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FEATURES

Ludwig von Mises

COLUMNS

BOOK REVIEWS

by Richard M. Ebeling

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1914 and the World We Lost

Ninety years ago this month, on June 28, 1914, Archduke Francis Ferdinand, heir to the throne of the Austro-Hungarian empire, and his wife, Sophie, were assassinated by a Bosnian-Serb nationalist in the city of Sarajevo. It served as the spark which set off the events that started World War I later that summer. It also ended the predominantly classical-liberal epoch of the nineteenth century and ushered in roughly the last hundred years of collectivism, interventionism, and war.

What the epoch before 1914 was like was concisely expressed by John Maynard Keynes in his 1919 volume *The Economic Consequences of the Peace*:

> What an extraordinary episode in the economic progress of man that age was which came to an end in August, 1914! The greater part of the population, it is true, worked hard and lived at a low standard of comfort, yet were, to all appearances, reasonably contented with this lot. But escape was possible, for any man of capacity or character at all exceeding the average, into the middle and upper classes, for whom life offered, at a low cost and with the least trouble, conveniences, comforts, and amenities beyond the compass of the richest and most powerful monarchs of other ages. The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend. He could secure forthwith, if he wished it, cheap and comfortable means of transit to any country or climate without passport or other formality, could despatch his servant to the neighboring office of a bank for such supply of the precious metals as might seem convenient, and could then proceed abroad to foreign quarters, without knowledge of their religion, language, or customs, bearing coined wealth upon his person, and would consider himself greatly aggrieved and much surprised at the least interference. But, most important of all, he regarded this state of affairs as normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable. The projects and politics of militarism and imperialism, of racial and cultural rivalries, of monopolies, restrictions, and exclusion, which were to play the serpent to this paradise, were little more than the amusements of his daily newspaper, and appeared to exercise almost no influence at all on the ordinary course of social and

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economic life, the internationalization of which was nearly complete in practice.

However imperfectly, throughout all that was called at that time "the civilized world," the rule of law prevailed and the rights of individuals to their life, liberty and property were widely respected. Governments rarely consumed more than 10 percent of the wealth of their citizens and subjects—leaving the remaining 90 percent to be consumed, saved, and invested as those citizens and subjects considered most useful, advantageous, and profitable. Freedom of trade generally prevailed among these nations, with the tariff barriers that existed being minor stumbling blocks to the competitive flow of goods and services around the world.

Free to Move

In addition, there was virtual free movement of people from one end of the globe to the other, with only the Russian and Turkish Empires, among the European nations, imposing visa requirements. And American immigration restrictions were only beginning to be imposed to any noticeable extent. Between 1850 and 1914 almost 60 million people had migrated from their home countries to other parts of the world, with almost half of them making their destination the United States.

The welfare state was still in an embryonic stage, having been introduced in its modern form in Imperial Germany, starting in the 1880s, by the "Iron Chancellor," Otto von Bismarck, to undermine the appeal of the German Socialist Party. Inspired by the German model, Great Britain had only introduced the first of its national health-care programs in 1911. In the United States, proponents of the German welfare state were propagandizing for a similar system; but in those years before 1914, assisting the less fortunate was still considered a matter for private philanthropy, voluntary charitable associations, and local communities.

Governments tended to balance their budgets, with surpluses used to pay off any debts accumulated during national emergencies. While the monetary systems of the major nations of Europe and North America were under the control of government-run or -sponsored central banks, in general those systems were managed on the basis of the gold standard—with actual gold coins and bullion in circulation as the media of exchange; bank notes and checks were redeemable in gold on demand at legally enforced fixed rates of exchange.

The tragedy of war had not disappeared from the human scene in the decades before 1914, but wars were few and more limited in their impact on both life and property than the "total war" and collectivist revolutionary violence of the remainder of the twentieth century.

How long ago that classical-liberal epoch now seems! Even with the demise of totalitarian collectivism in their fascist and communist forms, the individual remains a ward of the paternalistic welfare-interventionist state, with all his activities regulated by government.

What goes by the name of "free trade" is actually managed trade manipulated through a variety of international organizations controlled by the governments of the world. Gold was long ago replaced with paper currencies, the value and stability of which are totally dependent on the caprice of governments that pander to special interests and pursue ideological agendas.

World War I, of course, did not create by itself the century we have just experienced. The trends toward collectivism and interventionism had been developing for at least 20 years before the war began. Indeed, World War I was the culmination of the rise of socialism and nationalism in the late nineteenth century. What the war provided were the means and the rationale to bring socialism and nationalism into complete control of society. The world still has not recovered from what used to be called the Great War. □

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PERSPECTIVE

Nock Revisited

Some books and essays require regular rereading. In the course of our busy lives, we can allow their subtle wisdom to fade into the landscape and lose their initial effect. A work of this kind is easy to spot: it is fresh and sparkling on every subsequent reading; each encounter with it feels like the first.

For me, Albert Jay Nock's masterly essay "On Doing the Right Thing" is one of those works. (Written in 1924, it is reprinted in the Nock collection *The State of the Union: Essays in Social Criticism,* edited by Charles H. Hamilton and published by Liberty Fund.)

Nock's essay is a reminder that the advocates of the paternalistic state, whether "left" or "right," have it backward: good conduct isn't a *precondition* of freedom; it is a *consequence* of freedom. He contrasts the "region of conduct" regulated by force, that is, by government, with the region regulated by the individual's sense of "doing the right thing."

Nock wrote, "The point is that *any* enlargement [of the first region], good or bad, reduces the scope of individual responsibility, and thus retards and cripples the education which can be a product of nothing but the free exercise of moral judgment. Like the discipline of the army, again, any such enlargement, good or bad, depraves this education into a mere routine of mechanical assent. The profound instinct against being 'done for our own good' . . . is wholly sound. Men are aware of the need of this moral experience as a condition of growth, and they are aware, too, that anything tending to ease it off from them, even for their own good, is to be profoundly distrusted. The practical reason for freedom, then, is that freedom seems to be the only condition under which any kind of substantial moral fibre can be developed."

Across the political spectrum, social engineers think they need to deprive us of freedom in order to make us moral. So they use the law to keep us from "discriminating," gambling, taking drugs, smoking in restaurants, abstaining from helping others, leaving our seat belts unbuckled, you name it.

Nock saw through this long ago: "Freedom, for example, as they keep insisting, undoubtedly means freedom to drink oneself to death." But "it also means freedom to say with the gravedigger in *Les Misérables*, 'I have studied, I have graduated; I never drink.' . . . [F]reedom to do the one without correlative freedom to do the other is impossible; and that just here comes in the moral education which legalism and authoritarianism, with their denial of freedom, can never furnish."

Of course, some people will choose badly. Nock wasn't naïve. But rather than wallowing in that fact, he "turns to contemplate those men and women who act responsibly decent, decent by a strong, fine, self-sprung consciousness of the Right Thing, and . . . declares [the] conviction that the future lies with them."

The Nockian understands that it is not the threat of state action that keeps most people decent. He "does not believe that any considerable proportion of human beings will promptly turn into rogues and adventuresses, sots and strumpets, as soon as they find themselves free to do so; but quite the contrary."

Nock concluded that the purpose of his advocating freedom was nothing less than "that men may become as good and decent, as elevated and noble, as they might be and really wish to be."

The lesson of Nock's essay is that champions of the freedom philosophy need never be silenced by the charge that freedom makes vice possible—for without freedom, there can be no virtue.

* * *

Thirty years ago, in modest New England surroundings, an important intellectual revival began. Richard Ebeling details the significance of Austrian economics, a pillar of the freedom philosophy.

Some prominent politicians cast aspersions at corporations that move to Bermuda to reduce their taxes. One presidential candidate would block such moves. Robert Stewart sees things differently.

What could be more sensible than believing that "buying American" is good for Americans? Robert Carreira shows that things aren't always what they seem.

The Progressive Era was a turning point for the formerly near-laissez-faire United States. But how exactly did it turn America around? Fred Smith has an evolutionary analysis.

Is it okay to download copyrighted music from the Internet without permission? What would economist Ludwig von Mises have said? Bettina Bien Greaves looks for clues in Mises's writings on copyrights.

The self-described advocates for the world's poor despise trade and globalization. But what do the poor themselves think? You might be surprised by what Jim Peron found out.

People expect economists to be able to read tea leaves, and many economists encourage that expectation. Arthur Foulkes says let's get real.

In the columns department, Richard Ebeling remembers World War I. Donald Boudreaux demonstrates that a trade deficit is not debt. Robert Higgs recounts a unique land-privatization program. Walter Williams utters the S-word (secession). And James Otteson, reading a psychologist's claims that choice is bad for us, replies, "It Just Ain't So!"

Our reviewers have been perusing books on principles of government, choice in education, free trade, and capitalists who undermine capitalism.

—SHELDON RICHMAN

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Choice Is Bad for Us?

It Just Ain't So!

One of the often-unperceived consequences of an expanding welfare state is the gradual atrophy of independent judgment. Judgment is a skill, and, like other skills, it must be exercised to be vigorous and dependable. The fewer opportunities people have to exercise their judgment and the more that others make decisions for them, the weaker this skill becomes. And if the progression continues, it can result in the sorry spectacle of adults unable to make the simplest decisions, nonplussed by options and flummoxed when faced with new situations.

Because the welfare state tends to expand slowly, however, this atrophy is slow. That is why it is rarely perceived. I came to appreciate it only after having lived several months in the United Kingdom, where the welfare state has progressed a few steps further than it has in the United States. The difference this makes in people's abilities to form independent judgments is remarkable. The extent to which Britain's government either makes decisions for people or insulates them from any untoward consequences from having chosen badly has resulted in grown men and women who increasingly find themselves unable to negotiate a business or employment contract, buy a car, decide or even think about health care, provide for their own or their families' well-being, think and plan ahead, weigh short-term against long-term interests, judge their children's educational program, and on and on. If you treat people like children, and structure their world so that they can only act like children, it should be no surprise if what you get is a population with the judgment and intellectual maturity of, well, children.

And now comes Barry Schwartz, a professor of psychology at Swarthmore College, writing in the *New York Times* (January 22, 2004) that "there is growing evidence" that "for many people, increased choice can lead to a decrease in satisfaction." Why? It "makes people feel worse" when they have to decide among too many kinds of jam or chocolate (Schwartz's examples) because "increased choice creates an enormous burden on people to seek the information needed to make a good decision"; moreover, "plentiful choice increases the chances that people will regret the decisions they make, because of all the bypassed alternatives, many of which might have been better." "Indeed," Schwartz warns, "there may be a point when choice tyrannizes people more than it liberates them." He concludes: "The implication of this news, both for individuals and for government officials, is that sound social policy simply cannot consist of throwing an ever-greater menu of options at the American people."

Of course, the *real* implication of Schwartz's view, which he refrains from stating explicitly, is that some people—perhaps Schwartz himself and his fellow researchers?—will have to limit the options available to all the rest of us, who, lacking judgment and intellectual maturity, just could not handle them all. One wonders how Schwartz and the other experts would escape the paralysis, depression, regret, and ultimate tyranny resulting from having to choose which options to make available to us. One might also wonder about Schwartz's apparent worldview in which the government possesses all the things people might want or use, and therefore must decide whether to offer them or not.

But the real perniciousness of Schwartz's argument is its tendency for self-fulfillment. Slaveowners in the antebellum South some-times argued that they could not in good conscience free their slaves because the slaves were unable to fend for themselves; they were just too unskilled or unintelligent or uncivilized to figure out what to do, where to go, and how to get what they needed. Thus simply turning them out into the cold threatening world would be to treat them cruelly, not humanely—like abandoning a five-year-old child in the middle of the forest and expecting him to survive on his own.

Imagine your reaction to an eighteenth-century researcher who presents "evidence" that when slaves are given the choice of jam or chocolate, they do not feel liberated but instead are uncertain, confused, even paralyzed. That would prove it, then: "sound social policy simply cannot consist of throwing an ever-greater menu of options at the American [slaves]"; more choice "tyrannizes [slaves] more than it liberates them." What a transparently self-serving argument that would be! You would reject it summarily.

But that is Schwartz's argument. Only this time it is not about slaves or children. It is about ostensibly free adults.

Self-Doubting Americans

Perhaps there were American slaves who themselves believed they were unable to manage their own lives, as today there are Americans who think that government experts need to make decisions about which medicines people should take, what constitutes a just employment contract, how to educate children and provide for people's retirement, and so on. As Schwartz writes, "Who has the time to find the best digital camera, the best cellphone plan, the best 401(k), the best health insurance or the best school for his children?"

Well, I do, for one, as do millions of other people who make decisions about these things daily.

But Schwartz would have us turn over all these decisions to the government experts instead. Yet in addition to the fact that "individuals are the best judges of their own welfare," which Schwartz takes to be the only support for individual freedom, it is also true that no one other than the individual in question has the proper incentives to make good decisions. If the government expert makes a bad decision, its consequences are suffered by everyone under his purview—which on Schwartz's view would be just about everybody.

