhaps because of its lifelessness, my dog, in contrast to his usual bounding ways, trails closely behind me. As our expeditionary force of three makes slow and steady progress toward our destination, I fantasize I am Captain Scott heading toward the South Pole.

But when we arrive, our hopes are dashed in much the same way I suspect Captain Scott's were when he found that the Norwegian interloper, Roald Amundsen, had beaten him. After hunting throughout various warehouses and loading bays, we find an agent who gives us the bad news. Hardly looking up from a newspaper he is reading, a gruff man with an inflated sense of self-importance exposes prodigious gaps in his cigar-stained teeth when he tells Grandma, "We ain't buyin' anymore raviolese from youse ladies. We're importin' 'em in frozen from Italy. We can get 'em a lot cheaper dat way." Grandma's protestations fall on deaf ears. The man whose jawline had long ago disappeared into one of his chins rises from his chair while making a lifting gesture with both arms and says, "Listen lady, I gotta make a living, too."

As we leave the building with our still heavily-laden wagons we encounter a bitter wind laced with sleet. We are preoccupied with our disappointment when a bus veers toward us and comes to a screeching halt just by the curb where we stand. The shrill sound of brakes and a fountain of slush sprayed by the huge wheels paralyzes my Grandma and me, but Blackie bolts. I turn and see him rounding a corner at breakneck speed. We desperately follow, but lose sight of him.

Lost! Lost! My dog Blackie is lost.

Tears mingle with the sleet on my face as we venture further into an unknown neighborhood. Grandma pleads with me to abandon the search, but I don't give up until she bodily drags me off. Even though I know down deep that Blackie must be hopelessly lost, I fight, scream,

and cry. It is only when I see the look on Grandma's face that I realize we too are lost. My attention turns away from dog-saving to people-saving.

As dusk settles upon us the cold turns colder and the sleet turns icier. Like Captain Scott and his men and the ill-fated trip back to base camp, our movement is painfully slow and misdirected as we trudge in circles over previously covered ground. Several children seemingly oblivious to the cold, throw snowballs at each other in a dangerously boisterous way. Grandma is too proud to ask anyone for directions. When I, risking the ridicule that usually accompanies my speech, do ask and get us back on track I feel for the first time in my life the exuberance that comes when one sheds the weakness of youth and assumes responsibility and control. I fantasize that my decision to ask a stranger for directions is one of life-saving importance and is an heroic act that is witnessed, cheered, and applauded by many.

It is not long before we see the familiar spires of Our Lady of Pompeii Church. As we enter the sturdy old church where my parents were married and my oldest brother was baptized, the redolence of incense and burning candles invades our senses. The church feels peopled and full. Sisters of Mercy, in their glory, bustle up and down marble aisles, arranging altar cloths and poinsettia plants. The warmth of the church comforts us. Grandma prays for economic survival; I pray for Blackie's survival. Before we leave, Grandma fumbles in her purse and gives me a few coins to leave in the poor box.

A block from home, we give the unsold and now-surplus ravioli to Miss Amberg, the beloved director of Madonna Center, the settlement house where my parents first met. As we pull our now-empty wagons over that last block, our slow and spiritless walk conveys Grandma's woe at failing in the marketplace, my woe at losing a dog. In contrast to the quick movements down the steps when we loaded the wagons, Grandma now negotiates the steps with resigned fatigue as she brings both of her high-laced shoes together on each level before proceeding to the next step.

At the doorway, a scratching sound from within the flat is heard. Blackie! He jumps and slobbers on me when we open the door. A note is on the kitchen table.

Dear Ma,

When we came to bring you your Christmas present, we found Blackie yapping to get inside. The Christmas present in the back room is from all of us. See you tomorrow.

Your loving children

In the back room, rests a state-of-the-art swivel model mahogany RCA Victor black and white 21-inch television set wrapped in a large red bow.

Later that evening while watching the original Christmas episode of "The Honeymooners" on the new RCA set, I stuff pretzel-shaped biscotti in my mouth and wash it all down with cream soda. Blackie snuggles near me beside a clanging radiator.

Grandma looks outside. She hears carolers below the window from Madonna Center singing songs of Christmas celebration, celebrating her and her ravioli. She smiles a distant smile, but her eyes do not reflect contentment; they reflect apprehension. With that special sense of knowing that children sometimes feel but do not fully understand, I see a troubled woman, a woman oblivious to the joyful presence of Blackie, the RCA, the biscotti, the cream soda, and the carolers' songs.

She has no real monetary worries to speak of. Her children are all financially well-off and will gladly provide for her. But she is a fiercely independent woman. It is an independence that she may have been born with but more likely developed in the hard and brutal struggle it takes to leave one's native land, one's relatives, and one's traditions in order to emigrate to a new and strange land.

It was an emigration that allowed her to take her only possessions—her children and her values: respecting others and taking pride in one's work. She would use these values in a free land not merely to survive but to help her and her family live a fuller and more spirited life. They were strong values that she imbued in her children and her children's children.

But now she looked out the window with ap-

prehension. A heartless process in this free land, a process she did not understand, had taken away her sole means of independence and dealt her a cruel blow. She failed in the marketplace and with a fierce sense of pride, this was something she could not accept.

The Solution?

The solution to my grandmother's difficulty would be simple today: Form a strong political action committee and lobby for a stiff tariff on Italian ravioli. If such a course of action seems improbable, consider the fact that the National Pasta Association (NPA) recently convinced the White House to slap a stiff retaliatory tariff of 40 per cent on European pasta without egg and 25 per cent tariff on pasta with egg. The retaliation was aimed at the European Economic Community (EEC) for a tariff it had imposed not on U.S. pasta but on U.S. citrus products. Evidently, the EEC was convinced by the European citrus industry that it needed protection.

Meanwhile, the NPA is lobbying to protect its tariff. Corby Kummer in *The Atlantic Monthly* states:

> As soon as the tariff went into effect, it (NPA) mailed promotional literature (accompanied by packages of domestic pasta) to congressmen telling them to remember that American pasta must be protected. Before the tariff was imposed, the NPA predicted that, unchecked, Italian pasta could claim a 20 percent market share by 1988 or 1989—something extremely unlikely, given that it had only a 4.5 percent market share at the time. (*The Atlantic Monthly,* July, 1986, p. 41.)

Although the pasta tariff and most other restrictions on trade are intended to protect domestic industries, as with most well-intended governmental policies, the ultimate impact is quite different. The reason for this is straightforward: Tariffs and other restrictive policies reduce the overall benefits to be derived from trade. A corollary to this is that protected industries in the long-run generally fare poorly when they are not fully subjected to the harsh realities of a competitive environment.

Almost all economists agree that free trade is better than protectionism. What is it that is so unmistakably good about free trade that has done the impossible—namely, get economists to agree with each other?

We can be very analytical about it and show the net benefits of trade by describing the theory of comparative advantage. Adam Smith was far too interesting a writer to get bogged down with such analytics; David Ricardo, however, had no such compunction. Ricardo rigorously showed that two nations will benefit from trade even when one of the nations is absolutely more efficient in the production of all goods.

We need not be so analytical. Actually the benefits of free trade are simple to understand within the context of a free enterprise system. Our economic system is based on greed. Of course, this is not as bad as it sounds. Thankfully, almost everyone is a profit-maximizing individual and competition among many profit-maximizers assures that prices are kept low and that goods and services are being produced that people demand.

How does free trade enter into this? Free trade simply allows more profit-maximizing producers to get in on the action and helps insure that the competitive process functions more efficiently. Looking at a concrete example, consider the impact of the 1980 automobile import quotas. Is it so surprising that U.S. automobile prices increased 50 per cent from 1980 to 1985 when overall consumer prices increased at half that rate or that automobile profits increased over 80 per cent to $10 billion over that time period? Such a result is not surprising. It is a typical short-run outcome of protectionist policies.

Why Erect Barriers?

If the case is so open and shut in favor of free trade, why do we erect barriers? The answer to this question, I believe, is that vocal private interest groups stand to gain much in the short-run by pushing for self-serving laws. Unfortunately, the political strength of a vocal minority is often more politically potent than that of a more disinterested majority. Case in point: As a result of steel quotas, the share of steel imports is projected to drop from 30 per cent to 18 per

cent of the U.S. market. Presumably, some domestic jobs in the steel industry will be saved in the short-run. But how many jobs will be lost in countless other industries as a result of having to pay higher prices for steel? The steel industry recognizes the short-run private gains accruing to it because of restrictive trade policies; the costs of such policies are spread too thinly and across too many industries to ferment much opposition. The fact that the costs of trade regulations far outweigh the benefits, however, should be clear. As F. Kenneth Iverson writes in *The Wall Street Journal:*

> The cost to consumers is staggering. The trigger price mechanism under Preident Carter cost consumers an estimated $1 billion per year for more than three years and saved, temporarily, some 12,000 steelworking jobs. That's more than $80,000 per year per job, quite a bit more than the jobs paid.
>
> But the delay in modernization and the cost to consumers are only two parts of the picture. The greatest hazard is the destruction protectionism causes to U.S. manufacturers for whom steel is a significant part of their costs. Because the American steel industry is sheltered, world prices on some steel items are $100 to $200 a ton lower than in the U.S. This enables foreign manufacturers or American companies that move abroad to undersell domestic manufacturers. Automotive parts, oil rigs, farm implements, appliances, railroad parts and numerous other products are examples of domestic products suffering under this handicap. In 1979 the imports of these downstream steel products were estimated at five million tons. In 1985 they reached an estimated 15 million tons.
>
> One steel analyst has projected that the increased imports of such products will cause a decrease in the domestic steel market of more than 1% a year. As this occurs, our steel industry will have to shrink even further. How ironic that protectionism will accomplish the very thing it is supposed to prevent. (*The Wall Street Journal,* August 21, 1986, p. 22.)

Adam Smith understood all this as long ago as 1776:

> Each nation has been made to look with an invidious eye upon the prosperity of all the nations with which it trades, and to consider their gain as its own loss. . . .
>
> That it was the spirit of monopoly which originally both invented and propagated this doctrine, cannot be doubted; and they who first taught it were by no means such fools as they who believed it. In every country it always is and must be the interest of the great body of the people to buy whatever they want of those who sell it cheapest. The proposition is so very manifest, that it seems ridiculous to take any pains to prove it; nor could it ever have been called in question, had not the interested sophistry of merchants and manufacturers confounded the common sense of mankind. Their interest is, in this respect, directly opposite to that of the great body of the people. As it is the interest of the freemen of a corporation to hinder the rest of the inhabitants from employing any workmen but themselves, so it is the interest of the merchants and manufacturers of every country to secure to themselves the monopoly of the home market. Hence in Great Britain, and in most other European countries, the extraordinary duties upon almost all goods imported by alien merchants. Hence the high duties and prohibitions upon all those foreign manufacturers which can come into competition with our own. (*The Wealth of Nations,* Modern Library Edition, 1937, pp. 460-61.)

In commenting on the discovery of America, Adam Smith also states:

> It is not by the importation of gold and silver, that the discovery of America has enriched Europe. . . . By opening a new and inexhaustible market to all the commodities of Europe, it gave occasion to new divisions of labour and improvements of art, which, in the narrow circle of the ancient commerce, could never have taken place for want of a market to take off the greater part of their produce. The productive powers of labour were improved, and its produce increased in all the different countries of Europe, and together with it the real revenue and wealth of the inhabitants. (*Ibid,* pp. 415-16.)

Nor should it be supposed that restrictive trade policies provide long-run benefits to the protected industries. Notice that the benefits al-

luded to in the above examples were couched in terms of "short-run" benefits. Without the unbridled powers of competition present to give correct signals to an enterprise, protected industries will soon become dead industries.

After years of protection, the steel industry is ailing, and there are no immediate signs of turnaround. Indeed, the current question is whether a viable steel industry will exist in the U.S. ten years from now. Even in the case of the pasta tariff, the volume of pasta imports into the U.S. is as high as it was before the imposition of the tariff.

The fact that restrictive trade policies offer no long-run protection to beleaguered industries is even more obvious in a world of multinational enterprise. An interesting case-in-point is offered by Marc Levinson, a senior editor at *Dun's Business Month* who writes:

> International Salt Company, based in Clark Summit, Pennsylvania, charged last year that dumped Canadian rock salt endangered the welfare of U.S. salt companies and of some 1,600 American workers. A Commerce Department investigation found that the salt was indeed being sold in the United States at less than its Canadian price. Low profits for U.S. salt producers in 1983, when dumping was alleged to have occurred, seemed to make International Salt's case even stronger.
>
> But there was a twist to this otherwise mundane matter. The "U.S. company" claiming injury, International Salt, is owned by a company based in Holland. The villain alleged to be doing most of the dumping was none other than Morton Salt Company of Chicago, the largest producer of rock salt in the United States as well as a major importer. Was Morton dumping Canadian salt to injure itself? Should America's dumping laws protect a foreign firm against imports by a U.S. firm? These questions remain unresolved: In January, the ITC ruled that the domestic salt industry's problems in 1983 were due to a warm winter, not to dumping. ("Down in the Import Dumps," *Across the Board,* April, 1983, p. 57.)

The automobile, steel, salt, pasta, and all other industries do not need protection from free trade. Neither did my grandmother.

March 18, 1956—St. Joseph's Day

I withdraw a spoonful—no more, no less—of ricotta filling and almost simultaneously place the filling onto a rolled sheet of dough. Grandma rolls another sheet of dough out of her newest capital investment, a deluxe Rolletti pasta-making machine. She ritualistically places the smooth and elastic sheet of dough onto the sheet containing twenty dollops of ricotta filling.

The final step is the most satisfying and certainly my favorite part. A newly purchased ravioli cutter allows me to cut and seal the ravioli pockets at the same time. The satisfaction of seeing the clean serrated edges left by the cutter is not unlike the sense of satisfaction one feels when correctly tying a complex knot.

The efficiency in ravioli production brought about by the recently acquired capital equipment ($14.78), allows Grandma to make 500 ravioli in the same amount of time it took to make 100 ravioli several months ago. Moreover, she charges a lower price to compete with the frozen Italian product and still makes it all worthwhile.

Grandma may not even have to worry about the inferior Italian product much longer. It turns out that the frozen patties have a tendency to break apart in the cooking process, leaving a large quantity of naked ricotta balls and trails of pasta remnants floating in a pot of boiling water. Even those ravioli that survive the cooking process are mushy—not the requisite *al dente.*

She smiles at me while I take the tray full of ravioli to the bedroom to dry. I suddenly realize the sense of pride and satisfaction one must feel when ingenuity and hard work bring success in the marketplace.

Grandma beat the market, and that smile on her face told me she knew it. □

Should We Organize for Liberty?

by Robert James Bidinotto

The mark of the idealist is his desire to "do something," to make over the world in the image of his ideals. But there is nothing more tragic than the idealist whose means contradict his ends.

While advocates of liberty understand the contradictions of collectivism, many have failed to recognize contradictions of ends and means within their own camp. The problem usually arises in organized, cooperative activities to promote their shared convictions.

This problem is both sad and enduring. Pro-freedom journals have long chronicled the bitter machinations of feuding factions. Cults of personality and chronic organizational rifts preoccupy many inhabitants of our ideological world. Impressive sums of time and money have been expended on bloodletting that would have been the envy of medieval physicians.

What concerns us here are not unavoidable conflicts over philosophical ends, but those *avoidable* conflicts arising from inappropriate *means*. Such unnecessary strife is diverting precious thought, energy, and resources from the battle for individual human liberty.

Some years ago, I drafted some thoughts on this subject. Recently, I was reminded of them when I read the late Leonard Read's "How to Gain Liberty," and found that he had anticipated many of my own conclusions:

> Organization, though much used, seems to be little understood. In the field of extending individual liberty, organization has strictly limited, technical possibilities. Unless these limitations are scrupulously observed, organization will inflict on liberty more harm than good; thwart, not abet, the spread of understanding.[1]

In short, Mr. Read would have asked us to consider the meaning of our principles—and then consider whether those principles really animate our organized activities.

Individualism and Collectivism

The battle for individual liberty is rooted in the wider battle of individualism versus collectivism.

Individualism is a social philosophy prescribing full personal self-responsibility. The individualist accepts the responsibility of thinking for himself (independence), and of acting consistently on his unborrowed vision (integrity).

Collectivism is a social philosophy prescribing individual subordination to some wider collective. It requires individuals to abandon personal moral responsibility, trading their independence and integrity for unthinking obedience and helpless dependency.

To accept uncritically the ideas of others, rendering oneself blind and vulnerable, is the antithesis of independence. And to sever one's thoughts from one's actions, heading on an inconsistent and self-defeating course, is the antithesis of integrity.

These considerations are not irrelevant asides. They lead logically to the following

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© *1986 by Robert James Bidinotto.* *Mr. Bidinotto is contributing editor for* On Principle, *a biweekly newsletter of political analysis.*

conclusion: *No activity to establish liberty can succeed while dispensing with the moral and psychological requirements of individualism.* Phrased another way: *No activity to establish liberty can succeed which fosters authoritarian and dependent personalities.*

As Leonard Read put it:

> Just as government becomes dangerous when its coercive, restrictive, and destructive powers are extended into the creative areas, so do voluntary organizations pervert and destroy the benefits of intellect when the capacity to merge is carried to the point of subjecting individual judgments to the will of the majority or group. Truth, as each person sees it, is the best that the mind of man has to offer. Its distortion, inevitable when achieving a collective chorus, does injury to understanding.

Is it possible that some groups espousing the free society are "subjecting individual judgments to the will of the majority or group"? Has a form of collectivism afflicted even pro-freedom organizations? Is it even possible to "organize individualism"?

There are several types of cooperative ideological efforts, some consistent with individualism, some not.

I. Orthodoxies

I was once a leader in an idealistic group which promoted a systematic philosophical position. Soon my concern for the identity and integrity of the group drew me into the unwanted role of an ideological policeman of fellow members. More of my efforts became diverted into that role than in advancing the purposes of the group. Board meetings became heated shouting matches, as each of us attempted to preserve the "consistency" of the group as we individually saw it. Our common affiliation turned former friends and allies into bitter foes and rivals. Predictably, the group fell apart.

Some years later, I was hired by a decent, idealistic businessman to head a project to promote the free market system. I had assumed the two of us agreed on what "the free market system" implied. But I soon discovered that we had serious disagreements, even of thrust or emphasis. Paralyzed by competing loyalties to my job, and to my own views, the project failed and the two of us parted company.

Both projects failed because they were structured to be *ideological orthodoxies.*

An ideological orthodoxy is any group or publication supporting a specific *system* of ideas, and permitting only *authorized* interpretations of those ideas to be advanced in the name of the group.

This last qualification is critical. *Whose* interpretation is to represent the views of all members? *Some* authority has to define the collective position of any group advancing a systematic viewpoint. If the group's position is to appear self-consistent, the implications of general principles must be decided upon for all. That is why the orthodoxy cannot tolerate dissent.

The basic problem of the orthodoxy is that of public representation. If people promote a common philosophy individually, no orthodoxy could arise: each person would be assumed to be speaking for himself. But the structure of the orthodoxy links everyone's views and reputation, making each member a *de facto* "spokesman" or "representative" of the common philosophy.

Soon, the leaders become preoccupied with being "misrepresented" by zealous followers; and they then feel impelled to restrain members from making "unauthorized" public statements. For anyone to think independently, creatively, innovatively—or even to disagree occasionally—raises the specter of public "misrepresentation." Thus conformity, usually far from the intention of the leadership, becomes the glue holding the group together.

What alternatives are left to an individual in such a structure? He may decide to impose his perspective on the group, by "taking over"—in which case he suppresses the independence of other participants. He may decide to suppress his own views and "go along," even though he may disagree in principle with some of the group's positions—in which case he undermines his personal integrity. Or he may decide to quit—in which case he preserves his own independence and integrity by undermining the group.

Hence the endless factionalism, excommunications, schisms, and heretic-burnings which have characterized orthodoxies throughout his-

tory. Hence the interminable power struggles, as competing members attempt to purify the group from what they see as heresies. And hence the unsavory behavior that too often afflicts such groups: boot-licking, back-stabbing, bullying, blindness. Authoritarianism and appeasement are the inevitable by-products of every effort to make thought a group process.

Paradoxically, the orthodoxy is spawned of two laudable impulses: the desire for cooperative ideological action, and the desire for integrity and consistency. But when the scope of agreement must include *an entire intellectual system,* the two impulses contradict each other. That is because no two minds can consistently interpret the vast implications of general principles exactly the same way.

No mind can represent another—not systematically, not philosophically. Total agreement can be based only upon a totally shared context of understanding. That is clearly impossible. And that is the inescapable problem of the orthodoxy. Only the illusion of harmony exists in such groups, an illusion rooted in dogmatic self-suppression, and enforced by authoritarian measures.

Among advocates of laissez-faire capitalism, relatively few orthodoxies have arisen; but those few have had explosive histories. Needless to say, they are hardly consistent with independence and integrity. Orthodox structures may indeed be appropriate to advance *collectivism*; but they have nothing in common with individualism and liberty. They "pervert and destroy the benefits of intellect"—as Mr. Read observed—by "subjecting individual judgments to the will of the majority or group."

II. Coalitions

In reaction, many proponents of liberty have attempted to escape from the trap of orthodoxy, via the route of *coalitions.*

Coalitions attempt to build a broad consensus around some vaguely ideological label, slogan, or premise. Common examples include the more ideological political parties, or those groups and publications bearing ambiguous designations such as liberal, conservative, libertarian, socialist, and so on. But unlike the orthodoxy, the coalition's exact ideology is never precisely defined, unambiguously identified, or fully systematized.

Why? Because identifying such philosophical ramifications would impose "divisive" ideological requirements on members—leading them back into orthodoxy. So, ideological coalitions characteristically issue moralistic pronouncements, while cautiously tiptoeing around any rationales for such pronouncements. In the name of "tolerance," the coalition rejects authoritarianism . . . for agnosticism.

Lacking a common theoretical base, the coalition's concerns are reduced to the lowest common denominators of agreement: usually, their common label, and some common enemy.

The common label sustains the illusion of a definite ideological position, while its undefined status permits unrestricted recruiting. Meanwhile, the common enemy cements the coalition, by diverting attention from its unresolved (and unmentionable) identity problems.

Thus the futility of the ideological coalition. It cannot offer a *fundamental* challenge to society, since it avoids any systematic theory. Eschewing theoretical roots, it cannot tell the public *why* its pronouncements should be accepted. The same agnosticism that binds the coalition, leaves acceptance of its declarations and assertions in the realm of blind faith.