By contrast, if an individual makes a bad decision, its consequences redound essentially to that individual himself. Even if they also affect his close family or friends, that is a significantly smaller problem than the catastrophe of one distant expert's making a bad decision for everyone.

This precisely explains what we see: when the freedom to choose and the responsibility for one's choices are respected, one develops judgment and independence; one becomes an adult. When that freedom and responsibility are taken away, however, judgment atrophies and one becomes dependent, like the slave or child.

In the end, what we want the government to do depends on what kind of people we want. If we want a docile, servile, dependent populace, then we should take Professor Schwartz's advice and continue extending the welfare state apace. If, on the other hand, we want a free and responsible populace—along with all the diversity, unpredictability, and independence that comes with it—then we should stop the welfare state in its tracks.

It is probably clear that I endorse the latter course, and that I find arguments like Professor Schwartz's to be contemptible. Freedom is a bracing thing, and it does indeed entail both successes and failures, not to mention hard work. But what in this life that is worth having does not?

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Austrian Economics and the Political Economy of Freedom

by Richard M. Ebeling

The revival of the modern Austrian school of economics may be said to have begun 30 years ago, during the week of June 15–22, 1974, when the Institute for Humane Studies sponsored a conference on Austrian economics for about 40 participants in the small town of South Royalton, Vermont.

In 1974 the Austrian school had been in hiatus for almost a quarter of a century. For more than 60 years before the 1940s, the Austrian economists had been considered some of the most original contributors to economic theory and policy. They were among the leading developers of the theories of marginal utility, opportunity cost, value and price, capital and interest, markets and competition, money and the business cycle, and comparative economic systems—capitalism versus socialism versus the interventionist welfare state.

But the rise and triumph, in the late 1930s and 1940s, of the Keynesian explanation of and prescription for the Great Depression eclipsed all competing approaches to the problems of economic depression and high unemployment. This included the Austrian theory of the business cycle, which in the early 1930s had been a leading alternative to the emerging Keynesian macroeconomics.[1]

At the same time, there developed what came to be called the neoclassical approach in microeconomics. The study of the logic of individual decision-making, the allocation of scarce resources among competing uses, and the distribution of income among the factors of production—land, labor, and capital—became increasingly an exercise in mathematical optimization under conditions of various quantitative constraints. The focus of attention was on the specification and determination of the narrow and often highly artificial conditions under which a market economy would be in general equilibrium.

This, too, was in stark contrast to the approach of almost all Austrian economists, who attempted to explain the logic and processes of market competition in a world of constant change. The Austrians, unlike their neoclassical rivals, emphasized imperfect knowledge, the pervasive role of time in all market decision-making, and the nature of market coordination through continual adaptation to changing circumstances.[2]

Eight months before that conference in South Royalton, in October 1973, the most important contributor to Austrian economics in the twentieth century, Ludwig von Mises, had died at the age of 92.[3] The second most prominent member of the Austrian school at that time, Friedrich A. Hayek, had been invited to attend the conference, but had declined due to health problems that

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made it impossible for him to travel to America from Europe. No one at the conference anticipated that only four months later, in October 1974, Hayek would be awarded the Nobel Prize in economics.[4]

The speakers at the conference were three other leading figures in Austrian economics: Ludwig M. Lachmann, who had studied with Hayek at the London School of Economics in the 1930s; Israel M. Kirzner, who had studied with and written his dissertation under Mises at New York University in the late 1950s;[5] and Murray N. Rothbard, who had attended Mises's NYU seminar for many years beginning in the late 1940s and had received his doctoral degree in economics from Columbia University.

One evening during the conference, Milton Friedman came from his summer home in Vermont to join us for dinner and make a few remarks after the meal. Friedman commented that he was delighted to be with us and recalled he had long known both Mises and Hayek, having been a founding member of the Mont Pelerin Society and present at its first meeting in Switzerland in April 1947.[6] But what stood out in his remarks for many of us there was his statement that there are no different schools of thought in economics; there is only good economics and bad economics. Clearly, therefore, in Friedman's mind, we were on a fool's errand attending a conference on something called "Austrian" economics.

Acting Man as the Core of Austrian Economics

Yet most of us attending that conference did not consider ourselves on a fool's errand. We just considered Austrian economics to be "good economics."[7] At its most fundamental level, Austrians see the individual as "acting man." This was already clearly stated by Ludwig von Mises in 1933:

> In our view the concept of man is, above all else, also the concept of the being who acts. Our consciousness is that of an ego which is capable of acting and does act. The fact that our deeds are intentional makes them actions. Our thinking about men and their conduct, and our conduct toward men and toward our surroundings in general presuppose the category of action.[8]

The Austrian view of man refutes the positivist, historicist, and neoclassical conceptions of man as a mere physical, quantitative object, or as a passive subject controlled by the dark forces of history, or as a "dependent variable" in a system of mathematical equations. Positivism tried to reduce man and his mind to mere magnitudes to be studied and manipulated like the inanimate matter experimented on in the natural sciences. Historicism claimed that man is determined and molded by external laws of history that shape his thoughts, actions, and destiny, with little latitude for the individual to design and guide his own future.[9] Neoclassical economics treats man like a mathematical function possessing given tastes and preferences, which are themselves induced by his surroundings and on the basis of which he responds in predictable ways when confronted with various constraining and objective tradeoffs in the form of market prices.[10]

For Austrians, on the other hand, man is a purposeful being. He thinks, plans, and acts. Man may be made up of matter, but he possesses consciousness. He has the capacity to imagine, create, and initiate. His mind is not simply reducible to lifeless matter. He has spirit and will. Man reflects on the circumstances in which he finds himself. He judges aspects of his physical and social surroundings less than satisfactory. He imagines states of affairs that would be more to his liking. He creates in his mind plans of action that would bring those preferred states of affairs into existence. He discovers that the things he can use as means to achieve *some* of his ends are insufficient to achieve *all* of his ends. He has to weigh the alternatives and decide which he prefers more, since some of them, in the face of scarcity, will have be forgone today or forever. He therefore has to decide the tradeoffs he is willing to make, and as a result he determines the costs of his own choices in the form of goals he is willing to give up in order to pursue others that he considers more important.

Those ends and means that neoclassical economics take as "given" are, in fact, created and compared in the actor's mind. They change and are modified as man experiences successes and failures. They are not static. Nor is man a hopeless victim or captive of history. He makes his own history by reflecting on what has happened in the past and mentally projecting himself into the future. He decides what past course of action is worth trying to continue or what might be a better course as he looks ahead.

Imperfect Knowledge and Market Opportunities

This is why Mises insisted that in every man there is the element of entrepreneurship. In all his actions, man searches for and creates profitable opportunities to improve his lot and tries to avoid losses, that is, circumstances worse than they need to be. By necessity, man is therefore a speculator in everything he does.[11]

Creating profitable opportunities and avoiding losses are concepts that have no meaning in the traditional neoclassical conception of "perfect competition," in which every market participant is assumed to possess perfect or sufficient knowledge of all possibilities that might be relevant to his decisions. What is the meaning of "opportunities discovered" or "losses avoided" when the actors already know from the beginning what are the best and indeed the only options that should be followed, given perfect and sufficient knowledge of all relevant circumstances?[12]

From the Austrian perspective, to choose is to select from alternatives, and to select from alternatives must mean that, at least from the individual's perspective, the future is not preordained. If that future is not preordained, but can be influenced by the choices he makes, then perfect knowledge is logically inconsistent with the very concept of acting and choosing man. Otherwise, man would know already all the decisions he will make and the necessary outcomes. But what then remains of any commonsensical notion of choice? Even if we assume only knowledge of objective probabilities and not absolute certainties about the future, every man would still know what is the precise set of options from which he has to choose and the exact weight he should assign to each possible outcome; then, given his tastes and preferences for risk, he would again know from the start the only courses of action he could and should logically follow.

Many neoclassical economists may despair of a world in which imperfect knowledge and uncertainty prevail, a world in which their mathematically deterministic models lose their force. But for Austrians, this reality of the human condition is a reason for optimism about man and his world. The fact that man does not know for certain what the future holds, including what his own future actions may be, means that the world in which he lives is one of wondrous possibility. Individuals have incentives to experiment with creative new ideas precisely because they don't know for sure or with any probabilistic degree of certainty how those ideas may actually turn out. It is this element of uncertainty about the future that permits imagination and action to influence the shape of things to come—including all the advancements in the social, economic, and cultural condition of mankind.[13]

For the neoclassical economists, the market is reduced to a series of simultaneous equations of supply-and-demand functions, the properties of which specify whether a general-equilibrium "solution" exists for the market as a whole, and whether that solution is "unique" and "stable." Prices are the quantitative ratios of exchange at which goods may be bought and sold, and which "objectify" the tradeoffs for which alternatives in the market may be obtained. Likewise, the theory of comparative advantage, in the neoclassical framework, merely determines the relative opportunity costs of potential trading partners so they may assume their highest-valued roles in the division of labor. In addition, property rights, money, and social and political institutions are usually treated as "givens" in neoclassical analysis. They are merely the context in which the supply and demand functions interact.[14]

Minds, Markets, and the Entrepreneur

For Austrians, the essence of the market is missed when reduced to a skeletal representation in the form of mathematical functions. The market is where the minds and the meanings of men meet. It is the place where the plans of multitudes of individuals overlap, enabling people mutually to improve their situations through discovered and created gains from trade. It is where the wants of men find greater degrees of satisfaction than in isolated self-sufficiency, and where achieving things never conceived of before is practicable. In the Austrian conception of the market, prices are not simply quantitative ratios of exchange; they are also the encapsulation of the market participants' valuations and appraisements, which result from the participants' buying and selling.[15] As Carl Menger, the founder of the Austrian School, expressed it in 1871:

> [Prices] are by no means the most fundamental feature of the economic phenomenon of exchange. This central feature lies rather in the better provision two persons can make for the satisfaction of their needs by trade. . . . Prices are only incidental manifestations of these activities, symptoms of an economic equilibrium between the economies of individuals [and consequently are of secondary interest for the economic subjects]. . . . The force that drives [prices] to the surface is the ultimate and general cause of all economic activity, the endeavor of men to satisfy their needs as completely as possible, to better their economic positions.[16]

In neoclassical theory, prices are usually taken as "given," with any changes coming, somehow, from the "outside," with market participants responding accordingly. In the Austrian approach, prices emerge out of the interactions of market actors. They initiate price bids and offers, and competitively move prices up or down. In Eugen von Böhm-Bawerk's famous horse market, any resulting equilibrium between suppliers and demanders arises out of their efforts to attract trading partners by offering better terms than their rivals.[17]

Thus the Austrian focus is on *the logic and sequential process of price formation*, rather than only on any final equilibrium price that may result from this active market rivalry. It is why one prominent member of the Austrian school referred to the Austrian theory of price as *the causal-genetic approach*: the purpose of the theory is to explain the "causal origin" of prices in the valuations and actions of market actors, and the process by which prices adjust to reach a final equilibrium.[18]

The theory is also the basis for the later Austrian emphasis on the role and significance of the entrepreneur. In the division of labor, entrepreneurs are not only the "undertakers of enterprise" who imagine the patterns of future consumer demand, conceive of ways of organizing production processes to better satisfy that demand, oversee the stages of production to the completion of finished goods, and bring the goods to market. They also set and change consumer prices when they discover that they over- or underestimated how intensely consumers want the goods.[19]

It is the "promoting and speculating entrepreneurs" who are "the driving force of the market," Mises wrote. Their "social function" is to coordinate the use of resources, capital, and labor with the demands of consumers through the rewards of profits and the penalties of losses.[20] Again, as Mises concisely put it, "It is the entrepreneurial decision that creates either profit or loss. It is mental acts, the mind of the entrepreneur, from which profits ultimately originate. Profit is a product of the mind, of success in anticipating the future state of the market. It is a spiritual and intellectual phenomenon."[21] The intentionality of entrepreneurship, the creative mental processes that are the essence of the enterpriser's activities, are drained of all understanding if the market is reduced to a simplified and barren mathematical function.

Economic Calculation and the Market Process

The social institutions of private property and monetary exchange are not simply conceptual backdrops to the determination of equilibrium prices and outputs, as has tended to be the view in neoclassical economics. In the standard textbooks, from which most economists learn the core concepts of their discipline, private property is described as an "incentive mechanism" for work and the conserving of scarce resources; and money is explained as a "unit of account" that serves as a common denominator for comparing the value of goods bought and sold in the market. Both descriptions are true and important. But they fail to capture the institutions' profundity for the functioning and coordinating of the complex and ever-changing market order.