This is especially apparent in the history of the more ideological political parties. As orthodoxies, such parties rarely attract a broad constituency. Broadening their base of support requires them to tolerate a wider spectrum of members; and to trade explicit, controversial doctrines for more ambiguous slogans and generalizations. But such coalition-building waters down the philosophical identity of the party. So, at some point, party "purists" decide to move in the opposite direction—toward purging heretics and reimposing strict doctrinal requirements. The resulting orthodoxy once again drastically narrows the party's public appeal.

The dilemma of the ideological political party is that it is attempting to do two competing things: change public opinion, and win public approval. The former can be done only by challenging the audience; the latter, only by resembling it.[2] This dilemma is shared by most coalition groups.

Many pro-freedom organizations and publi-

cations are structured as loose, eclectic coalitions. Most have proved impotent and unstable. Invariably, some members become impatient with intellectual self-suppression in the name of "unity," and try to take over. A running battle then ensues between the group's "purists" and it's "pragmatists." Members are tugged between the two sides, seldom realizing that *both* are united against the definition of individualism: the authoritarian "purists," against independent judgment; the agnostic "pragmatists," against definitions as such.

Happily, the alternatives among cooperative ideological projects are *not* limited to orthodoxies or coalitions.

III. Forums

Forums are groups and publications whose participants maintain a platform to promote a range of diverging views.

The essential difference between forums, and orthodoxies or coalitions, is that forums are directed toward *the self-education of participants*, while both orthodoxies and coalitions are aimed at *educating an external audience with a (presumed) common perspective.*

There are several types of forums.

1. *Unlimited forums* are intellectual marketplaces, open to any and all ideas, with each participant given an unrestricted platform and impartial consideration. It is clearly understood that no participant necessarily represents anyone other than himself. Examples include most letters-to-the-editor columns, broadcast "talk" programs, many "think tanks," debating societies, and public speaking forums.

Any forum requires some criteria for selecting participants, of course. But in an unlimited forum, that does not include the need to hold certain ideological perspectives. Instead, the choice of participants is usually based upon their reputation, the controversy they might provoke, or the fundamental alternative that they might offer.

The most common objection to supporting an unlimited forum is that one will frequently assist the propagation of views he opposes. But the same criticism might be made of any marketplace. If one truly believes that his perspective would fare well in public competition with others, he will welcome the existence of an unlimited forum. Just as a man should welcome the existence of the economic marketplace (even though he may not like all the goods and services offered), so should he regard a marketplace of ideas as to his long-term interests.

This is especially true for those holding unpopular views in a culture where an intellectual Establishment often ignores minority perspectives. The existence of an outlet for new and unpopular ideas is in the best interests of everyone—most of all, to the world's smallest minority: the individual. *An unlimited forum facilitates innovation*, in a manner which respects the integrity and independence of all participants.

2. *Limited forums*, by contrast, allow only certain *categories* of views or subjects to be considered, but permit divergent viewpoints and interpretations within those categories. They may be limited either topically, or philosophically.

a) *Topical forums* limit participation not by ideological content, but by intellectual context. Examples: the various professional journals, each restricted in subject matter to a narrow field of concern. Within each field of study, divergent viewpoints openly compete. Nobody represents anyone but himself; innovation is encouraged; and the individualist virtues of independence and integrity are fully respected.

b) *Philosophical forums* limit participation to those sharing common philosophical premises or perspectives; but within that context, various interpretations compete. Examples: journals devoted to the study of Marxism, or Austrian economics, or Freudian psychology—in which writers sharing a common theoretical approach debate fine points and applications. Likewise, a journal or a public speaking forum might devote itself to the study of liberty, and admit a range of contesting perspectives.[3]

There is nothing in the structure of the philosophical forum that violates the requirements of individualism. The only danger is that a philosophical forum may drift beyond its proper lim-

its, and become instead a dogmatic orthodoxy or an agnostic coalition.

For instance, a journal which admits only those articles strictly conforming to some officially authorized "party line" is not a forum. And a journal which advocates a variety of specific political reforms, but which is incoherently eclectic in its arguments and contributors, is not philosophical.

The basic issue is the difference between *study* and *propaganda*, between personal education and public activism. A forum aims at the self-education of its *participants*; coalitions and orthodoxies aim to offer an allegedly united perspective to the *public*. The philosophical forum, focused on self-education, respects the integrity and independence of participants. The coalition and orthodoxy, requiring unified action, do not.

Those involved in a philosophical forum must be extremely careful that its activities do not cross the boundary line from self-education to public propaganda. To the extent that this occurs, the forum will find itself becoming more unstable and divided over the question: Whose interpretation of our "common" perspective are we going to promote?

The temptation to move from self-education to public activism was often addressed by Leonard Read, and never more forthrightly than in "How to Gain Liberty":

> The best thing to do even in an intellectual fight for liberty, many think, is to organize—which is a form of action. Usually they think in terms of organizing someone else to do something instead of organizing their own time and energies. . . . This mania for organizing is usually little more than an effort, doubtless unwitting, to transfer responsibility from oneself to some other person or persons whose competence is often unknown. . . .

Is there any way, beyond self-education, for individualists to make common cause?

IV. *Ad Hoc* Projects

Ad hoc projects are organized with predefined and carefully delimited positions on predetermined issues.

Examples: A committee is formed by fans of a book to distribute it to libraries. A film project is undertaken by those who like a particular story. A petition is circulated by those who agree with its wording. Backers of a particular political candidate work to elect him to office.

Observe that while such projects require some agreement by all participants, that agreement is specific, delimited, and *predetermined.* No *system* of abstract ideas, requiring somebody's eventual interpretation, is promoted; participants do not "represent" each other beyond the predetermined area of agreement; and thus, the independence and integrity of all is respected and maintained.

By definition, any group based upon some abstract idea(s), and which must constantly interpret or apply its doctrines to new issues, is *not* limited and is *not ad hoc.* Groups always redefining their identities with new platforms, goals, and positions are guilty of a kind of "bait-and-switch" fraud. They are not the same groups established by their founders. After joining with certain expectations, a member may be dismayed to find his group turning into something quite different.

I was once a board member of an *ad hoc* organization promoting passage of state tax-limitation laws. To this end, the group rallied broad support and was highly successful. But in time, its leaders began to plot ambitious goals beyond the realm of taxation. In addition, they proposed that all board members make their public positions conform to those of the board's majority. The combined effect was to require conformity on *unlimited* future issues. Needless to say, a number of us quit; and the "new" group has since achieved nothing.

Ad hoc projects bypass such problems by being structured to avoid them. They minimize discord, are flexible in what they can be designed to accomplish, focus everyone's energies on a narrow range of concerns, respect the individuality of all participants, and thus maximize the chances of success. They recognize what I shall call "Bidinotto's Law of Organizations": The narrower a group's philosophical agenda, the broader its public appeal; the broader the range of required agreement, the narrower its public appeal.

Ad hoc projects are the best means of engaging in political activism. Those attracted to poli-

tics should not try to "take over" the major parties—or even establish some "party of principle" of their own. For all the reasons cited above, such attempts will result either in an orthodoxy, or some unstable and ineffective coalition. Instead, would-be candidates should run either as independents, or as *nominal* members of the (non-ideological) major parties—fully recognizing that a political candidacy is not the best forum for public education.

The Ideal Alternative

Limiting cooperative efforts to those structures consistent with individualism might seem depressingly restrictive—especially to those whose fantasy is to lead a mass crusade. Those so moved would do well to read Eric Hoffer's *The True Believer*.[4] Their vision might be called many things; "individualist" is not one of them.

But it is not my purpose to single out individuals and groups for criticism. Most idealistic activists are not aware that there are principles underlying organizational structures, and have simply chosen among the available options. This writer himself has learned the principles of individualist cooperation the hard way.

The greatest lesson I learned is that the ideal solution to the problems of organized individualism is the simple individualism of a personal career. The most influential and innovative idealists in history have acted alone, in personal undertakings, loyal only to the inner voice of their convictions. Those at a loss for things to do, would do well to follow their example. Said Leonard Read:

> Action? The casual thinker might imagine that the best course is to try to tell others what to do and how to think. But reason supplies a contrary answer. It suggests that pursuit of one's own personal understanding is the only practical action for one to take. . . . Some persons will assert . . . that this suggested student approach—this process of self-improvement—is too slow to meet the challenge of these times. . . . But, in my opinion, there is no short cut. The only way to truth—that is, to understanding—is through one's own person.

The world is stampeding toward collectivism in an orgy of organizing. Let advocates of liberty remember that in individual understanding lies our power, and in the individual life, our glory. □

1. Leonard Read, "How to Gain Liberty," a 1955 essay reprinted in *The Freeman*, January 1986. All subsequent quotations from Mr. Read are from this article.
2. Robert James Bidinotto, "Marketing the Free Market," *Notes from FEE*, January 1984. In this essay, I dealt with these two competing approaches as, respectively, the "exemplar" and the "salesman" strategies.
3. *The Freeman* has been fulfilling this role for many years.
4. Eric Hoffer, *The True Believer* (New York: Harper & Row, 1951).

IDEAS ON LIBERTY

Start When Ready

Anyone can begin the practice of freedom whenever he chooses to do so. It is easy, and one need not wait upon other persons to agree before he begins. No committee resolutions or elections or laws are needed for a person to begin the practice of freedom. One need merely resolve not to impose his will—legally or illegally—upon his peaceful fellow men in their religions, their economic theories, their attitudes, their morals, their mores, or whatever. And then start to practice it.

—DEAN RUSSELL

Deficits Do Matter

by Hans F. Sennholz

Politicians and officials in high places are telling us that government debt does not matter; after all, we owe it to ourselves. As long as government borrows funds internally and expenditures are financed from internal sources, so the notion goes, no real cost is incurred. Interest payment on debt merely represents transfers from taxpayers to bondholders. Debt to foreigners, by contrast, is seen as a wholly different matter because it necessitates interest payments to outsiders. It is analogous to private debt.

The recurrent notion that "we owe it to ourselves" springs from the doctrines of mercantilism. It was very popular with European monarchs during the 16th, 17th, and 18th centuries because it placed them in the center of economic life and made them the promoters and guardians of national prosperity. Kings and princes who looked upon the economic lives of their subjects as mere extensions of their own economic activities viewed their debts as both accounts payable and accounts receivable. After all, if the subjects belong to his lordship, also their property is his. The debt he may owe them he owes to himself.

The so-called Keynesian revolution during the 1930s revived the doctrine and promoted it to a great principle of economic knowledge. Economists throughout the Western world accepted it almost universally. And yet, it is as fallacious today as it was when the kings and their ministers proclaimed it. It is the rationale of spendthrift governments ever eager to run into debt.

The federal government debt now exceeds $2 trillion and is expected to reach the $3 trillion mark by the end of the decade. We do not owe these sums to ourselves, the U.S. government owes them to individual savers and investors. Surely, in a command system such as communism or fascism, government owns and controls everything and everyone and, therefore, may be said to owe it and simultaneously own it all. But in our free order, individuals do have rights and may own property. They may own treasury bills, notes, and bonds and expect to be paid; the fact that they, too, may be taxpayers is irrelevant for the claim. They expect to be reimbursed by the debtor, the government, which in turn depends on taxpayers for payment. It does matter to every individual whether he owns such obligations or merely owes taxes that service the debt.

The core of the fallacy lies in the holistic way of equating individual action with community action as a whole. If individuals were part and parcel of the collective whole and personal property an integral part of government property, it would not matter how the credits and

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debits are listed; they all would balance out. But in our free order, private property is not government property and government property is not private property. This is true no matter whether the individual owner is a native or foreigner. The law protects both from government infringement and transgression.

Deficits Curtail Investments and Are Tax Liens

Government debt usually signals the consumption of individual savings and economic resources. It is a rare exception for government to invest its funds productively, applying property for future income or benefits. Politics tends to favor present use and enjoyment at the expense of the future. A huge debt signals huge consumption of economic resources for political ends, incurred in the past at the expense of the future. It speaks of factories not built, stores not opened, businesses not started, and jobs not created.

Deficits consume funds that otherwise would be available for private investment; they represent a direct transfer from investment to consumption. The deficits of the U.S. government curtail the rate of economic expansion, keep productivity and labor income lower than they otherwise would be, impede international competitiveness, and cause American levels of living to fall relative to those in other countries where people save and invest more.

It may be argued that other governments throughout the world incur similar deficits and, therefore, exert similarly restrictive effects on their countries. But such an argument is badly misleading because the savings rate is much higher in many other countries. Where the investment rate exceeds 20 to 30 per cent of income, the impact of a 5 per cent deficit is less adverse on investment than in the U.S. where the savings rate barely reaches 5 per cent. Americans cannot afford any further reduction in investment through government deficits.

Deficits and debts also signal future tax exactions. Having incurred the debt in the past, government, in order to repay the funds or just pay the interest, must levy taxes in the future. In essence, therefore, a government debt is a government claim against private property—an unpaid tax bill so to speak—that will fall due in the future. Like all other business taxes, it is bound to depress labor productivity and the value of productive property.

To most people government spending is a panacea for all economic evils and difficulties, a cure-all for human woes. Where economic stagnation impedes progress and prosperity, government is expected to stimulate through deficit spending. Where there is unemployment, government is expected to supplement private demand and thus create jobs. Where there is poverty it is expected to provide affluence through more spending and debt. But nature forgives no debt and grants no benefit without cost.

There can be no beneficiary of government largess without a victim of exaction. Government cannot pile up debt without every paying it off; all government expenditures must ultimately be paid out of tax revenues or be repudiated through inflation, which is merely another form of taxation. Either immediately or ultimately every dollar of government spending is taken out of the pockets of taxpayers. When seen in this light, the supposed benefits of government spending are rather questionable. To build a pyramid of Federal debt is to delay the inevitable and pay interest thereon.

Inflation Reduces Debt

Politicians point out that over the decades the Federal debt has actually declined in terms of purchasing power as well as relative value. If growing budgetary deficits are accompanied by shrinking real debt and rising ability to pay the debt, the happy spenders may indeed be right that Federal debt no longer matters.

True, the Federal debt has actually declined both in purchasing power and relative value. But this decline in itself is a great evil that is spawning many other evils. Most of it is the handiwork of inflation, the willful policy of currency debauchery, that enriches one class of people at the expense of another. It deprives creditors of their rightful claims and enriches the debtors, primarily politicians and government officials who incur the debt and place it on the people. It breeds economic and political conflict as it pits the economic interest of one

"As budget deficits continue, the U.S. dollar must ultimately fall not only in purchasing power but also in the money markets of the world. When foreign investors finally conclude that they have enough dollar liquidity and enough investments in the U.S., the dollar must fall."

social class against another, jeopardizing peaceful social cooperation and endangering the democratic process. Surely, debt and depreciation do matter.

Depreciation of debt by inflation is repudiation pure and simple. It is deceit, wicked and desperate; its consequences can never be foreseen. When deceit has been practiced in matters where all should be fair, confidence cannot be easily restored. In financial terms, interest rates signal the dangers of repudiation; they cannot be expected to return to normal as long as deceit can be expected. In this sense, the deceiver is bound to pay a price for his evil ways.

The rising burden of interest on the Federal debt illustrates the point. In fiscal year 1986 the U.S. Government is estimated to pay $196.095 billion in interest on its debt; in 1987 it is scheduled to pay $206.855 billion. In terms of Federal revenue the interest is expected to consume some 25 per cent of estimated receipts, in terms of gross national product some 4.5 per cent, which is the highest in U.S. history. Even in 1945 when the Federal debt amounted to 133 per cent of GNP, the burden of interest consumed less than 10 per cent of net receipts and barely 2 per cent of GNP. If government expenditures on goods and services were deleted from GNP figures because government revenue merely consists of exactions from private production, the interest burden on every American would be seen to be even greater. Surely, debt and interest do matter.

Deficits Disrupt Foreign Trade

Federal budget deficits cause interest rates to be higher than they otherwise would be, which may induce the American people to save more and foreigners to move funds into the United States. The foreign investments alleviate the savings shortage, permitting the federal government to continue the deficit spending and the American people to maintain their levels of living. But the foreign investments also serve to drive up the value of the dollar, which causes American goods prices to rise in international markets and American firms to become noncompetitive. In other words, the inflow of foreign capital leads to an overvalued dollar, which leads to more imports of foreign goods and to what is commonly called, balance-of-trade deficits. The imports, in turn, keep the price inflation low but also hamper American competitiveness, depressing competing industries and causing the loss of jobs in those industries.

If the budget deficits continue, American competitiveness may be damaged permanently. The consumption of capital in the U.S. and the formation of capital abroad may necessitate permanent adjustments in patterns of produc-

tion and international trade. Capital-intensive industries may contract in the U.S. but expand wherever capital continues to be formed. American wage rates may fall while some foreign rates continue to rise.

As budget deficits continue, the U.S. dollar must ultimately fall not only in purchasing power but also in the money markets of the world. When foreign investors finally conclude that they have enough dollar liquidity and enough investments in the U.S., the dollar must fall. In fact, it may plummet when foreigners lose confidence in U.S. economic and monetary policy, when willful dollar depreciation inflicts painful losses on their dollar investments, and causes them to liquidate rather than invest. When foreigners become dollar sellers rather than dollar buyers the international situation is bound to change. The American dollar will fall, American competitiveness will improve, the flood of imports will cease, competing American industries may relax, but goods prices will soar. After all, if the rising dollar stimulates foreign imports and investments, a falling dollar tends to bring forth the opposite. Smaller supplies signal higher prices. Moreover, as foreign imports decline the American firms that compete with imports can now, in turn, raise their prices. In the end, large Federal deficits are bound to generate serious inflationary pressures.

Even Keynesians Object

Large budget deficits usually induce monetary authorities to engage in massive credit expansion in order to finance the deficits. They conduct what Keynesian economists call "an infusion of aggregate demand" which in time is said to add to inflationary pressures. The inflation effects are said to be rather slow, though, given idle plant and equipment and a high unemployment rate. Nevertheless, Keynesian economists recommend that budget deficits should be avoided as the economy approaches full employment. Federal deficits, Keynesians reassure us, are the appropriate remedy for recessions; they are inflationary at other times. If they are already very large at the beginning of a recession, public policy makers may be reluctant to pursue yet larger deficits during the recession. They may be reluctant to prescribe Keynesian remedies so that, according to Keynesians, recessions will be deeper and larger than they otherwise would be.

One may disagree completely with the Keynesian rationale, and yet agree with the conclusion that government budgets should be balanced. In fact, they should be balanced all the time, not just during periods of "full employment," which may be slow in coming. Government deficits consume economic substance and wealth; by their very nature they depress economic activity. The stimulation that may be observed in the wake of deficit spending is the result of willful currency and credit creation; it is the effect of the injection of monetary funds that lower interest rates and misguide businessmen in their investment decisions. When interest rates are lower than market rates and goods prices are made to rise faster than wage rates and fringe costs, the demand for labor tends to rise and unemployment may fall. This morsel of economic knowledge constitutes the secret ingredient of the Keynesian recipe.

Keynesian deficit spending during recessions is destined to fail whenever goods prices don't rise faster than labor costs. Workers and their trade unions may see through the inflation machination and readjust their demands to the willful depreciation, demanding cost-of-living clauses and other compensation adjustments to offset the inflation losses. When the workers no longer can be made to suffer reductions in real income the Keynesian recipe loses its power. Moreover, when deficit spending is given in large doses in recessions after large deficits were suffered in a boom period, deficits may turn into a prescription for deep depression and mass unemployment. A twenty per cent inflation rate may cause a twenty per cent unemployment rate because productive capital may no longer function; it may join other assets in the flight into inflation hedges.

Deficit spending is the mother of debt, which is the prolific mother of folly and despair. A small debt may be cleared off in a little time, whereas a large debt may never be repaid. A debtor who owes a great deal may despair of ever being able to pay and, therefore, may be tempted to default. As the U.S. government debt soars past the $2 trillion mark, the possibility of default looms ever larger. □

The Illegality of Legal Tender

by Philip W. Newcomer

The coming of the Civil War brought with it four years of savage fighting, resulting in an unprecedented loss of life and property. Both the Union and the Confederacy, however, failed to anticipate the sustained nature of this conflict. In fact, Northern troops, at first, were enlisted for only ninety days.[1] This lax attitude toward the war was shared by Lincoln's Secretary of the Treasury, Salmon P. Chase. As a result, the taxes levied at the suggestion of Chase during the beginning of the conflict provided little of the revenue needed to meet Federal expenditures. During the fiscal year ending June 30, 1862, revenues were a mere eleven per cent of the government's outlays.

To meet these growing expenses, President Lincoln signed the first Legal Tender Act on February 25, 1862. This act authorized the printing of $150,000,000 in United States notes, that amount being increased by later legislation to $450,000,000. These notes were declared to be "lawful money and legal tender in payment of all debts, public and private, within the United States, except duties on imports and interest on the public debt."[2] Because they were printed in green ink, the United States notes quickly became known as greenbacks.

As the bill made its way through Congress, it sparked considerable debate. Chase reluctantly submitted the currency scheme to a subcommittee chaired by Representative Elbridge G. Spaulding of New York. Spaulding led the drive to pass the legislation, claiming that its acceptance was necessary for the survival of the Union.[3] Many congressmen, however, refused to view the bill in this light. This proposal was, after all, a " . . . radical departure from traditional monetary theory and practice."[4] Historians have indicated that the proponents of the bill did not fully explore traditional methods of public finance. Wesley Clair Mitchell noted, in his *History of the Greenbacks,* that no United States notes were issued until three months after all specie payments were suspended. Mitchell points out:

> Had these three months been utilized energetically in passing a few simple sanctions of an internal revenue tax act, . . . and in organizing machinery for the sale of bonds, there seems to be slight reason for believing that the government would have failed to obtain sufficient funds, particularly when account is taken of the improvement of credit caused by the military successes of the winter and spring.[5]

Despite evidence that the Act wasn't needed, many political leaders, viewing it as a desirable alternative to an unpopular increase in taxes, found the measure to be warranted during this state of war. Since the Act was considered as a part of Congress' war powers, few people questioned the constitutionality of legal tender. That issue was not addressed until after the war, when controversies concerning the Legal Ten-

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der Acts reached courts throughout the nation. The opinions resulting from decisions handed down concerning greenbacks, both in favor of and against their tender status, show that the concept of legal tender is repugnant to the spirit of the Constitution of the United States.