Private property and money are, instead, the core—the indispensable features—of the market economy and the civilization that develops with it. The evolution of private property rights and a medium of exchange has made possible the economic calculation without which rational market decision-making would be impossible. And, again, it is Mises who articulated this most clearly:

> Monetary calculation is the guiding star of action under the social system of division of labor. It is the compass of the man embarking upon production. He calculates in order to distinguish the remunerative lines of production from the unprofitable ones. . . . Monetary calculation is the main vehicle of planning and acting in the social setting of a society of free enterprise directed and controlled by the market and prices.[22]
>
> We can view the whole market of material factors of production and of labor as a public auction. The bidders are the entrepreneurs. Their highest bids are limited by their expectation of the prices the consumers will be ready to pay for the products. . . . The competition between the entrepreneurs reflects these prices of consumers' goods in the formation of the prices of the factors of production. . . . To the entrepreneur of capitalist society a factor of production through its price sends out a warning: Don't touch me, I am earmarked for the satisfaction of another, more urgent need.[23]

Only private property enables all marketable commodities and means of production to be available for sale and purchase in the area of exchange. Only a medium of exchange provides the means by which heterogeneous things may be reduced to a valuational common denominator. Only the competitive market enables every participant in society to contribute to the formation of prices through his bids and offers.[24] Only economic calculation enables the integration of billions of people's actions into a network of mutually beneficial market relationships and coordinated plans.

Yet every man is free to make his own decisions, guided by his own hopes, dreams, goals, and plans. The money prices that make economic calculation possible are used by each individual for his own purposes. He weighs their significance for the ends he has in mind. He uses them to evaluate his past actions and to plan his future actions.[25] He is at liberty to integrate himself into the division of labor on the basis of his own evaluations of the costs and benefits of alternative courses of action—while bearing the consequences, good or ill, for the choices he makes.

It is through economic calculation in the free market that individual freedom is made compatible with social order. It is through economic calculation that billions of individual plans are combined into patterns of rational social coordination. No wonder Mises concluded that "Our civilization is inseparably linked with our methods of economic calculation. It would perish if we were to abandon this most precious intellectual tool of acting."[26]

The "Law of Association" as the Foundation of Society

Austrians see more in the theory of the division of labor and comparative advantage than simply the determination of specialization at various prices, given the capital and labor available. Once again it was Mises who insightfully clarified the implications of the eighteenth- and nineteenth-century classical economists' views on the benefits of the division of labor. The theory of the division of labor, Mises explained, is really the basis of what he called the *law of human association* and therefore the foundation of a theory of society. Based on Adam Smith's and David Ricardo's expositions of the benefits from specialization, it was possible to show how society emerged and took form over the centuries as the result of individuals' discovering the mutual benefits from trade.[27] The additional gains through specialization resulted in an expanding network of human relationships. The theory of the division of labor, therefore, is able to serve as the analytical tool for explaining the emergence of society as the result of human action but not of human design. As Mises explained this process:

> The law of association makes us comprehend the tendencies which resulted in the progressive intensification of human cooperation. We conceive what incentive induced people to not consider themselves simply as rivals in a struggle for the appropriation of limited supplies of means of subsistence made available by nature. We realize what has impelled them and permanently impels them to consort with one another for the sake of cooperation. . . . Thus we are in a position to comprehend the course of human evolution.[28]

The theory of the division of labor and comparative advantage becomes the basis for a "science of society." A foundation is laid for the theory of market relationships, the interconnections between supply and demand, and the network of market prices for finished goods and the factors of production. The way is opened to understanding the "inevitable laws of the market and exchange," which is the "one of the greatest achievements of the human mind."[29]

Out of the classical economists' theory of the division of labor there now comes the classical-liberal "philosophy of peace and social cooperation," which is the basis "for the astonishing development of the economic civilization of [our] age."[30] The greater material productivity of a peaceful division of labor, Mises explained, provides the means for the development of what we call civilization. The means are now provided for leisure and the peace of mind required for art, literature, and scientific and philosophic reflection.

Men increasingly become differentiated from one another, but not only in the specialized tasks and skills through which they find their place in the division of labor. They also differentiate themselves by developing their individual personalities, thanks to the greater abundance of resources and free time with which they can cultivate the pursuits that most interest them. Individualism, meaning man as distinct from the tribal mass and unique in his character and qualities as a singular human being, is a product of the extension and intensification of the division of labor.[31]

At the same time, the division of labor and its law of association are the foundation for a philosophy of world peace. Through specialization and exchange, men become allies against the niggardliness of nature. No longer are individuals and nations opponents, where the improvement of one requires a loss to another. Instead, all benefit from everyone's talents, industry, and creativity.

Competition, both within and between nations, is no longer a life-and-death struggle. The competitive market process becomes the peaceful procedure through which each member of society finds his most productive and profitable niche for improving his own circumstances by furthering the ends of others. Again, Mises captured the essence of this great social process:

> All collaborate and cooperate, each in the particular role he has chosen for himself in the framework of the division of labor. Competing in cooperation and cooperating in competition all people are instrumental in bringing about the result, viz., the price structure of the market, the allocation of the factors of production to the various lines of want-satisfaction, and the determination of the share of each individual.[32]

The world, therefore, becomes one community of free men who, though separated by time, distance, and interest, are peacefully guided to assist one another by the information and incentives supplied by market prices. People's buying and selling determine the patterns of production that best serve the wants and needs of all humanity. The market economy thus is the means to the peaceful unity of mankind.

The Political Economy of Freedom

None of these Austrian insights about man and the market is compatible with the positivist, historicist, and neoclassical economic views of the world. Reduced to physical object or mathematical function, man is stripped of his most essential human qualities. What are intention and imagination, choice and creativity, if the human mind is banished from social and economic analysis? What meaning, therefore, does freedom have when man is merely a measured magnitude or a dependent variable in a system of simultaneous equations?

It should not be surprising that so many members of the Austrian school of economics have also been classical liberals—defenders of individual liberty, private property, and the market economy. Once you see the individual as thinking, creating, and acting man, with so much potential within him, who can tolerate the idea of making him the slave to another's will—of denying him his humanness? Once you comprehend the majesty of the market order, in which each man is free to follow his own plans while advancing the welfare of others, who can want to restrict him to the dictates of a central planner or political intervener? Once one understands the significance of prices for social coordination within the market process, who can presume to have the knowledge and ability to command humanity's consumption and production?[33]

It is no wonder, therefore, that so many of freedom's friends have been influenced by the Austrian economists. In the last 100 years, they have been the true political economists of liberty. The Austrian school of economics has enriched our understanding of the market economy and advanced the cause of freedom in our time. □

1. For an exposition and contrast of the Austrian and Keynesian explanations of and policy prescriptions for the Great Depression of the 1930s, see Richard M. Ebeling, "The Austrian Economists and the Keynesian Revolution: The Great Depression and the Economics of the Short-Run" in Richard M. Ebeling, ed., *Human Action: A 50-Year Tribute* (Hillsdale, Mich.: Hillsdale College Press, 2000), pp. 15–110.

2. For an overview of many of the theoretical and policy themes in the writings of the Austrian Economists, see Richard M. Ebeling, "The Significance of Austrian Economics in 20th Century Economic Thought," *Austrian Economics and the Political Economy of Freedom* (Northhampton, Mass.: Edward Elgar, 2003), pp. 34–60; also, Ludwig M. Lachmann, "The Significance of the Austrian School of Economics in the History of Ideas" [1966] reprinted in Richard M. Ebeling, ed., *Austrian Economics: A Reader* (Hillsdale, Mich.: Hillsdale College Press, 1991), pp. 17–39.

3. For expositions of Mises's many contributions to economic theory and policy, see Richard M. Ebeling, "A Rational Economist in an Irrational Age: Ludwig von Mises," *Austrian Economics and the Political Economy of Freedom*, pp. 61–100; Richard M. Ebeling, "Planning for Freedom: Ludwig von Mises as Political Economist and Policy Analyst," in Richard M. Ebeling, ed., *Competition or Compulsion? The Market Economy versus the New Social Engineering* (Hillsdale, Mich.: Hillsdale College Press, 2001), pp. 1–85; and Richard M. Ebeling, "The Economist as the Historian of Decline: Ludwig von Mises and Austria Between the Two World Wars," in Richard M. Ebeling, ed., *Globalization: Will Freedom or World Government Dominate the International Marketplace?* (Hillsdale, Mich.: Hillsdale College Press, 2002), pp. 1–68. Also, Murray N. Rothbard, *Ludwig von Mises: Scholar, Creator, Hero* (Auburn, Ala.: Ludwig von Mises Institute, 1988); and Israel M. Kirzner, *Ludwig von Mises* (Wilmington, Del.: ISI Books, 2001).

4. For a summary of Hayek's life and contributions to economics, see Richard M. Ebeling, "Friedrich A. Hayek: A Centenary Appreciation," *The Freeman* (May 1999), pp. 28–32; also, Bruce Caldwell, *Hayek's Challenge: An Intellectual Biography of F. A. Hayek* (Chicago: University of Chicago Press, 2004).

5. For a summary of Kirzner's contributions to Austrian economics, see Richard M. Ebeling, "Israel M. Kirzner and the Austrian Theory of Competition and Entrepreneurship," *Freedom Daily*, August 2001, pp. 8–14.

6. See R. M. Hartwell, *A History of the Mont Pelerin Society* (Indianapolis: Liberty Fund, 1995).

7. For a summary of the conference's events, see Richard M. Ebeling, "Austrian Economics on the Rise," *Libertarian Forum*, October 1974, pp. 3–6; the lectures delivered by Lachmann, Kirzner, and Rothbard at South Royalton were later published in Edwin G. Dolan, ed., *The Foundations of Modern Austrian Economics* (Kansas City, Kan.: Sheed & Ward, 1976).

8. Ludwig von Mises, *Epistemological Problems of Eco-*

nomics (New York: New York University Press, 1981 [1933]), p. 14.

9. One of Mises's most insightful but unfortunately highly neglected works was devoted to undermining the assumptions and absurdities in both positivism and historicism; see Ludwig von Mises, *Theory and History: An Interpretation of Social and Economic Evolution* (Auburn, Ala.: Ludwig von Mises Institute, 1985 [1957]); also F. A. Hayek, *The Counter-Revolution of Science* (Indianapolis: Liberty Fund, 1980 [1955]); and Murray N. Rothbard, *Individualism and the Philosophy of the Social Sciences* (San Francisco: Cato Institute, 1979).

10. For a contrast of the Austrian and neoclassical conceptions of man in relation to action and choice, see Richard M. Ebeling, *Austrian Economics and the Political Economy of Freedom*, pp. 3–7.

11. Ludwig von Mises, *Human Action: A Treatise on Economics* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1996), p. 254: "Entrepreneur means acting man in regard to the changes occurring in the data of the market." And Mises, The *Ultimate Foundations of Economic Science* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 2002 [1962]), p. 51: "Every action is a speculation, i.e., guided by a definite opinion concerning the uncertain conditions of the future."

12. For the classic Austrian criticisms of the neoclassical mathematical general equilibrium approach, and the theory of perfect competition, see Hans Mayer, "The Cognitive Value of Functional Theories of Price" [1932] in Israel M. Kirzner, ed., *Classics of Austrian Economics: A Sampling in the History of a Tradition* (London: William Pickering, 1994), pp. 55–168; F. A. Hayek, "The Meaning of Competition" [1946] *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948), pp. 92–106; Mises, *Human Action*, pp. 350–57, and Mises, "Comments on the Mathematical Treatment of Economic Problems," [1953] *Journal of Libertarian Studies*, vol. I, no. 2 (1977), pp. 97–100.

13. Mises, *Human Action*, p. 105: "The uncertainty of the future is already implied in the very notion of action. That man acts and that the future is uncertain are by no means two independent matters. They are only two different modes of establishing one thing."

14. It should be pointed out that there has developed what is now referred to as the "new institutional economics," which attempts to explain the emergence, evolution, and significance of the underlying institutional order in which market processes operate. Some of these economists have consciously incorporated elements of the Austrian perspective in their theories; see, especially, Wolfgang Kasper and Manfred E. Steit, *Institutional Economics: Social Order and Public Policy* (Northampton, Mass.: Edward Elgar, 1998), and Eirik G. Furubotn and Rudolf Richter, *Institutions and Economic Theory: The Contribution of the New Institutional Economics* (Ann Arbor, Mich.: University of Michigan Press, 1998).

15. Mises, *Human Action*, pp. 327–33.

16. Carl Menger, *Principles of Economics* [1871] (New York: New York University Press, 1981), pp. 191–192. The bracketed clause was restored by the present author from Menger's original German volume, *Grundsätze der Volkswirtschaftslehre*, 2d ed. (Vienna: Holder-Pichler-Tempsky, 1923), pp. 182–83.

17. Eugen von Böhm-Bawerk, *Capital and Interest*, vol. 2: *The Positive Theory of Capital* (South Holland, Ill.: Libertarian Press, 1959), pp. 216–35.

18. Mayer, p 57.

19. See the much-neglected analysis on this point by Philip Wicksteed, *The Common Sense of Political Economy*, vol. 1 (London: Routledge & Kegan Paul, 1933 [1910]), pp. 212–37.

20. Mises, *Human Action*, pp. 328–29.

21. Ludwig von Mises, "Profit and Loss," [1951] in *Planning for Freedom* (South Holland, Ill.: Libertarian Press, 1980), p. 120.