The first cases dealing with greenbacks to reach the Federal courts did not specifically address the issue of constitutionality. These cases, however, focused attention upon the legal tender question. In *Lane County* v. *Oregon,* 74 U.S. 71 (1868), the Supreme Court placed a restriction upon the application of the Legal Tender Acts, holding that states may require payment of taxes to be made in specie rather than in United States notes. The power of a state government to tax was viewed as essential to the operations of that state. Federal legal tender requirements interfered with the states' ability to declare a method of payment. In the majority opinion, the Court stated, "There is nothing in the Constitution which contemplates or authorizes any direct abridgement of this power by national legislation." The principle established in *Lane County,* and later cited in *National League of Cities* v. *Usery,* 426 U.S. 833 (1976), proclaimed that the states were free to exercise their inherent governmental powers without fear of Congressional intervention.

This principle had a significant implication when applied to the concept of legal tender. Since Congress could not interfere with the fundamental powers of a state government, it was fair to deduce that Congress also was forbidden to tamper with constitutional restrictions upon those powers. In Article I, Section 10, Clause 1 of the Constitution, states were forbidden to "make any Thing but gold and silver coin a Tender in Payment of Debts." It was clear, therefore, that Congress could not force a state to pay its creditors in legal tender notes.[6] To do so would violate the constitutional legal tender disability placed upon the states. The decision of *Lane County* v. *Oregon,* then, opened the question of Congressional legal tender powers for further judicial review.

The constitutionality of the Legal Tender Acts was first challenged in a number of state courts. Initially, many states, including New York, Pennsylvania, and Indiana upheld the acts as a logical extension of Congressional war powers. In 1864, however, Indiana reversed its earlier decision by declaring, in *Thayer* v. *Hayes,* 22 Ind. 282, that the acts were unconstitutional. The Kentucky Court of Errors also recognized the invalidity of legal tender in its decision of *Griswold* v. *Hepburn,* 63 Ky. 20 (1865). In this case, Griswold sued Hepburn for interest and principal due on a promissory note signed in 1860. Legal tender notes offered in payment by Hepburn had been refused by Griswold. Considering the intent of the Founding Fathers, the court's opinion stressed that, "When the people who adopted it [the Constitution] delegated to Congress exclusive power 'to coin money,' they intended that nothing else than metallic coin should be money." Despite the strength of the court's argument, it was the appeal of this case which led to the most resounding condemnation of the legal tender concept.

Hepburn v. *Griswold*

In 1869, *Hepburn* v. *Griswold* came before the Supreme Court. On February 7, 1870, the Court, by a four to three vote, upheld the earlier decision of the Court of Errors of Kentucky.[7] In so holding, the Court clearly rejected the constitutionality of the Congressional legal tender legislation. Ironically, the majority opinion was written by Chief Justice Salmon P. Chase, who, as Lincoln's Secretary of the Treasury, originally endorsed the first Legal Tender Act. The reasoning of his argument greatly clarified the legal tender issue.

In writing his opinion, Chase searched in vain for a constitutional basis for legal tender. Clearly, Article I, Section 10 denied legal tender power to the states. Yet, this fact did not automatically imply that such power resided in the federal government. Chase found no expressed Congressional legal tender power within the text of the Constitution. He also declared that such actions cannot be reasonably implied as necessary and proper to the execution of any expressed power. John A. Sparks noted in his essay, "The Legal Standing of Gold—Contract Versus Status," that the Tenth Amendment reserved for the states powers which were not delegated to the United States. Powers denied to the states which were not del-

egated to the United States, therefore, were reserved for the people.[8] Since the declaration of legal tender was forbidden to states and was not delegated to Congress, the acceptability of a currency was to be determined freely in the marketplace.

After finding no constitutional basis for the legislation, Chase isolated the ill effects of these laws. The Fifth Amendment stated that the United States cannot deprive any person of "life, liberty or property, without due process of law." By requiring the repayment of debts in a depreciated medium of exchange, the Legal Tender Acts impaired the obligation of contracts. Creditors, therefore, were denied property by Congress without due process of law. Chase declared the legislation to be nothing less than a violation of the due process clause of the Fifth Amendment. This holding was in keeping with later substantive interpretation of the due process clause. Under this interpretation, a person could be denied due process even when all procedural due process requirements were met. In later cases, such as *Allgeyer* v. *Louisiana,* 165 U.S. 578 (1897), the Court struck down various nonmonetary economic regulations by applying this substantive approach to the due process clauses of the Fifth and Fourteenth Amendments.[9] Chase's opinion in *Hepburn* recognized the true nature of legal tender laws: Such legislation is an unconstitutional economic regulation.

Shortly after the *Hepburn* decision was handed down, a change in the Court's composition forever altered judicial interpretation of legal tender. On the day that *Hepburn* v. *Griswold* was decided, President Grant sent the names of William Strong and Joseph P. Bradley to the Senate as candidates to fill vacancies on the Supreme Court. Both men were confirmed by the Senate and appointed to their seats by March of 1870. Four days after their appointments, the Attorney General moved that the Court consider the two legal tender cases still undecided. With a five to four vote, the Court ordered re-examination of the legal tender question.[10] Not only did this action undermine public opinion of judicial integrity, it signaled the formation of a new majority in favor of legal tender. The Court then took up both cases, *Knox* v. *Lee* and *Parker* v. *Davis,* 79 U.S. 457 (1871), together and overturned the ruling of *Hepburn* v. *Griswold.*

Justice Strong, in writing his majority opinion of *Knox,* unknowingly made a powerful argument against the constitutionality of legal tender. The errors of Strong began with his concept of the role of the judiciary. He wrote that, "decent respect for a co-ordinate branch of the government demands that the judiciary should presume, until the contrary is clearly shown, that there has been no transgression of power."[11] Such a position was inconsistent with the traditional concept of judicial review.[12] This concept was defined by Chief Justice John Marshall when he stated in *Gibbons* v. *Ogden,* 22 U.S. 1 (1824), that the judiciary must act "with that independence which the people of the United States expect from this department of the government."[13] Failure to do such would result in the collapse of the Federal balance of power. Strong's defense of the actions of Congress failed to address this critical point.

A Necessity?

In arguing for legal tender, Strong contended that the necessity of the legislation gave it merit. In fact, he did not even consider the necessity of such laws to be a questionable notion. According to Strong, the idea that the Legal Tender Acts did "save the government and the Constitution from destruction is not to be doubted."[14] This point, however, was questioned by Chief Justice Chase in his dissent.

> Was the making of the notes a legal tender necessary to the carrying on of the war? In other words, was it necessary to the execution of the power to borrow money? . . . In their legitimate use the notes are hurt, not helped, by being made a legal tender. The legal tender quality is only valuable for the purpose of dishonesty. Every honest purpose is answered as well and better without it . . . the making of these notes a legal tender was not a necessary or proper means to the carrying on of the war or to the exercise of any express power of the government.[15]

Strong's necessity doctrine was also attacked in Mises' *Theory of Money and Credit,* which stated that "In order to appraise correctly the

weight of this emergency argument in favor of inflation, there is need to realize that inflation does not add anything to a nation's power of resistance, either to its material resources or to its spiritual or moral strength."[16] Even if the legislation were necessary, "the doctrine of 'necessity' has no logical place in constitutional law under any circumstances."[17] The constitutionality of legislation never should be determined solely by the apparent importance of the law in question.

Strong then searched beyond necessity for further grounds upon which he could uphold legal tender. He quickly noted that legal tender was "a power confessedly possessed by every independent sovereignty other than the United States."[18] Legal tender, therefore, was a right which was inherent in the sovereignty of all nations. Such reasoning, however, was not common to the Supreme Court. Except in cases of international relations, "the Court has never since suggested that the federal government enjoyed powers implied from the mere fact of its being a sovereign nation."[19] The Constitution, not the act of another nation, provided the foundation upon which the American government was built. The actions of that government must be judged according to the standard established by the Constitution. The alleged sovereign right to declare legal tender was not proof of constitutionality.

Continuing in his reasoning, Strong looked to the text of the Constitution to find justification for the Legal Tender Acts. At this point, Strong forged his resulting powers doctrine, which he summarized as follows:

> And here it is to be observed it is not indispensable to the existence of any power claimed by the federal government that it can be found specified in the words of the Constitution, or clearly and directly traceable to some one of the specified powers . . . Powers thus exercised are what are called by Judge Story, in his *Commentaries on the Constitution,* resulting powers, arising from the aggregate powers of the government.[20]

Strong, when unable to find an expressed power of legal tender, dispensed with the necessity to do so. The resulting powers doctrine gave virtually limitless power to the legislature. Congress found no need to confine its role to that for which its powers were delegated. This doctrine was clearly outside the realm of the Framers' intent. Strong's failure to find a reasonable constitutional basis for legal tender was evidence that Chase was correct in claiming that no such basis existed.

Greenbacks Reissued

Judicial interpretation of the legal tender issue did not cease with the decision of *Knox* v. *Lee.* In 1878, an Act of Congress provided for the peacetime reissuing of greenbacks. Under this law, the notes retained their legal tender quality. In 1884, the validity of this reissue was challenged in *Juilliard* v. *Greenman,* 110 U.S. 421 (1884), which was heard by the Supreme Court on a writ of error from a Federal circuit court. With the exception of Justice Field, all the judges agreed that the greenbacks were an extension of the Congressional power to borrow money.[21] Using reasoning similar to that of Strong in *Knox,* Justice Gray delivered a majority opinion which was equally unconvincing.

Quoting Strong, Gray claimed that the federal government possessed the right to impair contracts. Strong had earlier cited the power to declare war and the power to make bankruptcy laws as examples of sanctioned interference with contract obligations. These powers, however, were delegated to Congress. As Chase noted in both *Hepburn* and his dissent in *Knox,* no such delegated power existed for legal tender.[22] Gray never commented upon Chase's assertion concerning the impairing of contracts. This interference, Chase realized, was hostile to the spirit of the Constitution.

Like Strong, Gray relied upon necessity as an argument for the validity of legal tender. With the excuse of war gone, Gray implied that the legislation was essential due to "the inadequacy of the supply of gold and silver coin to furnish the currency needed for the uses of the government and the people."[23] Gray, like many others, believed that a growing money supply is a prerequisite for a strong economy. In making his statement, Gray failed to realize the basic economic principle that inflation only dilutes the value of each unit of currency. The eventual result of inflation is stagnation, not economic

growth. Had Gray realized that fact, he would not have viewed the legislation as necessary.

Gray was not content to find precedent for his decision solely in *Knox* v. *Lee.* He also looked beyond America's borders to find aid for his reasoning. He cited a contemporary case in England which upheld the exclusive power of the Emperor of Austria to emit legal tender notes.[24] In doing such, Gray relied upon the same fallacy that Strong had earlier committed. In American law, English common law was only addressed when one considered the origins of the Constitution. Contemporary foreign proceedings have no bearing upon the Constitutionality of American legislation.

In upholding legal tender as a peacetime measure, Gray referred to Marshall's opinion in *McCulloch* v. *Maryland,* 17 U.S. 316 (1819), which stated:

> We admit, as all must admit, that the powers of the government are limited, and that its limits are not to be transcended. But we think the sound construction of the constitution must allow to the national legislature that discretion, with respect to the means by which the powers it confers are to be carried into execution, which will enable that body to perform the high duty assigned to it, *in the manner most beneficial to the people.* [Emphasis mine.][25]

Gray, however, wrongly applied Marshall's words to this legal tender issue. The legal tender power is not beneficial to the people. Upon that power rests the government's ability to inflate the money supply. As Dr. Hans F. Sennholz points out, "Legal tender laws permit government to take income and wealth without the people's consent . . . "[26] Furthermore, "Legal tender legislation is one of the great evils of our time, the necessary basis of inflation and monetary destruction. It gnaws at the moral and economic foundations of economic society, largely because it is misunderstood and ignored."[27] Such legislation, because of its harmful nature, could not be the proper subject for the application of Marshall's words. By quoting Marshall, Gray actually found no support for the validity of the legislation. Gray, like Strong, offered a weak defense of the concept of legal tender.

These flawed decisions upholding legal tender, when considered in conjunction with the reasoning of earlier cases, indicate that legal tender laws lack a firm basis in constitutional law. Even without that basis, the decisions of *Knox* v. *Lee* and *Juilliard* v. *Greenman* served as dangerous precedents for the government's monetary monopoly. Because of those decisions, legal tender compulsion was given the approval of this nation's judiciary. That approval began with the decision of five justices in *Knox* v. *Lee.* Yet, "Another day may come when five other justices will read the Constitution and arrive at a different conclusion."[28] Should that day come, those judges will find ample support for their actions in the reasoning of the various cases addressing the issue of greenbacks. □

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17. Vieira, *Pieces of Eight,* p. 199.
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21. Juilliard v. Greenman, 110 U.S. 421 (1884), cited by Emlin McClain, *Cases on Constitutional Law* (Boston: Little, Brown, and Company, 1900), p. 443.
22. Sparks, "The Legal Standing of Gold . . . ," pp. 89-90.
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Can "Industrial Policy" Work?

by Frank W. Bubb

After a wave of enthusiasm for "industrial policy" in 1983 and 1984, the idea now seems dormant at the national level. The advocates of industrial policy, placed on the defensive by pro-market forces and a robust economy, were compelled to backtrack from their initial assertions that a government agency could successfully pick "winners" among private sector firms. Since picking winners is the core of industrial policy, its once-bold proponents were reduced to advocating a drab patchwork of reforms.

More recently, however, several state governments have jumped on the industrial policy bandwagon as if the entire national debate had never occurred. Over a dozen states, principally in the "rust belt" of the upper Midwest and the Northeast, have funded agencies whose unabashed goal is to pick winners. According to Michael Finn of the Michigan Venture Capital Fund, "What we're trying to create is the environment for the same type of phenomenon as Silicon Valley." In the past four years, the Michigan fund has invested $48 million in 23 new companies.[1]

The amount of state activity suggests that industrial policy may be heading for a comeback at the national level. If the resurrection of industrial policy coincides with a serious recession, it may not be possible for advocates of the market to defeat it again with generalized assertions that the market can pick winners better than a government agency. Market advocates must be able to articulate precisely *why* this is true.

Any industrial policy that dispenses government subsidies to businesses is automatically a policy of picking winners. When a government agency grants firm A's request for a subsidy but rejects firm B's request, it is perforce picking winners. Indeed, picking winners—in the sense of spotting "winners" ahead of the market and nurturing them—is the best result advocates of industrial policy could hope for; the only other alternatives for a subsidy program are propping up losers and random redistribution.

What exactly is a "winner"? Industrial policy advocates seem to accept a fairly conventional economic criterion: profitability. Those firms which can grow most profitably by using invested capital most efficiently should be termed "winners." The more a subsidy program channels capital to such firms, that is, the more efficiently its subsidies are used, the better the results for the economy as a whole.

What do the advocates of industrial policy find objectionable about the market's method of picking winners? To show that private capital markets allocate capital efficiently, it must be shown that: (1) efficiency is enhanced when firms seeking investment capital maximize their own profits, (2) private investors can effectively pursue their own self-interest, and (3) the market effectively links points (1) and (2), that is, that investors' pursuit of their own gain channels capital to those firms that can use it most profitably.

Advocates of industrial policy seem, by and large, to accept points (1) and (2). As I understand it, their principal concern is that the market is a flawed mechanism for translating investors' pursuit of gain into the most efficient use of capital by investees.

Much of this concern may stem from simple ignorance of how the market functions. There-

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fore, this article will first describe how the market picks winners. Then it will discuss how a government agency that is optimally structured to achieve its objective might undertake the same task.

A variation on the debate over socialist economic calculation. This discussion is based in part on the insight developed by Ludwig von Mises[2] and Freidrich Hayek[3] that economic calculation is impossible under socialism. In 1920, Mises first presented his now-famous challenge to socialism. He argued that, since the socialist state would own all means of production, there could be no market on which the prices of the myriad productive inputs would be established. Without such prices, which operate as "aids to the mind" by conveying information in a highly condensed form, the managers of the socialist economy would have no way to allocate capital efficiently.

Eventually, socialist economists regrouped around "market socialism," under which managers of socialist firms would be instructed to operate *as if* they were profit-maximizing corporate managers buying and selling productive inputs. Mises and Hayek counterattacked with a variety of arguments, the most basic of which focused on the role of the central planning board, which would select firm managers and allocate capital among the competing firms.

The prescribed role of the socialists' central planning board is strikingly similar to that which industrial policy advocates wish to confer on a subsidy-granting agency. The only difference is that the former would have a monopoly on its function, while the latter would attempt to operate as an alternative to an already-existing private capital market.

The special form of uncertainty faced by investors. No system can guarantee that its selection of future winners and losers is correct at any given time. But that is inherent in the situation faced by investors in any economy, whether they be private investors, a subsidy-granting agency of the sort envisioned by industrial policy advocates, or the market socialists' central planning board. As Victor Borge once put it, "Forecasts are very difficult, particularly about the future."

Uncertainty about the future is a fact of life for all participants in an economy. But the uncertainty facing investors is magnified by the nature of competition among investees. No investee walks around with the word "winner" stamped on his forehead, waiting to be discovered by investors. Rather, winners emerge from an often unpredictable evolutionary process, a process of struggle which may impel a firm which everyone thought to be a "loser" to develop a decisive innovation in technology, marketing, manufacturing, or some other field. Such a firm may in turn be overtaken by others whose innovations once again help to remake the economy.

Economic progress is utterly dependent on this unpredictable process of rivalrous competition among investees. A society seeking a method of allocating capital among investees can face this fact in one of two ways: (1) it can cover up the problem by squelching competition among investees, with stagnation as the result, or (2) it can select a capital allocation procedure that adjusts to change as rapidly as possible. Such a procedure must provide incentives for the rapid communication and use of information, and for the formation of realistic expectations in the face of risk and uncertainty.

How the Market Picks Winners

Advocates of industrial policy often decry the lack of information about how "we" should allocate "our" capital. According to Representative Stan Lundine, "We don't even have credible information on which to base our decisions," and "You have to get down to the ball bearing industry; you can't just talk about industry in general."[4]

Such statements seem to assume that information doesn't exist unless it resides in written form in a central location. This assumption causes industrial policy advocates to overlook the market's largely non-written, decentralized method of storing and communicating information. Sitting in the midst of the most sophisticated capital market in the world, U.S. advocates of industrial policy fail to grasp how that market picks winners because they don't understand the signals continually transmitted among investors and investees.

How the market stores and communicates information. The market stores information in the form of prices, in this case, the prices of corporate equity securities.[5] The price of each corporation's shares tends to encapsulate the information about the corporation and its relative prospects which is widely dispersed among investors. No single investor possesses all the information extant about a particular firm, much less an industry or the entire economy. Yet the market as a whole possesses such information because it is able to draw on the knowledge and judgment of millions of investors.

For example, if a new industrial process is developed which increases demand for ball bearings, those investors who first spot the change in data and correctly evaluate its effect on the earnings of ball bearing makers will profit by buying the shares of such firms, thus driving their prices up. Sparked by the profit-seeking behavior of investors, this process of adjustment continues rapidly until the share prices of ball bearing makers fully incorporate the new data.

The crucial point is that this adjustment process operates without most investors having to learn about the new industrial process or its effect on ball bearing usage. The market gains the use of this information by, in effect, paying for it. The profit received by those who first come into possession of the information is their payment for transmitting it to other market participants.[6]

What information is reflected in security prices? Investors tend to bid each firm's shares to a price equal to the sum of expected future after-tax returns thereon (in the form of capital appreciation and dividends), discounted by current and anticipated interest rates, and adjusted for the investment's perceived risk.

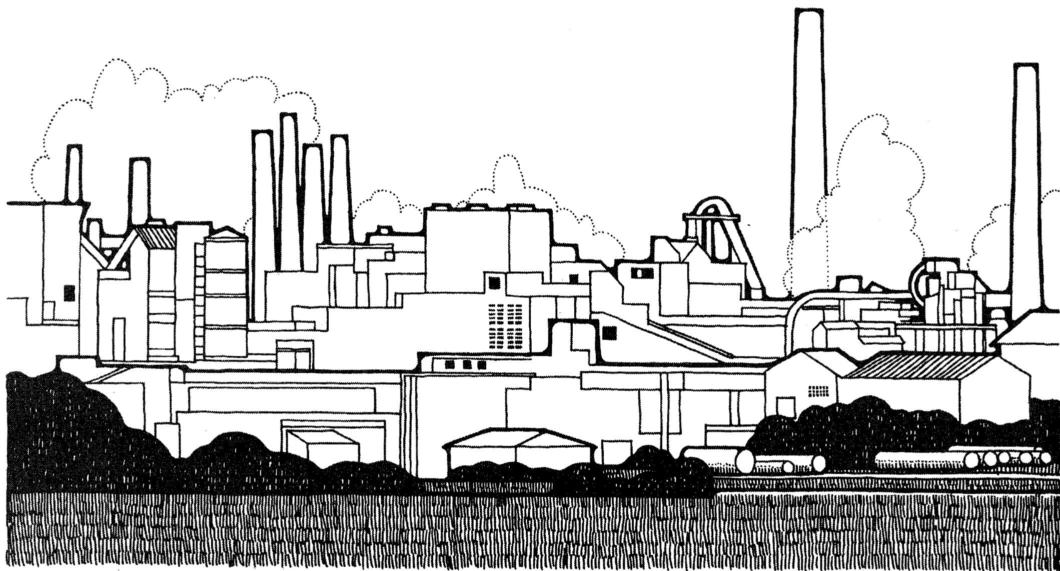
The ability of the market to price securities correctly has led a number of academic economists to formulate the "efficient market theory," which Paul Samuelson describes as follows:

> If intelligent people are constantly shopping around for good value, selling those stocks they think will turn out to be overvalued and buying those they expect are now undervalued, the result of this action by intelligent investors will be to have existing stock prices already have discounted in them an allowance for their future prospects. Hence, to the passive investor, who does not himself search out undervalued and overvalued situations, there will be presented a pattern of stock prices that makes one stock about as good or bad a buy as another. To that passive investor, chance alone would be as good a method of selection as anything else.[7]

Since Samuelson's statement, some of the more enthusiastic efficient market theorists seem to have gotten carried away with the allegedly automatic, instantaneous character of market adjustment. The vital role of active investors in bringing about such adjustment is described as follows by Arlene Hershman in the October 1984 *Dun's Business Month:*

> . . . academics are reexamining the role of information in an efficient market. Some economists believe that information isn't free, that it has a price that is paid for in time, money and effort; they assert, further, that market participants who dig out new information will be paid for it in stock market profits. . . . Some money managers, who also are efficient market adherents, believe that it has sectors of inefficiency and that they can outperform the market by searching out ideas that are strikingly new or different.