22. Mises, *Human Action*, pp. 229–30.

23. Ludwig von Mises, *Bureaucracy* (New Rochelle, N.Y.: Arlington House, 1969 [1944]), pp. 28–29.

24. Ludwig von Mises, *Liberalism in the Classical Tradition* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1985 [1927]), pp. 71–72. On p. 75 Mises wrote: "This is the decisive objection that economics raises against the possibility of a socialist society. It must forgo the intellectual division of labor that consists in the cooperation of all entrepreneurs, landowners, and workers as producers and consumers in the formation of market prices. But without it, rationality, i.e., the possibility of economic calculation, is unthinkable."

25. Mises, *Human Action*, p. 229: "Monetary calculation is entirely inapplicable and useless for any consideration which does not look at things from the point of view of individuals. . . . The premeditation of planned action becomes commercial pre-calculation of expected costs and expected proceeds. The retrospective establishment of the outcome of past action becomes accounting of profit and loss."

26. Mises, *Human Action*, p. 230.

27. Adam Smith, *The Wealth of Nations* Book I, Chapters 1–3 (New York: The Modern Library, 1937 [1776]), pp. 3–21; Piero Sraffa, ed., *The Works and Correspondence of David Ricardo*, vol. I: *On the Principles of Political Economy and Taxation* (Cambridge: Cambridge University Press, 1951 [1821]), pp. 128–49; Jean-Baptiste Say, *A Treatise on Political Economy, or the Production, Distribution, and Consumption of Wealth* (New York: Augustus M. Kelley, 1971 [1821]), pp. 90–99; John R. McCulloch, *The Principles of Political Economy, with Some Inquiries Respecting Their Applications* (New York: Augustus M. Kelley, 1965 [1864]), pp. 37–46, 85–116.

28. Mises, *Human Action*, pp. 160–61.

29. Ludwig von Mises, *Interventionism: An Economic Analysis* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1998 [1941]), p. 24.

30. Ludwig von Mises, *Socialism: An Economic and Sociological Analysis* (Indianapolis: Liberty Classics, 1981 [1922]), pp. 55–56, 268–69.

31. Mises, *Socialism*, pp. 256–72; *Human Action*, pp. 157–74.

32. Mises, *Human Action*, p. 338.

33. See F. A. Hayek, "The Use of Knowledge in Society," [1945] *Individualism and Economic Order*, pp. 77–91; reprinted in Richard M. Ebeling, ed., *Austrian Economics: A Reader*, pp. 247–63.

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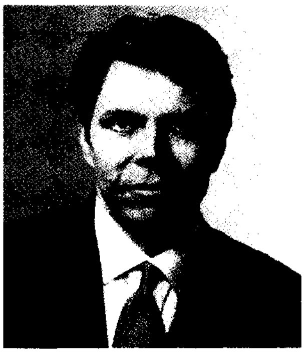

A Deficit of Understanding II

Writing in the January/February 2004 issue of *The Atlantic Monthly*, Sherle Schwenninger of the New America Foundation joined Warren Buffett and scores of politicians in bewailing America's trade deficit. Like his intellectual compatriots, Schwenninger simply assumes that the trade deficit is debt and that it's ominous. It is neither.

A trade deficit exists for the United States whenever Americans, during some period, import a greater dollar amount of goods and services than they export. This deficit means that some of the dollars which foreigners earn from selling things to American consumers are not spent during this same period buying things from American producers. This difference between the larger dollar-value of imports and the smaller dollar-value of exports is the trade deficit.

Whether or not all or part of this "deficit" *becomes* debt depends on what foreigners do with their dollars. If foreigners hold all their unspent dollars as cash reserves, none of the trade deficit becomes debt. Foreigners own some dollars while Americans own the goods and services they bought with this cash. Likewise, no debt is created if foreigners use their dollars to buy ownership shares in American companies or if they buy real estate in the United States.

Debt to foreigners is created only when Americans borrow from foreigners.

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It's true that Americans can and do borrow from foreigners. For example, Intel might borrow dollars from foreigners by selling bonds to them. Likewise, Uncle Sam might borrow dollars from foreigners by selling Treasury notes to them. In such cases, Americans do become indebted to foreigners—and, indeed, this indebtedness is facilitated by Americans running a trade deficit. But a trade deficit is not *necessarily* debt.

Let's suppose, though, that every last dollar of America's trade deficit does become debt. That is, suppose that if America's trade deficit is $500 billion, not a cent of this $500 billion owned by foreigners is held as cash reserves, and not a cent is used to buy American real estate or ownership shares in U.S. businesses. Instead, foreigners lend the money to Americans.

Should we worry?

One response is that foreigners who lend to Americans display confidence in the American economy. How many of us lend money to economically unpromising entities (who aren't our brothers-in-law)? To the extent that investor confidence drives the trade deficit, it should cause no concern.

Another response is that such loans strengthen the economy by enabling more productive investment to occur.

But insofar as America practices free trade, there's a more fundamental reason not to worry. An open economy is not defined by political borders. Therefore, measuring trade between people living in one particular space and people living in other spaces is misleading if these spaces are economically integrated.

Consider a straightforward example. Suppose you live in the only house on Elm Street, in the town of Townville. You're frugal; each month you save some of your income. Your financial future is bright because your sacrifices today will likely raise the value of your portfolio tomorrow. If we calculate the current account for Elm Street we will find that it is in surplus: you export more (in the form of supplying labor services to your employer) than you import (that is, than you consume).

Not-So-Frugal Neighbor

One day a house is built next to yours. Your new neighbor is a spendthrift; each month he not only spends all his income, but he also adds an amount of debt to his credit-card balance that exceeds the amount you save each month.

When we now calculate the current account for Elm Street, we find it to be in deficit. But are *you* worse off than before? No. Your rate of saving hasn't fallen. The fact that you live in an area that not only has a current-account deficit, but also where every cent of that deficit is in the form of debt does not worsen your economic prospects one bit. If you continue to save, you'll prosper.

Suppose that the issuer of your neighbor's credit card is First Townville Bank. Further suppose that this is the bank that holds your savings. First Townville Bank "imports" capital from you and "exports" capital to your neighbor. (The difference between the amounts borrowed and saved is made up through fractional-reserve banking.)

Now let's calculate the trade account for the entire town. If everyone else in Townville spends on consumption exactly the amount that he or she earns in income, and if First Townville Bank does business only with citizens of Townville, then Townville's current-account and capital-account both equal zero.

As this example shows, changing the geography over which we calculate trade accounts can generate significant changes in these calculations. If your house alone is reckoned as the relevant geographic unit, we find a current-account surplus; if both houses on Elm Street are reckoned as the relevant unit, we find a current-account deficit; if the entire town is reckoned as the relevant unit, we find that the current-account is neither in deficit nor surplus. Regardless of the way we choose to reckon, however, you are no better off or worse off.

The relevance of this example for the larger economy is obvious. To the extent that Americans trade freely with foreigners, Americans become integrated into an economy larger than that part of the North American landmass identified as "America." And it is this larger economy ("the global economy") that is most relevant.

Investment, of course, is desirable. And saving is necessary for investment. For a variety of reasons, much of the investment that today takes place within U.S. borders comes from the savings of non-Americans. But so what? If the research lab in Boston and the vineyard in Oregon are built with dollars borrowed from the Japanese, I and other Americans are no worse off or better off than if these productive assets were built with dollars borrowed from other Americans. I would likely be better off if I, too, saved more and invested in these assets. But whether or not I invest, the nationality of those who do invest is irrelevant to me and my economic prospects.

Opportunities for mutually advantageous trade are what matter. The greater the number of such opportunities, the better. Classifying the world's producers and consumers according to the issuer of their passports creates an illusion of relevance out of an utterly irrelevant happenstance. ☐

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Bermuda, Freedom, and Economic Growth

by Robert Stewart

Senator John Kerry of Massachusetts, the presumptive presidential candidate of the Democratic Party, says he wants to end Bermuda's offshore "creed of greed" and crack down on the "corporate Benedict Arnolds" who move offshore to avoid paying U.S. taxes. (The statements are taken from the Bermuda *Mid Ocean News*, January 23, 2004.)

Kerry said, "I am tired of seeing chief executives permitted to take their millions or billions to Bermuda and leave the average American here at home stuck with the tax bill. You know what I call that? Unpatriotic."

As someone who lives in Bermuda, who is committed to the free market, and who is also an investor in the U.S. stock market (and, incidentally, who pays U.S. taxes on dividends), do you know what I call CEOs who relocate to Bermuda to reduce their tax burden and improve their profitability? Smart and conscientious.

They are protecting the interests of the owners of their companies—the shareholders, the raison d'être for the corporation. In the long run they are also looking after the interests of their employees and consumers. As if moved by Adam Smith's invisible hand, the CEOs are promoting an end that is no part of their intentions: the health of the world economy and freedom of the individual. Let me elaborate.

Once profits are taxed and disappear into the black hole we call the government treasury, the funds cannot be invested. When capital investment is curtailed, productivity tends to plateau, which has a depressing effect on wages. In addition, diminished investment arising from high taxation means that consumers are unable to benefit from cheaper and better goods and services.

One of the financial facts of life is that private investment provides greater benefits to the public than government-sponsored projects, such as sports arenas, pork-barrel stunts, or national airlines. Consumers are helped with more products and lower prices, employees with higher wages and benefits. General prosperity is enhanced. A 1998 Joint Economic Committee report for Congress showed that if government expenditures as a share of GDP in the United States had remained at 1960 levels, the average income for a family of four would have been $23,440 higher. (See James Bovard, "Political Accounting," *The Freeman*, September 1999.)

Government expenditure on prestige projects or roads to nowhere wastes funds that could be better used in investments to raise living standards. Government is too inefficient, too big, and too powerful; and it generates more costs than benefits for the populace. Low-tax countries do everyone a favor,

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except the governing classes and their minions, by compelling governments to compete with each other to be more efficient, more nimble, and less repressive. What is not clearly understood is that business creates prosperity and wealth, while government inhibits innovation and consumes (and often wastes) wealth created by others. The answer to the problems faced by high-tax regimes is surely to reduce the tax burden, not to penalize low-tax countries that prevent financial mugging and wealth destruction.

The United States is a country founded on the principle of low taxation, although ironically after more than 200 years of increasing government interference in the economy, it is now a country of high taxation. In 1902, Tax Freedom Day, which is calculated by the Tax Foundation, was January 31; in 2002, it was April 19.

Low taxes result in more freedom and more prosperity; high taxes result in less freedom and less prosperity. Citizens of the United States now hand over to their governments (federal, state, and local) something approaching 40 percent of their incomes. In many European countries that percentage is closer to 50. Ten percent was considered appropriate by God, but 40 percent or more is deemed appropriate by today's politicians. Who knows what the appropriate percentage is? It could be 50 or 60 or 70 or 80 or more. Once the power to tax becomes unlimited, government power also becomes unlimited, and freedom for the individual is diminished.

As former President Grover Cleveland put it, "When more of the people's sustenance is exacted through the form of taxation than is necessary to meet the just obligations of government and expenses of its economical administration, such exaction becomes ruthless extortion and a violation of the fundamental principles of free government."

In a similar vein, Frédéric Bastiat, with his usual clarity and wit, observed, "Look at the law, and see if it does for one man at the expense of another what it would be a crime for the one to do to the other himself." In Bastiat's opinion, when government taxes highly, it becomes a brigand and looter, and a device by which "everyone seeks to live at the expense of everyone else."

Docile People

Politicians regard taxpayers as a gigantic cash machine. The taxpayer in the United States (and elsewhere) is a model of docility, living under more oppressive conditions than King George III imposed in 1776. Most politicians depend for their success on that docility—taxpayers acting like cattle who stand passively in the barn waiting for a handout. They count on voters to keep their mouths shut, because high taxation depends on the silence of good men. The electorate is expected to fall for the hooey that avoiding taxes is unpatriotic.

Clearly most American voters have never heard, or understood, the statement of Judge Learned Hand: "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. Over and over again the courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike, and all do right, for nobody owes any public duty to pay more than the law demands."

It is not well understood by many in the media that when a U.S. corporation moves its headquarters to a foreign location, it is not "evading" taxes. It still must pay the full U.S. tax on the portion of its income effectively connected to a U.S. trade or business. It just does not pay U.S. tax on its foreign operations in lower-tax countries. It is also worth noting that corporations are abstract legal entities, which means that any tax paid by a corporation is, in the final analysis, paid by real flesh-and-blood people like you and me, who may be shareholders, employees, or customers of the corporation.