Market prices as a means of communication among investors. Samuelson's statement focuses on what market prices communicate to the *passive* investor, while Hershman's focuses on what they communicate to the *active* investor. Integrating these statements, we can see what the market, through its particular constellation of security prices, is telling each investor and potential investor at every moment: "Here, in the highly condensed form of security prices, is the sum total of all that everyone else knows and expects about the firms with shares outstanding. If you have something positive to contribute, in the form of new information or understanding, the market will tend to compensate you with profits. If you don't, you are nevertheless protected to a large degree by the fact that other, more active, investors have bid stock prices to levels which reflect their knowledge and understanding."[8]



Just as a scientist stands on the shoulders of all those who have gone before him, each investor stands on the shoulders of the market as a whole. Both the scientist and the investor are presented with an immense amount of information generated by others; both must be exceptionally good to improve on what they receive.

The movement of security prices through time also communicates information to each investor. The investor's profit or loss on each investment provides him with feedback on his investment decisions, and to some degree allows him to learn from his past successes and failures.

Market prices as a means of communication by investors to investees. So far we have focused on security prices as a means by which investors communicate with each other. Security prices are also a means by which investors communicate with companies with securities outstanding. The higher investors bid up a firm's share price in relation to its book value (invested and reinvested capital per share), the more efficiently they expect the firm to use its capital. That is, the more the market expects the firm to be a "winner."

The higher a firm's share price, the more cheaply it can raise additional capital; that is, the smaller the percentage of the company's future earnings that must be given up by its existing shareholders to raise a given amount of cash. Since management tends to act in the interest of existing shareholders (for reasons explained below), management is encouraged to issue more shares when investors bid up the company's share price. In effect, such investors are pre-buying the company's next stock issue.

The more cheaply a firm can raise additional capital, the greater its incentive to expand its operations. Conversely, the lower a firm's share price, the more it costs to raise new capital and expand.

In sum, relative security prices are the way millions of investors tell companies whether to expand or contract, to continue what they are doing or make changes. The market "picks winners" (and losers) every day.

Market prices as a means of communication by investees to investors. The communication described so far—among investors and from investors to investees—would go for naught if investees wasted new capital. How do investors know that investees will use newly raised capital productively?

Since management tends to act in the interest of existing shareholders, it will attempt to offer securities on the market at the highest price that clears the market, that is, at a price which gives

> ***"The problem of economic calculation is a problem which arises in an economy which is perpetually subject to change, an economy which every day is confronted with new problems which have to be solved. Now in order to solve such problems it is above all necessary that capital should be withdrawn from particular lines of production, from particular undertakings and concerns and should be applied in other lines of production, in other undertakings and concerns. This is not a matter for the managers of joint stock companies, it is essentially a matter for the capitalists—the capitalists who buy and sell stocks and shares, who make loans and recover them, who make deposits in the banks and draw them out of the banks again, who speculate in all kinds of commodities."***
>
> —LUDWIG VON MISES, *Socialism*

investors an expected rate of return equal to or just above the market rate (adjusted for risk). For the same reason, management will offer securities which provide such a return only if it believes it can use the invested funds to generate a greater return for the business.

By "stepping up to bat" in the securities market, management is telling investors that it believes such returns are achievable. Just as active investors adjust stock prices in a manner that tends to allow the passive investor to earn nearly a market rate of return with a minimum of investigation, the incentives faced by corporate managers *tend* to decrease the need of investors to investigate the expected returns on a corporation's proposed investments. Prices convey information in a condensed form.

The role of selection and incentives. The market's ability rapidly to communicate meaningful information and to put it to good use is only as good as the incentives facing market participants. So far, we have assumed that investors seek profits and corporate managers tend to serve the interest of existing shareholders. But the capital market consists of more than individual investors and ultimate investees. Capital often flows through long chains of intermediaries, each of which is subject to incentives that enhance the rapid flow and use of information. To fully understand why the market will pick winners better than a subsidy-granting agency, we must explain the incentives facing each type of market participant.

- *Individual investors*—The desire for profit gives investors a strong incentive to act competently. In addition, the market tends to select in favor of more competent investors and against the less competent by reshuffling assets from the latter to the former.
- *Managers of investees*—Corporate managers have an incentive to act in the interest of existing shareholders because their compensation tends to be tied to their company's stock price (the market has selected in favor of firms which compensate their managers in this way); because a lower stock price reduces a corporation's ability to expand, giving the manager a smaller organization to govern; and because a low stock price encourages tender offers to oust incumbent managers.
- *Managers of intermediaries*—Mutual funds, pension funds, banks, insurance companies, brokerage firms, and other intermediaries are managed by people who face similar incentives to those described above (although some intermediaries are not subject to tender offers). Often their compensation is tied to their firm's investment performance or to the dollar value of assets managed (again, because the market

has selected in favor of firms which compensate their managers in this way).

• *Managers of tender offerers and other acquirers*—Corporations which are not usually thought of as intermediaries can play that role when they buy or sell other companies, either through negotiated transactions or hostile tender offers. The managers of such firms have exactly the same incentive to keep their stock price high as do other corporate managers.

• *Employees of intermediaries*—Most intermediaries are too large for their managers to select and monitor investments personally, so they must hire others as portfolio managers, investment analysts, researchers, etc. Because managers are affected by their subordinates' performance, they have a strong incentive to select and reward competent employees.

This brief description presents a pattern. In each case, (1) a party (let's call him "A") entrusting funds to another ("B") is directly affected by B's performance, (2) B's performance can be measured by monitoring investment results, and (3) A has the power to replace B or affect B's remuneration. As we shall see below, the breaking of this pattern, this chain of accountability and control, underlies much of the explanation of why a government-created agency could not pick winners as well as the market.

How a "Non-Political" Government Agency Would Pick Winners

It is sometimes argued that, while industrial policy works in other countries, it could not work in the United States because our political culture is different.[9] Jobs in government planning agencies are insufficiently "prestigious," such agencies are not given the requisite "flexibility" and are subject to too much political pressure from special interests, and so forth.

To see whether such factors are all that stand between the American people and a successful industrial policy, let's imagine how an agency could be structured to maximize its ability to pick winners. Let us assume:

• Congress creates the agency with competent, independent directors, as little Congressional oversight as constitutionally permissible, and a large enough initial appropriation that it need never return to Capitol Hill for more funds;

• the agency is able to hire the most competent staffers with large salaries and performance-based bonuses, and can terminate and promote staffers without regard to civil service rules;

• the agency can spend as much as it desires on research; and

• the agency can make its investment/subsidy decisions on any basis it desires, free of any requirement to treat applicants on an equal or rational basis.

In short, the agency could be structured to look and act like a first-rate investment fund, with just two exceptions that go to its very nature and purpose:

(1) Let us recall that advocates of industrial policy seem not to contest the idea that private investors can effectively pursue their own self-interest, but rather argue that the market cannot effectively translate investors' pursuit of gain into the most efficient allocation of capital among investees. Therefore, if our hypothetical agency were to operate as a nationalized mutual fund, trying to maximize its own profit like any private investor, it would not be addressing the problem it was created to solve. Since the agency must assume the market is not allocating enough capital to winners, it would have to channel more capital to such firms than its own profit expectations could justify, thus acting at least in part for the firms' benefit. The agency must operate on the basis that the full return on its "investments" can be calculated only by including the benefits it confers on its "investees." In summary, the only way the agency could attempt to improve on the performance of the market as an institution is to operate as an alternative institution which grants subsidies to those it perceives as winners.

(2) Since the agency would be created by Congress for a public purpose, it could not be operated for the private profit of its appointed directors or anyone else to whom they would be accountable. Whatever the proponents of industrial policy want, it is clear they do not advocate conferring on any private party the economic benefit that could flow from the power to dis-

burse billions in public funds.

The agency would underperform the market in picking winners for four reasons, the first three of which arise from exception number (1) and the fourth of which arises from exception number (2).

Why the Agency Would Underperform the Market

Inability to use information communicated by other investors. As noted earlier, the market prices of equity securities serve as a highly efficient form of communication among investors, telling each investor what everyone else knows and expects about investees. Since our agency is premised on the idea that the market's selection of winners via stock prices is flawed, the agency has no choice but to disregard such prices and all the information they convey. Instead, it would have to rely entirely on the nonprice information gathered by its own research department.

To pick winners better than the market, the agency's research department would have to outperform the market in quickly acquiring, evaluating, and using information. Let us assume that the agency would be able to hire "enough" researchers and that it could properly structure their incentives. The agency would still face an insurmountable problem: the larger its research department, the more its internal communications would become overloaded by the sheer mass of verbal and numerical (nonprice) data. Like any intelligence agency, its problem would lie not so much in gathering data, but in getting it to the right people, integrating it, and evaluating it. By contrast, the problem of "internal" communication within the market is handled primarily by the price mechanism, with the system's participants paid (in the form of profits) for ensuring that the information encapsulated in prices is as accurate and current as possible.

It might be objected that the task faced by the agency's research department is the same as that performed every day by investment analysts and researchers for intermediaries such as mutual funds, namely, attempting to obtain information not already reflected in stock prices. This objection misconceives the role of such research efforts. Such research uses current stock prices as benchmarks, continually attempting to determine whether a stock is overpriced or underpriced compared to other stocks in light of new data. By using stock prices in this way, investment analysts stand on the shoulders of the market. By contrast, the agency would be attempting to see farther by getting down from the market's shoulders and standing on its own feet.

It might also be objected that, if the agency makes favorable loans or outright grants to its "investees," its research would be comparable to that of other lenders. After all, lenders seldom make their credit decisions based on a prospective borrower's stock price. The problem with this objection is that lenders also do not pick winners; that function is performed by the *equity* markets. Therefore, the relevant comparison is between the respective information-gathering methods of the agency and the market for equity securities.

Since the agency would be making its "investments" on the basis of less complete, less current information than the market, a higher proportion of the agency's funds would be malinvested. The agency would probably earn less than passive investors, who tend to be saved from malinvestments by the price-adjusting behavior of more active investors. The agency's information-gathering handicap relative to the market would be greatest with respect to the most rapidly changing segments of the economy, which happen to be those segments disproportionately inhabited by "winners."

Unreliability of information communicated by investees. As discussed above, investees communicate information to investors whenever they issue securities. New securities can be only issued if the offering price gives investors an expected rate of return (adjusted for investor-perceived risk) at least equal to the market rate. By offering securities at that price, the managers of investees communicate their expectation that the proceeds can generate greater returns for the business. This process forces corporate managers to realistically evaluate the risks of alternative strategies and investments. As anyone familiar with corporate planning could attest, projects presented to

management with a stated return of 20 per cent or 25 per cent are a dime a dozen; the real trick is for managers to reject those projects which are too risky in light of the firm's cost of capital.