When citizens decide that they do not like high taxes on income, they will take actions to avoid the unpleasant plundering activities. Once the government bite on individual incomes reaches 30 percent or thereabouts a silent tax revolt takes place. People either stop working, or they fudge their tax returns, or they shift assets and commercial activities abroad where the tax regime is less hostile to earnings and the preservation of capital. Just as the exploited and victimized physically left Europe in the eighteenth and nineteenth centuries for the freedom of the United States and elsewhere, the wealthy also vote, not with their feet as did "the huddled masses yearning to breathe free," but with their bank balances and intellectual capital. They are heirs to a time-honored custom of free people telling overbearing government to take a hike. Confiscatory taxes force otherwise law-abiding citizens into revolutionary action called tax avoidance by its supporters and tax evasion by its critics.

There is a huge morally important point at stake. Government confiscation of private property through taxation is usually justified by the fact that it performs good works and provides endless benefits to its citizens. The state is wiser than the individual, and the taxpayer should willingly cough up his share because of all the benefits showered on him by benevolent rulers. Others, like the American Founding Fathers, argue that the individual takes precedence over government and that there are inalienable rights to privacy, life, liberty, and property.

Once income and corporate taxes are imposed, the level of earnings the taxpayers and corporations are allowed to keep becomes dependent on the goodwill of the government; they become the modern equivalent of medieval serfs. Those who value individual freedom over government benevolence (or should that be malevolence?) seek to protect their assets and their privacy from prying eyes, but they are usually portrayed as greedy, selfish, and unpatriotic, neglectful of their responsibilities to those at home.

However, it is not only ambitious American politicians who pillory insignificant dots on the map like Bermuda and seek to make them vassals of the United States for having the temerity to enact tax codes fundamentally different from high-tax jurisdictions. Over the past ten years or so, European governments and quasi-governmental organizations such as the Organization for Economic Cooperation and Development (the reason for whose existence is best determined by the anthropologist rather than the economist) have targeted so-called tax havens like Bermuda and the Cayman Islands on the grounds that they siphon off legitimate tax revenues. This has been described as "harmful tax competition" (a code name for lower levels of taxation and a contradiction in terms), or has been categorized as illegal tax evasion. In some cases, vague accusations of money laundering have been made. To identify such miscreants, it is argued that governments should exchange financial information.

Nothing to Fear?

It is said that honest people having nothing to fear from governments' sharing tax and banking information. But this assumes that governments are honest too, a mistake that has cost many honest people their liberty or lives in the past—just check the history of Germany and Russia.

Making it easier for government to have access to private information is simply storing up trouble for the future. The more power government has, the greater is the temptation to misuse it. And if history is a guide, that temptation is rarely resisted. The only way to keep government honest is to limit its powers and its access to private information about citizens, a lesson the Founding Fathers tirelessly taught. They knew full well that governments all over the world usually fail to operate at high moral standards.

Providing information to the authorities is one of the main ways the power of government expands. Indeed, when the records of the majority of governments in the world are examined, it is difficult not to conclude that government is the greatest threat to liberty and prosperity. History is full of examples of people naïvely trusting government by providing data and living to regret their actions.

Tax evasion is a crime, and it is necessary to formulate a policy to discourage criminal acts. Low tax rates, lower government spending, and simplification of Byzantine tax codes suggest themselves as being effective methods of minimizing tax evasion. The trouble is that high-spending Western governments, desperately seeking to keep their bloated welfare states afloat, are enamored of ending financial privacy for individuals and corporations, and of requiring governments to enforce such things as the European Union's Savings and Tax Directive.

This directive aims at ending or at least stemming the flow of legitimate money from the oppressive tax sinkholes of Europe to more welcoming and less-restrictive economies, like those in Switzerland and Bermuda. Such flights of funds are not illegal acts of tax evasion, and they are not acts of people who are unpatriotic. They are acts of legitimate tax avoidance by people and corporations who wish to protect their assets from seizure.

Just as government-sponsored cartels for the production of oil, cotton, or coffee are harmful to consumers, so is the creation of a tax cartel that prevents the most productive use of investment funds and that benefits high-spending politicians at the expense of taxpayers. Low-tax countries have no obligation to help high-tax countries drain the wealth of their citizens. Indeed, low-tax countries have an essential economic function—assisting productive citizens to make more effective use of their money rather than have it squandered by free-spending politicians.

Bermuda does not harbor latter-day Benedict Arnolds. It assists ordinary people by limiting the power of governments to tax their citizens, and by providing greater freedom to the individual. It has nothing to be ashamed of. □

THE FREEMAN
Ideas On Liberty
JUNE 2004

Buying Foreign Goods Saves American Jobs

by Robert Carreira

Roger Simmermaker of Orlando, Florida, is leading a national campaign to encourage Americans to "Buy American." In 1996 Simmermaker wrote *How Americans Can Buy American*, which recently was published in a second edition.[1] The book, as its title implies, provides guidance on how to identify and buy American products in today's integrated global marketplace. Simmermaker writes, "By changing just a few simple buying habits, usually at little or no cost or inconvenience to the consumer, we can re-direct literally thousands of dollars out of hands of foreigners and into the hands of Americans."

While this sort of consumer-led protectionism is preferable to subsidies, tariffs, and import quotas imposed by the government, it is unfortunately born of the same economic illiteracy. In a segment on CNN's "Lou Dobbs Tonight" last January, Simmermaker claimed that if Americans made a conscious effort to buy American products whenever possible, the impact on the U.S. economy would be enormous. He is correct that indiscriminately purchasing American products would have an enormous impact, but that impact would be enormously grave.

If consumers were unaware of, or unconcerned with, the origins of specific consumer goods, they would seek the highest-quality products at the best available prices. Thus for those American products that offer the highest quality at the best price, there is no need for crusaders such as Simmermaker to encourage Americans to buy them. What is left, then, is for Simmermaker to encourage American consumers to purchase those other American products that are higher priced and/or of lower quality than competing foreign goods. According to him and others, doing so will preserve American jobs and help the American economy.

In fact, inducing Americans to purchase higher-priced goods harms the American economy in several ways. The most significant, contrary to Simmermaker's basic presumption, is that indiscriminate buying of American goods costs American jobs.

One of the primary reasons American consumers purchase foreign-made goods is that those goods are often less expensive. Consider a simple basket of American products that cost $20,000, and includes an automobile for $18,000, an assortment of electronic items for $1,500, and clothing for $500. Now consider a basket of comparable foreign-made goods that cost only $15,000, including an automobile of similar quality for $13,500, electronic items for $1,250 and clothing for $250. Simmermaker would encourage American consumers to purchase the American goods, although they would cost an additional $5,000.

Indeed, if Americans follow Simmermaker's advice and buy the more-expensive

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basket of goods, American jobs would be preserved in the automobile, electronics, and clothing industries. Unfortunately, this is where Simmermaker's economic analysis ends.

Let's take the analysis a step further. If Americans were to purchase the less-expensive basket of foreign goods, in addition to having all their needs met that induced them to purchase the goods in the first place, they would also have an additional $5,000 with which to purchase other goods and services. Perhaps they would upgrade their computer operating systems, dine out more often, see more movies or plays, attend more concerts, and purchase more books. In this instance, the $5,000 saved by purchasing the less-expensive foreign goods results in the creation of additional jobs in the software, restaurant, entertainment, publishing, and other industries where the money saved would be spent.

But the benefits to Americans of buying the less-expensive foreign goods do not end there. Consider the $15,000 spent on the foreign goods. This money is now in the hands of foreign producers. One of two things will happen next. One possibility, a very unlikely one, is that nothing will be done with the money; that is, it will simply sit in some vault or be sewn into some foreign producer's mattress never to be seen again. In this case, the American consumer has received a basket of useful goods, while the foreign producer has received a bunch of useless slips of green paper.

Dollars Spent or Invested

The second and more likely possibility is that the money will be spent on American goods or services, or invested in the U.S. economy, either directly or indirectly. Perhaps the foreign producer will take his family on a trip to Disneyland, purchasing a host of services that will elude U.S. Department of Commerce balance-of-trade sheets, perpetuating the false impression of a trade deficit.[2] Perhaps the Japanese automaker will purchase a bottle of French perfume, and the French perfume producer will use the dollars to purchase the latest edition of Windows. In any case, the money, if not left simply to gather dust, will find its way back into the American economy creating jobs in countless American industries in the process.

Those opposed to foreign trade bemoan lost jobs to foreign competition. Yet they fail to account for the fact that as imports of goods and services have increased, the U.S. unemployment rate has declined. In the 15 years from 1988 through 2002, a period in which the United States experienced record levels of imports averaging over $928 billion per year[3] and in which we were deluged with cries that American jobs were moving out of the country in search of cheap labor, the average annual unemployment rate was a healthy 5.5 percent.[4] However, in the 15 years before that, from 1973 through 1987, when average annual imports of goods and services totaled a mere $312 billion per year (in 2003 dollars) and there was much less concern about losing jobs to cheap foreign labor markets, the average unemployment rate was significantly higher, 7.2 percent.

In addition to the creation of American jobs associated with increased imports, per capita income has also risen, from $14,291 per person in 1973 to $22,851 in 2001—an inflation-adjusted increase of nearly 60 percent.[5]

The best thing Americans can do to save American jobs is to be smart shoppers and purchase goods that offer the highest quality at the lowest price—wherever they are made. Merely acting in one's own self-interest is the best means of advancing the interests of society. □

1. See sample chapters at Simmermaker's website, www.howtobuyamerican.com.
2. For more on the fallacy of trade deficits, see Frédéric Bastiat, *Economic Sophisms* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1996 [1845]).
3. U.S. Department of Commerce, Bureau of Economic Analysis, interactive database at www.bea.gov/.
4. U.S. Department of Labor, Bureau of Labor Statistics, www.bls.gov/cps/prev_yrs.htm.
5. Personal income data expressed in 2001 dollars. U.S. Census Bureau, www.census.gov.

THE FREEMAN
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Freedom of Conscience and the Welfare State

Who says the welfare state respects freedom of conscience? Consider: In March the California Supreme Court ruled that employer-provided prescription-drug plans must cover birth-control products, even if contraception violates an employer's religious convictions.

The conscientious objector in the case is Catholic Charities of Sacramento. The nonprofit organization, which is part of the Roman Catholic Church, argued that because Catholic doctrine condemns contraception, Catholic Charities qualifies for the exemption written into the law.

But the court saw it differently, ruling that the exemption applies only to churches, not to affiliated organizations. As the *New York Times* reported: "[T]he State Supreme Court ruled that the organization did not meet any of the criteria defining a religious employer under the law, which was passed in 1999. Under that definition, an employer must be primarily engaged in spreading religious values, employ mostly people who hold the religious beliefs of the organization, serve largely people with the same religious beliefs, and be a nonprofit religious organization as defined under the federal tax code."

The executive director of the California Catholic Conference, Ned Dolejsi, said the court does not grasp the relationship between Catholic Charities and the Church. As the *Times* quoted him: "Every Catholic Charities is part of the Catholic diocese in the area where it is. Officially and formally, Catholic Charities of Sacramento is part of the Catholic Church in Sacramento, answerable to the local bishop and providing the services the church provides as a religious organization."

How comforting is it that legislatures formulate criteria for who qualifies as a religious employer, and courts decide who meets those criteria? Is Catholic Charities sufficiently part of the Catholic Church to qualify for exemption from an intrusive law? Some judges will let you know. Nineteen other states have similar mandates, and a challenge is underway in New York, brought by Catholic and Protestant plaintiffs.

This sort of thing is not supposed to happen in a free society. Yet it does, because state legislatures have become bazaars at which providers and users of medical services and products lobby to have those things incorporated by mandate into employer-provided medical plans. The politicians are happy to oblige. Besides birth control, state mandates include "treatment" for drug and alcohol use, infertility services, hair transplants and toupees, marriage and pastoral counseling, and Viagra. States have enacted more than a thousand such mandates nationwide.

The motives of the parties are easily discerned. The providers anticipate more business if people don't have to pay for their products and services out of pocket. The users prefer that someone other than them-

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selves foot the bill. Unrepresented in the lobbying frenzies are people who neither want the products and services nor want to pay for other people's use.

Insurance once meant the pooling of resources against financial ruin from possible but unlikely catastrophes. Today people expect medical insurance to cover volitional acts, such as taking birth-control pills, or events that are not diseases and often are volitional, such as pregnancy. In other words, insurance has become a way to have other people pay your bills. That's one reason the health-care system is such a mess. Insurance relieves us of the need to be cost-vigilant. The chief consideration is: "Does my insurance cover that?" If the answer is yes, there is no need to inquire further about necessity or price. This perverse system guarantees that demand will increase and prices for services will be bid higher than they would have been. This, in turn, makes medical insurance more expensive, discouraging more employers from offering it. (Special tax treatment rigs the system in favor of employer-based plans.)

Insurance by Force

Coercion is the key. There is nothing to stop insurance companies from offering any coverage customers want. But if insurers wish to stay in business, premiums would have to reflect the cost of the services, including administrative overhead. People who don't want coverage for contraception or alcoholism programs or hair transplants would buy basic, and cheaper, policies. Anyone who wanted that coverage would have to pay for it.