Since our hypothetical agency must seek to outperform the market by subsidizing investees it perceives as winners, it must require investees to project above-market returns on its funds, while its own returns must be below-market. What happens when a corporate manager is faced with the prospect of obtaining a subsidized investment of this sort? Obviously, the manager is given the incentive (1) to seek the agency's funds for any investment which he expects to earn more than the agency's below-market rate of return, and (2) to overstate the expected return on such investments, in effect underplaying their risk.

By altering the corporate manager's incentives, the agency's investment process would reduce the reliability of information communicated by investees about their own expectations. By eschewing information contained in stock prices, the agency would be forced to substitute largely futile after-the-fact efforts to determine the investee's actual rate of return on invested funds.[10] The more the agency grants subsidies rather than seeking its own profit, the less it could rely on information communicated by investees, and the lower the total return on its investments is likely to be.

Inability to calculate the return on its investments. So far, we have focused on two factors which suggest that, for investments made any given time, T_1, the agency is likely to underperform the market: (1) it would always be two steps behind the market in gathering information because it could not use information transmitted by other investors, and (2) the information obtained on investee expectations at T_1 would be less reliable than the information such investees transmit to the market.

The agency would also underperform the market because it could not calculate the return on its investments from time T_1 to any subsequent time T_2. Unlike a profit-seeking investor who can compare stock prices at T_1 and T_2 and add in dividends, our agency must attempt to measure its performance by factoring in the benefit it confers on its investees.

This task would be virtually impossible. The agency could not determine whether its investees are winners by comparing the performance of their stocks against the market's. To the extent an "investment" by the agency contains a subsidy element, the subsidy constitutes found money for the shareholders of the subsidized firm and would of course raise the firm's share price. By this standard, the agency could turn a corporate "dog" into a winner by giving it a large enough subsidy.

Nor could the agency determine whether it has selected winners by reference to the return on investment of subsidized firms. A firm which has a high return can always use its next investment dollar on a low-return or high-risk project (as the agency's subsidies would encourage it to do). The agency could measure its returns only by attempting to monitor the actual returns its subsidies generate for investees, a process which, as noted above, would be fraught with error and uncertainty.

The agency's inability to measure its performance would block its access to the self-correcting mechanisms that operate in the market, in effect severing its feedback loop. Unlike a profit-seeking investor, the agency could not learn from its past successes and failures.

And unlike other intermediaries, its managers could not measure the performance of staffers hired to make or recommend investments, and those ultimately in charge of the agency could not measure the performance of its managers. As a result, agency personnel could not be compensated, promoted, or fired based on performance. Even if the agency were to start with the "best and brightest," its ability to motivate its personnel and to select in favor of the most competent and against the least competent would be substantially impaired.

Lack of incentive. The fourth and final reason the agency would underperform the market in picking winners arises from the fact that it could not be operated for the private profit of those ultimately in charge of the agency. As noted earlier, the managers of investment intermediaries have a strong incentive to operate in the interests of their investors because (1) such investors can capture the benefits and detri-

ments of the managers' performance and (2) such investors have the power to replace the managers or affect their remuneration. The merciless judgment of investors is the means by which external reality impinges on managers, forcing them to be alert to opportunities for profit and to resist the natural tendency of organizations to become "fat" and to operate in set routines.[11]

By contrast, no one in a position to influence the agency's actions could capture the resulting benefits or detriments. Therefore, even if the performance of the agency's managers could be measured, no one would have a strong incentive to select and reward such managers based on their performance. As a result, even if all of the other objections to the agency could be overcome, its managers would have less incentive than private managers to ensure that it operates efficiently and alertly. Given enough time, our creative, high-powered agency would take on the appearance of any other government bureaucracy.

Bringing Politics Back into the Picture

In order to focus on the economics of industrial policy, we have temporarily assumed that our hypothetical agency could be operated free of political influence. Now this assumption can be relaxed.

In fact, eliminating political considerations would be impossible, if for no other reason than that Congress would retain the power to abolish or rein in the agency if its activities become politically unacceptable. On this point, the allegedly independent Federal Reserve System's continual accommodation of political pressure is instructive. A non-political government-created agency is a bit like a square circle.

Once it becomes apparent that the politicians would function as the owners of the agency, all sorts of things fall into place. The politicians, even those who might have opposed creation of the agency, can capture the benefits of its activities by influencing it to subsidize favored constituents, receiving payment in the currency of politics: votes, contributions, and favors. The effect on the agency's already modest ability to channel funds to winners ought to be readily apparent.

While the agency could not succeed by the market's criteria, it could succeed admirably by the very simple criterion of politics: *is the result visible to the voters?* As long as a politician can point to a government-subsidized project and say "this created (or saved) X jobs," the project's political benefits would probably outweigh its political costs. Why this is so—that is, why the political process weighs costs and benefits so much more crudely than the market—is an important and difficult subject, one that is beyond the scope of this article.

Nevertheless, the sharp divergence between political and economic criteria of success shows the principal danger of industrial policy. Once a subsidy granting agency becomes established, it will appear to be a success even as it draws resources from productive to unproductive uses, making us all poorer as a result. □

1. "States Back Risky Ventures In Effort to Create New Jobs," *New York Times*, June 23, 1986.
2. Ludwig von Mises, *Socialism: An Economic and Sociological Analysis* (London: Jonathan Cape, 1951), pp. 111-222 and especially pp. 137-142.
3. Friedrich A. Hayek, *Individualism and Economic Order* (Chicago: Henry Regnery Company, 1948), pp. 119-208.
4. *National Journal*, May 21, 1983.
5. This discussion focuses on equity securities rather than debt securities because it is by pricing the former that the market picks winners. Equity securities are residual claims against a business which can be realized only after all contractual claims, such as the obligation to pay principal and interest on debt securities, are satisfied. Because debt securities are partly insulated from the corporation's performance by a "cushion" of higher-risk equity securities, the market prices of its debt securities depend primarily on market-wide interest rates and only partly on the corporation's "downside" potential, that is, the likelihood of its default. By contrast, the price of a corporation's shares depends less on interest rates and more on expectations about its "upside" as well as "downside" potential. It is the ability of equity securities to capture the "upside" potential that makes them the market's vehicle for picking winners.
6. *See* Thomas Sowell, *Knowledge & Decisions* (New York: Basic Books, Inc., 1980), pp. 103-4.
7. Burton Malkiel, *A Random Walk Down Wall Street* (New York: W.W. Norton & Company, Inc., 1973), pp. 167-8.
8. There are really three broad categories of investors—active, passive, and what might be termed "pseudo-active." The third group engages in a great deal of trading activity, often on the basis of charts, but does little, if anything, to adjust prices to new information or more perceptive analysis. The third group probably creates short-term distortions in security prices which are then corrected by "true" active investors searching for profit opportunities.
9. Joseph L. Badaracco, Jr. And David B. Yoffe, "'Industrial Policy': It Can't Happen Here," *Harvard Business Review*, November-December 1983.
10. This task would be fraught with error and uncertainty. The projects funded by the agency would not necessarily be the ones so designated by the investee, but would be those which, in management's mind, would not have been undertaken but for the subsidy.
11. *See* Mises, *Bureaucracy* (New Rochelle, N.Y.: Arlington House, 1969).

A REVIEWER'S NOTEBOOK

The Farm Problem

by John Chamberlain

When Nikita Khrushchev came to America in 1959, he visited an Iowa farm. He was well aware that American agriculture was a great success story. But he never knew why.

The magnitude of the success story is apparent in the figures that are scattered through the 20 essays taken from *The Freeman* for publication in a book called *The Farm Problem* (Foundation for Economic Education, 144 pp., $5.95). In 1800 some 90 per cent of the U.S. population were non-city people, making their livings as farmers, hunters, or backwoodsmen. In 1960, when Karl Brandt was collecting statistics for his essay on "The Hard Core of the Farm Problem," only 10 per cent of the people were still on the farm. In 1983 Clarence B. Carson, for his essay on "The Trouble With Farming," had the 1980 census to consult. The total number of farms in the U.S. had declined from 6.1 milion in 1940 to 2.8 million in 1980. Farm population had declined from 30.5 million in 1940 to 8.8 million in 1980. The number of hired farm hands, which stood at 2.6 million in 1940, had been cut in half (1.3 million) in 1980.

With fewer and fewer people farming more and more land on bigger farms, the agricultural yields were tremendous. One American farmer was feeding himself and 24 others. In Russia the collectivized farmer feeds only a total of five. The 1981 corn crop in the U.S. was the biggest ever. The 2.7 billion bushels of wheat constituted another record.

The figures representing an incredible plenty can be spun out in all directions. George B. Mueller, in his "The New Agricultural Revolution," says that "as farmers we are presently investing twice the amount industry averages in capital tools per man." This puts food on the typical American's table for less than 17 per cent of his wages. Says Mueller, "rather than looking upon agriculture as a serious problem, we should consider it our biggest success story."

Famine

We have had dust bowls, but never famines. It hasn't been that way throughout recorded history in other countries. Edmund Opitz, in his "The War on Poverty Revisited," tells us that a French famine wiped out a million people, five per cent of the country's population, in 1709. The potato famine in Ireland in the 1840s claimed some 1.5 million lives. A famine in China in the late 1870s killed 15 million. India is now making use of improved strains of grain, but it has only recently escaped from the condition that cost one and a half million lives in the 1943-44 Bengal famine.

If Moscow had not had oil and gold to trade for wheat, there would have been acute starvation in Russia in nine out of 20 dry years between 1963 and 1983. Sven Rydenfelt, the Swedish economist who gives us this information, thinks that it is a cop-out for the Communists to blame everything on the weather. In Czarist times they had dry weather, too, but they also had wheat in exportable quantities.

The "planning" of agriculture in socialist countries outside of Russia has, as Rydenfelt makes plain, resulted in a general impoverishment.

Africa is the worst example. David Osterfeld, in his "African Famine: The Harvest of Socialist Agriculture," says that government marketing boards in most of the famine-threatened African countries have forced the peasants to produce without profit. Unable to get more than a fraction of his crops' actual value, the African peasant loses all initiative. Ethiopia is particularly reprehensible—over 60 per cent of the country is arable, but only 10 per cent is cultivated. Nobody with a hoe in his hands sees the point of producing anything beyond subsistence levels.

Technology

Statistics tell a story, all right, but there is nothing like personal experience to ram a point home. Howard Baetjer Jr., a graduate student at Boston College in 1983, took time out one summer to work as a field hand on a Nevada alfalfa ranch. They used laser beams to level the fields in the parched territory where he worked. The laser allows the rancher to get the ground absolutely even as it drops off at exactly the right rate. The laser light, pitched at the proper angle, is read by a sensor attached to a huge machine with a scraping blade and a reservoir of topsoil. When the ground rises up, the sensor tells the blade to shave the area down. When the ground drops off, it tells the machine to dump some soil.

A laser-planed field means that irrigation will be perfectly even. The alfalfa will soak up the water without waste. A hundred years ago nothing but sagebrush would grow on an average Nevada 40-acre field that now yields enough hay to fee 70 cows for a year.

Our politicians, chivvied by the more inefficient farmers who ought to be looking for jobs in industry, try to deal with the tremendous plenty by establishing price supports and limiting the number of acres to be planted. It doesn't work—the American farmer, with new seeds and fertilizers at his disposal, has always been able to defeat the government's purpose by growing more and more on less and less ground. The failure of the government programs is stressed in most of the essays in this volume. □

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