Advocates of insurance mandates point out that the per capita cost is lower when it is spread among more people. That may be true, although the stimulated demand and price rise might wipe out the savings. But it is also true that when everyone is forced into the pool, some people's moral or religious convictions are violated. Hence, Catholics pay for contraception even if they have no intention of taking advantage of the mandate. Do we really want to run roughshod over some people's consciences just so other people won't have to pay the full price for their choices?

Violation of conscience is nothing new in the welfare state. The U.S. Supreme Court has ruled that legislatures may pass laws against using a substance (such as peyote) even when it is part of religious observance. The courts have not been consistent, however. In 1972 the Supreme Court struck down a Wisconsin law that compelled parents to keep their children in school until age 16 even though the Amish conscientiously objected. Self-employed Amish are exempt from paying the Social Security payroll tax, but not so Amish who work for others. Moreover, Amish employers are compelled to withhold the tax for their employees, despite their conviction that Social Security violates their "take care of our own" ethic. By the same token, the Amish request for exemption from child-labor laws has not been honored.

Even the narrow exceptions make a larger point: The state does not take seriously an *individual's* moral objection to compulsory "benefits." Before an exemption is considered, the authorities have to be satisfied that the objection is rooted in established religious doctrine. An individual with "merely" personal philosophical convictions against compulsion, however well-grounded in reason, has no standing. How odd for a country founded on the principles of individualism.

None of this should be surprising. The point of the welfare state is to compel universal participation. If the state required payment from only those who wanted the benefits, it would be indistinguishable from a private organization. For the system to "work," everyone must take part—whether he wants to or not. But this means that conscience cannot intrude. Occasionally, the government will yield, but only in carefully defined cases that cannot be readily broadened into a full recognition of the individual's right to personal integrity.

In other words, freedom of conscience must always take a backseat to the ambitions of social engineers. □

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The Progressive Era's Derailment of Classical-Liberal Evolution

by Fred L. Smith, Jr.

> It is true that where a considerable part of the costs incurred are external costs from the point of view of the acting individuals or firms, the economic calculation established by them is manifestly defective and their results deceptive. But this is not the outcome of alleged deficiencies inherent in the system of private ownership of the means of production. It is on the contrary a consequence of loopholes left in the system. It could be removed by a reform of the laws concerning liability for damages inflicted and by rescinding the institutional barriers preventing the full operation of private ownership.
>
> —LUDWIG VON MISES
> *Human Action*

This statement captures the core dynamic nature of the classical-liberal view of civilization. Civilization is the slow evolutionary process by which a rich framework of institutions evolves (private property, contracts, the rule of law) and enables individuals to engage in exchange. By so doing, individuals advance and protect the values they hold. As new values emerge, as older resources become scarce, classical liberals envision the institutional framework expanding to encompass them. The framework is always in flux, gradually growing as mankind's interests and challenges also expand.

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Civilization evolved familial institutions, which allowed diversified management units—experimental entities that could take chances without endangering the tribe. Land moved from the tragedy of the commons to private property. In more recent times, the initial bundle of concepts comprising the idea of private property was unbundled to allow separate ownership of subsurface rights and then later ownership of even the electromagnetic spectrum. As discussed below, environmental resources are the latest challenge to this evolutionary process.

Classical liberals do not see the market as failing; rather, they see inadequate resources making it difficult for individuals to express their preferences. That tension creates the opportunity for institutional entrepreneurs to advance reforms that might better allow those preferences to be expressed. In the classical-liberal view, *we* are not charged with protecting the environment or anything else. There is no *social* utility function. Rather, individuals gain the right to own newly valued resources and to determine individually what sacrifices—what tradeoffs—they find worthwhile to protect those resources.

Precedents—in history or in other societies—guide that evolution. Innovators invent new ways of "fencing" the commons (barbed wire), devise methods of unbundling the "sticks" making up established property (creating divestible rights in subsurface minerals), and extend property rights to newly homesteaded resources (the electromagnetic spectrum). Institutional innovation is the process of *creative construction*, integrating an ever-greater fraction of the world's resources into a system of voluntary exchange. That integration liberates the *creative destruction* of the extended market, making it possible for man to resolve more and more disputes without conflict or the risks of collectivism. Civilization is the trial-and-error process in which these experiments are validated or rejected.

This classical-liberal evolutionary process accelerated during the Industrial Revolution, as man's creative energies found ways of working with nature to yield value. That process was weakened with the success of the "progressive" belief that planned order would better advance the human condition than the spontaneous order championed by economic liberalism. The progressives have largely succeeded in derailing institutional evolution for the last century or so. Resources not integrated into the classical-liberal order before 1900 are still not integrated today. Much of the western United States is the property of the federal government, as are almost all offshore areas. The electromagnetic spectrum, which Ronald Coase noted was actively being homesteaded privately, was brought back under collectivist control. And the air sheds, rivers and lakes, and wildlife—all of which became valued in the later nineteenth century—remain totally under political control. The *fatal conceit* that motivated progressives ensured that centralized political management would replace the evolutionary approach that had prevailed. The result is the mishmash of public policy today.

Approach to the Environment

Contemporary environmental policy illustrates the result of that derailment. Today, most policy analysts (even libertarians) addressing environmental problems raise the possibility of private ownership of environmental resources (water, wildlife, air sheds) as a means of addressing environmental concerns, only to swiftly dismiss that approach as infeasible. The transaction costs associated with environmental resource ownership, we are told, are too high.

The classical-liberal challenge is to re-examine this history and to assess what institutions might have evolved had America not adopted collectivism. The roots of most modern public-policy problems stem from the destruction of the evolutionary process.

The implications of this thesis are important. It explains many of the fallacies of modern economics: market failures, "natural" monopolies (never, one might note, found in nature), public goods, externalities, lack of competitive grids. All stem from the impoverished state of institutions throughout the modern economy. Only areas where government was too slow to block the evolutionary process (the Internet, for example) have escaped this stagnation. I develop this theme in the environmental area.

As the quote by Mises suggests, it is not obvious that any environmental problems would have emerged—or if they had emerged, would have persisted—had the Progressive Era not prevailed. After all, economic issues are as old as mankind. The first cave dweller who dragged home his kill must have suffered some criticism from his neighbors as the carcass began to decay. Those early environmental problems were dealt with by the evolution of cultural rules—carry away offal, pollute waters only downstream of the tribe, move fires safely away from the huts. Traditional societies evolved some sophisticated procedures for managing environmental issues.

The key question is: Why, as wealth increased and allowed this greater appreciation of environmental values, didn't new institutions evolve that would have empowered individuals to express their changing preferences?

The answer, I believe, lies in the undermining of the classical-liberal evolutionary process that occurred during the Progressive Era. Progressives believed that markets and private property slowed progress, and that collective management of resources would more surely advance the public interest. Thus they blocked the extension of private property to resources that had not yet been privatized (indeed, in the case of the electromagnetic spectrum and some arid western lands, rolling back fledgling homesteading efforts). Progressives also transformed the rule of law, making it more utilitarian, more willing to ignore individual values to advance the "common good." Social concerns trumped individual rights. Earlier common-law defenses of individual property rights that might have encouraged economic development along more environmentally sensitive paths were weakened or abandoned.

New Agencies

The progressives also created or expanded a vast array of "promotional" agencies—the Army Corps of Engineers, the Bureau of Land Management, the Rural Electrification Administration, the U.S. Forest Service—to dam rivers, build canals, manage timberlands, and string power lines. The pro-economic-growth biases of these institutions (undoubtedly the popular view at that time) led them to neglect environmental values. Progressive views came to dominate American culture, leading courts and legislators to weaken nuisance trespass. Economic activity became associated with low environmental protection; it is not surprising that many Americans saw economic development as "causing" disasters.

Thus when a wealthier America began to place greater value on ecological concerns—when, in fact, the effective political majority began to demand that the environment be protected—pollution and other environmental problems were viewed as a result of economic activity. The "market failure" explanation was accepted, even by most "free market economists."

Yet, as the initial quote by Mises suggests, this line of thinking is confused. Had classical-liberal institutions evolved, environmental values would have been integrated gradually into individuals' varying preferences. In earlier eras voluntary exchanges would favor economic development over environmental preservation—poverty leaves little room for aesthetics. But, even then, some minority interests would have preferred the tranquility of their undisturbed properties to wealth. Thoreau was not unique, even in his time. In a system that honored private property, Thoreau would have been able to enjoin those whose activities would have disturbed his peaceful use of his property.

Such preferences enforced by legal remedies would have encouraged economic developers to devise methods of alleviating environmental damages. Railroads would have acquired larger buffer zones around their lines; technologies would have evolved earlier to suppress noise, odors, and emissions. Noxious industrial activities would have been sited in areas far from sensitive individuals. Methods for re-aerating oxygen-depleted waters or restocking damaged hunting or fishery areas would have been explored by firms seeking to reduce costs.

Moreover, private property would have earlier been extended to ensure those protections for environmental resources as they became more valuable to the citizenry. As an example of this evolutionary process, consider the way property rights evolved to protect and advance the development of underground liquid resources. America had departed from the European tradition of transferring ownership and control of all underground mineral resources to the state. In America individuals privately owned subsurface mineral rights and could sell those properties to economic developers if they wished. That slight shift encouraged a far more aggressive entrepreneurial exploration for things of value. Privatization of the underground resource made possible the rapid development of the modern petroleum industry. (I am aware that oil wells had existed far earlier—in China around 1000 A.D.)

The result was that oil was always managed as a sustainable resource. From the time of Colonel Drake's first gusher in Titusville, Pennsylvania, in 1859 until today, America's private petroleum industry has aggressively spent vast sums mapping subterranean resources, seeking geological formations in which oil might be found. A new science, seismology, was developed to make this exploration more efficient. Once oil was discovered, owners sought to map the boundaries of each pool. Firms developed creative ways of contacting and negotiating with surface owners to acquire integrated ownership of these pools. One creative innovation was "unitization"—the acquisition of all initially dispersed subsurface rights and their economic reorganization into integrated physical units, allowing more efficient drilling, pumping, and extraction. The result of bringing this once-common property resource into the classical-liberal institutional framework has been spectacular. Oil has become an ever-more-abundant resource as we've become ever-more-skillful at discovering, developing, and refining it.

Note, however, that the evolution of property rights in petroleum occurred prior to the Progressive Era. Classical-liberal policies were still dominant; there was no force to block the creative evolution of rational institutional arrangements. The progressives had not yet derailed the process by which newly valued resources were gradually integrated into the market.

Groundwater and the Progressives

In contrast, groundwater became a scarce —and therefore valued—commodity after the progressives gained control. Groundwater was abundant in the nineteenth century—moreover, surface water was generally a more economical source of this resource. The value of groundwater in this early period did not encourage anyone to incur the costs of promoting the institutional arrangements that would have allowed it to be owned privately, as was oil. Thus property rights were never extended to groundwater, so it never became a "private" resource like oil.

The result of these different treatments of comparable underground liquid resources is striking: The relatively scarce commodity (petroleum) has become ever-more abundant, while the relatively abundant commodity (water) has become ever scarcer.

Another cost of the Progressive Era has been the increasing conflict surrounding water policy. If oil is discovered in a region, the residents are elated. There exists a well-established way in which the value of that resource can be exchanged with the outside world, creating wealth for the local region and greater resource availability for the consumers of the world. In contrast, for example, a bottled-water facility in a basin may find demand for its products growing dramatically, but face great opposition if it seeks to expand output. The lack of any agreed-on exchange method of transferring water ensures conflict rather than cooperation. PERC economist Terry Anderson notes that this explains the saying "Whisky is for drinking; water is for fighting!"

Of course, in some environmental areas, fragments of a classical-liberal institutional order did survive. In England, fishermen formed associations that were able to force reductions in harmful pollutants from both industry and municipalities. In some regions, custom and culture produced property-rights arrangements to protect shellfish in bays and estuaries.

But the broad outlines remain dismal. Resources that were outside the private sphere in the 1890s remain so today. And resources that were only beginning to enter the private sphere at that time—the electromagnetic spectrum, fisheries, and western lands—effectively reverted to political control and suffered the tragedy of the commons. The gradual emergence of the environment as a valued aspect of life occurred in a world bereft of classical-liberal institutions. Older property-rights defenses were slowly eroded, and their newer adaptations were blocked. The result was that when environmental values became majority values, few realized that they might better be protected privately via a creative program of ecological privatization.

The Challenge

The challenge to classical-liberal scholars today—and to all those championing environmental values—is to revisit the evolutionary steps that were underway before the Progressive Era. Our goal must be to gather up those embryonic threads and extend them to today. The difficulties of doing so are great. Absent the incentives and the innovations that would now exist, we are forced into an imaginative and difficult *gedanken*, or thought, experiment: what would the world look like had the Progressive derailment not occurred?

As discussed, leaders of the modern environmental movement are not only unaware of the value of private property in protecting environmental values, they are often antagonistic to the market and its institutional underpinnings. We must not only present reasonable steps toward a system of ecological privatization, but also work to legitimize this approach. One path to such reforms is to recognize the overcentralization of current environmental policy (the view that only the federal government has the wisdom and concern needed to protect environmental values) and reopen the *Green Laboratory of the States*. Most environmental problems are local and regional in nature, and even those larger-scale problems occur somewhere before they occur nationally. Steps that would allow local owners to protect their properties would have positive spillover (external) value to the nation as a whole. An effort should be made to identify and remove the barriers to classical-liberal environmentalism. The traditional common-law defenses of property—trespass and nuisance—should be reinstituted in areas where current practices permit, and phased in where past locational decisions would block any immediate reform. The direction that reform should take is clear—to think creatively about the changes that would likely have occurred had the Progressive tide not derailed the evolutionary process.

Restoring the classical-liberal order in the environmental field (or anywhere else) will not be easy, but there is no alternative. To manage the modern economy via centralized control is impossible; to "perfect" the market via pervasive government regulations is even more impossible. Yet the absence of property rights in environmental resources—wildlife in America, air sheds, rivers, lakes, and bays almost everywhere—means that we must begin the reform process almost from scratch.

Indeed, in the ecological field, the problems faced are similar to—but perhaps even greater than—those addressed by Hernando de Soto in establishing private property rights in such conventional resources as land and buildings in the developing world. In both cases, we know where we wish to go, but we have no roadmap to guide us. Indeed, the problem in the environmental field is far more complex than that in the economic sphere. In the economic sphere, there are working approximations of the classical-liberal world, while in the ecological field, there are only fragments.

We must repair the impoverished state of our institutional framework for addressing the environmental concerns that we all share. To fail in this task is to risk further losses of economic liberty. Eco-socialism is even more complex than traditional socialism. It will fail. Our challenge is to ensure that as this occurs, a free-market alternative is available and is understood. There is much work to do. □

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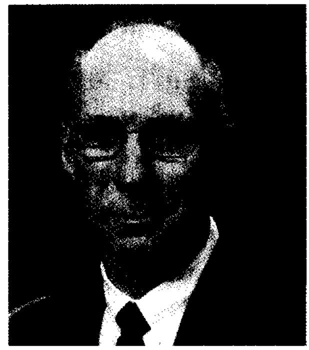

The Greatest Privatization Ever

After the Revolutionary War, the 13 newly independent states of North America came into conflict over their territorial boundaries, especially in the area west of the Appalachian Mountains. Seven states claimed territories extending to the Mississippi River. Between 1781 and 1802, however, the states resolved these conflicts, mainly by ceding most of their "western" lands (those beyond the Appalachians) to the U.S. government.

These lands then formed the first portion of the "public domain"—the area under the national government's ownership and control. (Kentucky, which was formed from part of Virginia's claim, and Tennessee, which was formed from part of North Carolina's claim, retained control of their own unclaimed lands, and thus those lands never became part of the public domain.) The state cessions amounted to more than 13 percent of the ultimate land-surface area of the United States (sans Alaska and Hawaii)—almost as great an area as that retained by the original 13 states.[1]

In the Land Ordinance of 1785 and the Northwest Ordinance of 1787, Congress spelled out how the public domain would be transferred to private owners and divided into new states. These laws had the greatest importance in determining how successfully the country would develop.[2]

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Although afterward few people have paused to consider how the matter might have been resolved differently, alternatives certainly existed. For example, the original states might have insisted on their claims and fought border wars to resolve their differences (as many states elsewhere have). Or the national government might have retained ownership of the public domain and administered it as a permanent colony, granting use rights to political favorites or tenants. Had such an alternative been adopted, the United States would not have developed as successfully as it did. By placing an enormous area of immense potential productivity into private hands, with the holdings precisely demarcated by careful surveys and the ownership validated by recorded titles, the government ensured that the land would tend to come under the control of the persons who would put it to the highest-yielding use and thereby maximize its value.

The importance of the land-disposition system loomed even larger as the nation expanded its territory. The most important acquisitions were the Louisiana Purchase (1803), Texas (annexed 1845), the Oregon Country (by negotiation with Great Britain 1846), and the Mexican Cession (by conquest 1848). Together these additions amounted to 68 percent of the ultimate land-surface area of the United States (sans Alaska and Hawaii).[3] Purchase of Alaska from Russia in 1867 added an area more than twice as large as Texas, although its remoteness, rugged terrain, and harsh weather diminished its economic value.

During the nineteenth century, the national government transferred ownership of much of the public domain to others in various ways. (Although Texas retained control of its unclaimed land when it joined the United States, it privatized much of that land.) After the Revolutionary War, the War of 1812, and the Mexican War, the U.S. government gave land warrants to veterans as a reward for their military services. It gave large tracts to the states to promote various projects, such as financing common schools, making transportation improvements, and establishing "land grant colleges." It gave land to private companies to subsidize transportation improvements, especially in the vast, thinly populated area beyond the Mississippi River. Beginning in 1862, it transferred a substantial amount to homesteaders on the condition that they occupy and cultivate the land for five years. The government sold much of the public domain at auction to the highest bidder or, under so-called preemption laws, at minimum prices to settlers who had occupied the land without a legal right to do so.

According to an authoritative summary, "By 1970, approximately 287 million acres of public lands had been patented to homesteaders, 328 million acres had been granted to States for various public purposes, 94 million acres had been granted to railroad corporations to aid in financing the construction of railroads, and about 434 million acres had been sold or otherwise disposed of."[4] In the United States (sans Alaska and Hawaii), approximately three-quarters of the land now belongs to private owners.[5]

Land as Commodity

How the public domain passed into the hands of private owners was less important than the sheer fact of its transfer. Once the land had been transferred, whether by sale to farmers or by gift to railroad companies, it became a commodity to be bought and sold on an open market. As such, it could be acquired by the potential user willing to pay the most, and it would be used in accordance with competing appraisals of how it might be made most productive. Today, evidence of that competitive process surrounds us: land that once belonged to the public domain has been put to an endless variety of uses by private owners, and in combination with labor and capital it yields a huge, tremendously varied stream of outputs in mining, forestry, ranching, agriculture, commerce, industry, housing, and other activities. It continues to be switched from one use to another as economic conditions change, facilitating the economy's flexible adjustment and thus promoting economic dynamism.

Unfortunately, since the late nineteenth century the privatization of the public domain has been slowed and even reversed, as more and more land has been withdrawn from availability for transfer to private owners and placed in national forests, national rangelands, national parks, military bases and reservations, and other government reserves. Currently, the United States government owns approximately 28 percent of the entire land surface of the nation, including 62 percent of Alaska and nearly half of the land in the 11 far west states of the lower forty-eight.[6] By keeping so much land under government management, the nation suffers a tremendous ongoing loss of opportunities to create wealth. □

1. Benjamin Horace Hibbard, *A History of the Public Land Policies* (New York: Macmillan, 1924), p. 31.
2. Brief analytical surveys include Jonathan Hughes and Louis P. Cain, *American Economic History*, 4th ed. (New York: HarperCollins, 1994), pp. 83–97; and Jeremy Atack and Peter Passell, *A New Economic View of American History*, 2d ed. (New York: W. W. Norton, 1994), pp. 249–73.
3. Calculated from data in Hibbard, p. 31.
4. "Land, Water, and Climate," in U.S. Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970* (Washington, D.C.: U.S. Government Printing Office, 1975), p. 423.
5. Calculated from data for circa 1954 in ibid., p. 433; confirmation for recent times calculated from data compiled by Natural Resources Council of Maine, available at www.maineenvironment.org/nwoods/Landowned0800.htm.
6. Calculated from data in U.S. Bureau of the Census, *Statistical Abstract of the United States: 2001* (Washington, D.C.: U.S. Government Printing Office, 2001), p. 209.

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Ideas On Liberty
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Mises on Copyrights

by Bettina Bien Greaves

The widespread reproduction and "sharing" of copyrighted music on the Internet led a friend to ask me what Ludwig von Mises would have thought about the situation. The more I pondered the question, the more I concluded that Mises would have considered this just another case where copyright law must play catch-up with new technology.

Many people believe they should be allowed to reproduce and "share" copyrighted material free of charge, some because they don't want to pay for the privilege and others because they believe it is wrong to grant monopolies to authors, composers, musicians, or anyone at all for that matter. But there is more to the problem than monopoly.

Mises once said, more or less facetiously, that while he had known book authors who opposed patents because of the monopoly privilege they give inventors, he had never known a book author who opposed copyrights because of the monopoly privilege copyrights give authors. Mises may have had Murray Rothbard in mind, for in *Man, Economy, and State* and *Power and Market*, Rothbard defended copyrights and criticized patents. Rothbard said it was possible for an inventor independently to come up with precisely the same invention that someone else had developed earlier and had already patented. In that case, the earlier inventor would receive patent protection and the other would be out of luck. Rothbard considered that unfair.

However, Rothbard said it was inconceivable that a second author would ever succeed in arranging words in the same order as they had appeared in a previously published book without having knowledge of the earlier book. Being a unique production, a book is entitled to copyright protection.

Mises, of course, didn't talk about monopoly itself as being "good" or "bad." Monopolies could exist on a free market in the rare case when the owner of a factor of production controlled the total supply of that factor. And in the even rarer case that the demand for a monopolist's product was such that buyers were willing to pay an above-market price for it, he *might* be in a position to reap a greater financial gain by restricting production and selling fewer units at a higher price per unit. Mises considered this perhaps the only instance in which producers could violate consumer sovereignty with impunity.

The case of government-created and/or government-protected monopolies was another matter. He didn't discuss them from the point of view of their "morality" or "immorality," however. He simply talked about their economic aspects, saying that

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government-granted monopoly privileges change the situation by introducing coercion into the picture. Such privileges make consumers pay higher prices for the monopolized good or service and force them to restrict their consumption of other things. Government grants of patent and copyright protection are examples.

However, it appears from what Mises wrote in *Human Action* that he wasn't opposed to copyrights and patents as such. A patent or copyright is defined as an agreement on the part of the government to protect the property rights of an inventor or author to his creation for a certain period of time. The inventor or author pays a price for this protection: he agrees to turn his creation over to the public, at no cost, when the protection expires.

Now if the government is to protect property, it must define that property.

Technological development is nothing new, and when it affects the character of a form of property, it inevitably requires the refining and redefining of the rights of individuals to their private property. The copyright laws have had to be revised and adapted whenever new methods of production and reproduction were developed. The *Encyclopedia Britannica* says that according to Roman law, when a person wrote words on a parchment, the composition belonged to the owner of the blank materials. This definition of ownership must have arisen when monks copied manuscripts laboriously by hand, letter by letter, on valuable parchment sheets furnished by their monastery.

The Development of Printing

When printing came along and books could be copied more cheaply, the question of property rights became more urgent. However, William Blackstone (1723–1780), the authority on British law, said the rights of an author "being grounded on labor and invention" were "too subtle and unsubstantial a nature to become the subject of property and the common law, and only capable of being guarded by positive statutes and special provisions of the magistrate."[1] Copyright was looked on as "a doubtful exception to the general law regulating trade," which at that time was generally opposed to monopoly.

Again according to the *Britannica*, British law began to protect intellectual property with copyrights in 1709 as "in the nature of personal property. . . . A man's own work, in this view, is as much *his* as his house or his money, and should be protected by the state."[2] This, of course, puts the onus on the government to define what personal property is copyrightable.

James Madison, fourth president of the United States, had been a participant in the 1787 constitutional convention in Philadelphia. The U.S. Constitution that he helped to write gave Congress the power to secure "for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." Several years later, Madison, when listing the various forms of property the government was "instituted to protect," included a person's intellectual property, his "opinions and the free communication of them . . . [their] enjoyment and communication."[3]

By the nineteenth century, the idea that published books would be copyrighted was widely accepted. Washington Irving, after whom Irvington-on-Hudson, New York, was named, was one of the first American authors to earn a living from royalties received from his books, although not a handsome living—he was usually close to broke. Charles Dickens was another prolific author who relied on the royalties his books earned under British law. His attitude toward America turned somewhat negative when pirated versions of his books were published in the United States.

It may be impossible to describe all the changes that have been made in copyright law over the years in response to the different ways copyrighted material might be disseminated. Adjustments have been made from time to time. For instance, arrangements were worked out over several decades to compensate musicians whose works were played on mass-produced recordings, in movies, and on radio and TV broadcasts.

And as photocopy machines proliferated, it was determined that copying excerpts from copyrighted works for reference, research and study fell within the law's "fair use" principle.

The government's protection of an author's or an inventor's creation makes it possible for the creator to ask a monopoly price. Although monopoly prices generally benefit sellers, harm buyers, and infringe the supremacy of the consumers' interests, Mises saw copyrights and patents as an exception to this rule. He wrote in *Human Action*—and here I quote with some interpolation in brackets:

> If on a competitive market one of the complementary factors, namely *f* [a recipe or invention], needed for the production of the consumers' good *g*, does not attain any price at all, although the production of *f* requires various expenditures and consumers are ready to pay for the consumers' good *g* a price which makes its production profitable on a competitive market, the monopoly price for *f* becomes a necessary requirement for the production of *g*. It is this idea that people advance in favor of patent and copyright legislation. If inventors and authors were not in a position to make money by inventing and writing, they would be prevented from devoting their time to these activities and from defraying the costs involved. The public would not derive any advantage from the absence of monopoly prices for *f*. It would, on the contrary, miss the satisfaction it could derive from the acquisition of *g*.[4]

External Economies

Later in the book Mises discussed patents and copyrights further, pointing out their "external economies," that is, the benefits they furnish to persons other than those who produced the protected material.

> The extreme case is shown in the "production" of the intellectual groundwork of every kind of processing and constructing. The characteristic mark of formulas, i.e., the mental devices directing the technological procedures, is the inexhaustibility of the services they render. These services are consequently not scarce, and there is no need to economize their employment. Those considerations that resulted in the establishment of the institution of private ownership of economic goods did not refer to them. They remained outside the sphere of private property not because they are immaterial, intangible, and impalpable, but because their serviceableness cannot be exhausted.
>
> People began to realize only later that this state of affairs has its drawbacks too. It places the producers of such formulas—especially the inventors of technological procedures and authors and composers—in a peculiar position. They are burdened with the cost of production, while the services of the product they have created can be gratuitously enjoyed by everybody. What they produce is for them entirely or almost entirely external economies.
>
> If there are neither copyrights nor patents, the inventors and authors are in the position of an entrepreneur. They have a temporary advantage as against other people. As they start sooner in utilizing their invention or their manuscript themselves or in making it available for use to other people (manufacturers or publishers), they have the chance to earn profits in the time interval until everybody can likewise utilize it. As soon as the invention or the content of the book are publicly known, they become "free goods" and the inventor or author has only his glory.[5]

Mises went on to say that this problem has nothing to do with the genius who creates out of the sheer urge to do so; he does not wait for encouragement. But:

> It is different with the broad class of professional intellectuals whose services society cannot do without. . . . [I]t is obvious that handing down knowledge to the rising generation and familiarizing the acting individuals with the amount of

knowledge they need for the realization of their plans require textbooks, manuals, handbooks, and other nonfiction works. It is unlikely that people would undertake the laborious task of writing such publications if everyone were free to reproduce them. This is still more manifest in the field of technological invention and discovery. The extensive experimentation necessary for such achievements is often very expensive. It is very probable that technological progress would be seriously retarded if, for the inventor and for those who defray the expenses incurred by his experimentation, the results obtained were nothing but external economies.[6]

Controversy Continues

Mises understood that patents and copyrights are controversial. "They are considered privileges, a vestige of the rudimentary period of their evolution when legal protection was accorded to authors and inventors only by virtue of an exceptional privilege granted by the authorities. They are suspect, as they are lucrative only if they make it possible to sell at monopoly prices. Moreover, the fairness of patent laws is contested on the ground that they reward only those who put the finishing touch leading to practical utilization of achievements of many predecessors. These precursors go empty-handed although their contribution to the final result was often much more weighty than that of the patentee. . . . [T]his is a problem of the delimitation of property rights. . . ."[7]

It should be noted that merely because copyright grants a monopoly privilege to the producer of intellectual property, there is no guarantee that buyers will pay a monopoly price should the producer choose to ask it. Many books, poems, and musical compositions don't sell well, or may not sell at all, and their authors and publishers may suffer losses. As Mises wrote, "Under copyright law every rhymester enjoys a monopoly in the sale of his poetry. But...[it] may happen that . . . his stuff . . . can only be sold at their waste paper value."[8]

Also, the producers of some copyrighted intellectual property, eager to spread their ideas, readily grant reprint permission for free. For instance, this is true of most articles in *The Freeman*.

With the new technological developments that now make it so easy to reproduce and "share" musical compositions, we are entering a whole new ball game. Without copyright protection, musicians, authors, and composers are in the position of having to bear all the costs of production while the benefits go to others. Thus the new technology calls for further refinement of the rights of private property owners. □

1. *Encyclopedia Britannica*, 11th ed., 1910, vol. 7, p. 118.
2. Ibid.
3. James Madison, "Property," March 27, 1792; http://press-pubs.uchicago.edu/founders/documents/v1ch16s23.html.
4. Ludwig von Mises, *Human Action* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1996 [1949]), pp. 385–86.
5. Ibid., p. 661.
6. Ibid., pp. 661–62.
7. Ibid., p. 662.
8. Ibid., p. 277.

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Antiglobalists Are Scarce in Poor Countries

by Jim Peron

Whenever some international conference on world trade takes place, without fail the organized forces of antiglobalization appear outside the gates. They whine; they protest; they frequently riot and attack. If you ask them, they'll tell you that what they do is justified because they represent the world's poor.

Rarely are the protesters themselves poor. They tend to come from wealthy nations, born to families that are better off than the people for whom they claim to speak. Their critics contend that they don't represent the poor at all, but are more in tune with the political fashions among the affluent of the world. Now a continuing poll of world opinion backs this up.

The Pew Global Attitudes Project surveyed some 66,000 people in 44 nations.* Generally the results have been met with much interest. But the antiglobalization movement itself is rather unhappy, and for good reason.

The populations of the poorest nations support globalization to a greater extent than do those of the wealthiest nations. The survey noted that: "Only one-in-ten Americans and Canadians (10%, 11%) characterize globalization as a very good thing, and fewer Europeans agree. By comparison, nearly six-in-ten in Nigeria (58%), and more than four-in-ten in Kenya (46%), Uganda (44%) and South Africa (41%) see globalization as a very good thing" (p. 85). Only Jordan has a majority that says globalization is bad.

It is true that in all 44 nations a majority of people said globalization is either "somewhat good" or "very good." But those who see globalization as "very good" are significantly more likely to come from poorer nations.

Even with contentious "cultural" issues, majorities, especially among the young, see globalization as good. And most agree that they have better selections of foods and medicines as a result. When antiglobalization forces target fast-food restaurants like McDonald's, it again appears they reflect the values of the world's economic elites. Germans, by a six-to-one margin, think that fast food has a negative effect on their lives. In Canada and the United States significant margins share the German view. But more than seven out of ten in the Philippines, Vietnam, and China, give fast food thumbs up.

"Commercialism" and "consumerism" are further favorite targets of the antiglobalists. And while 63 percent of the French say both are threats to their culture, the poorest countries, on the whole, don't see it that way. The survey reports that this criticism is not prevalent "in the Middle East/Conflict Area. Majorities in Lebanon (64%), Uzbekistan (57%) and Jordan (54%) say commer-

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*"Views of a Changing World," June 2003; www.people-press.org/reports/pdf/185.pdf.

cialism is no threat to their culture. Pluralities in Turkey, Egypt and Pakistan agree" (p. 88). In Vietnam 66 percent say commercialism doesn't threaten their culture. In Nigeria it's 65 percent, and in Angola it's 56 percent.

Multinationals Not Unpopular

Multinational corporations are another favorite target of the antiglobalists. Again this is at odds with the views of the world's poor. The survey reports: "In 33 out of 43 countries in which the question was asked, majorities think that foreign corporations have a generally positive influence on their countries. Majorities in every African country surveyed say major foreign companies have a good influence" (p. 97). The survey also notes that: "Dislike of foreign firms is mostly limited to people in the major advanced economies of Western Europe, the U.S. and Canada" (p. 11).

Once again anti-globalist attitudes are more in tune with those of the wealthy and well-off. For instance, 93 percent of Vietnamese and 78 percent of South Africans view multinationals favorably, while only half of Americans and French do. What is particularly ironic is that in every nation surveyed, multinationals have more favorable support than the antiglobalists do themselves.

Support for international markets tends to indicate support for domestic economic freedom as well. A majority in 33 of the nations surveyed agreed that people are better off with free markets. The highest level of support was found among the residents of Vietnam, ostensibly a socialist state, where 95 percent agreed. And while the United States is often seen as being the most "free market" country in terms of ideological support, in fact the free market has higher levels of support in Lebanon, Vietnam, South Korea, Nigeria, Ivory Coast, Ghana, Uganda, and South Africa.

The antiglobalists have denounced world capitalism and domestic free markets. They claim to do so on behalf of the world's poor. But it appears that globally most people disagree with them—most especially the poor themselves. □

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Fortune-Cookie Economics

by Arthur E. Foulkes

It is little wonder that some economists want to be perceived as having fortune-telling abilities. After all, history and literature are full of examples of revered and exalted prophets and oracles. So we can understand why many economists sit up straight, clear their throats, look us right in the eye, and foretell next year's change in GDP or holiday-season spending.

The ability to foretell the future accurately appears for some to be the essence of true economic science. None less than Milton Friedman, one of the most influential economists of our time, famously stated that the "only relevant test" of a theory is to compare its *predicted* results with actual experience.[1] Meanwhile, the trendy "econometric" school has flatly stated, "science is prediction."

But science is really a quest for knowledge, and the method used varies, or ought to vary, according to the particular subject. When studying human economizing action, the natural scientific method of hypothesis-building, data-gathering, and hypothesis-testing is inappropriate. Human beings are fundamentally different from the matter studied by the physical sciences, and far less predictable.

Yet many economists today use this approach almost exclusively. First they create models that often include assumptions such as everyone has perfect knowledge, or everyone is seeking maximum material satisfaction. Then they set some arbitrary "parameters" for things like "consumer confidence." Then they gather data, compute z-scores and other statistical analyses, and generate their "positive" predictions, which can be later tested against reality. And this is called "economics."

Clearly the use of past data, statistics, and mathematics is important for anyone attempting to make budgetary or business decisions. For example, an investor considering buying a hotdog stand will want to know recent income and expenditure data for the stand, as well as recent trends in hotdog prices, seasonal sales, the present prevailing rate of return on other investments, and any other data deemed useful to making the decision.

Yet data from past economic experience, such as last year's wheat prices or December's unemployment figures, are always snapshots of economic history, nonrepeatable data distilled from highly complex chains of events. They can be used in economic calculation, indeed they are critical to it, but they are not the source of economic truth forever and for all time. Only deductive conclusions starting from some fundamental truth about human beings can provide such knowledge. That is what economics is all about.

Economics begins with the understanding that to act is to seek goals, and these goals are based on human valuations, which

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involve ranking *a* over *b*, *b* over *c*, and *c* over *d*. Indeed, valuations of this sort drive all human action. And while we might be able to measure, calculate, and predict with near certainty the responses to various stimuli of things we study in the natural sciences, we cannot do the same with people. Human valuations are purely subjective and ever subject to change. We might know with near-apodictic certainty that water will freeze at zero degrees Celsius; we cannot know with the same degree of certainty how my wife will respond to a gift of a dozen roses or how consumers will respond to some new product. (While I might hope my wife would love a dozen roses, that is not necessarily so, especially if I send them one week after our anniversary.)

Ludwig von Mises put the differences between the natural sciences and the sciences of human action—such as economics—this way: "What distinguishes the sciences of human action [from the natural sciences] is the fact that there is no . . . foreknowledge of the individuals' value judgments, of the ends they will aim at under the impact of these value judgments, of the means they will resort to in order to attain the ends sought. . . . We know something about these things, but our knowledge of them and about them is *categorically* different from the kind of knowledge the experimental natural sciences provide about natural events."[2]

Cause and Effect

Of course, in a sense, it can be said we use economics to "predict" the future. For example, we can say with certainty that increasing the minimum wage to $10 an hour will, other things remaining equal, result in new involuntary unemployment, or that rent controls will result in deterioration of existing apartment units, as well as a drop in rentable space. But these "predictions" are not based on empirical observation; in fact they are not really "predictions" at all. They are simply statements of cause and effect linked by logical reasoning to the fundamental and incontestable truth that humans act purposefully to achieve their goals.

Wages and rental rates are simply reflections of consumer valuations. They are not really expressed in dollars and cents but rather in other goods and services available (and therefore competing with them) in the market. When artificial barriers are erected around certain goods or services, consumers and producers respond to the new data. We cannot know exactly, in any quantitative sense, how they will respond, but we know that when a good is overpriced (other things remaining equal) a surplus will result; when another good is underpriced there will be a shortage.

Certainly, anticipating future events or conditions is fundamental to all human action. Indeed, if we did not believe we could change the course of future events—if we did not believe in the law of cause and effect—we would not act at all. But the key to understanding human action (past, present, or future) does not lie in historical experience or econometric modeling. It lies in uncovering the essential *laws* of human action, that is, in understanding true economics. □

1. Milton Friedman, "The Methodology of Positive Economics," in *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953), pp. 8–9.
2. Ludwig von Mises, *Theory and History* (Auburn, Ala.: Ludwig von Mises Institute, 1985 [1957]), pp. 306–07.

BOOKS

Principles of Politics Applicable to All Governments

by Benjamin Constant

Liberty Fund • 2003 • 558 pages
• $22 hardcover; $12 paperback

Reviewed by Richard M. Ebeling

Nowhere does one find such clear and lucid expositions and defenses of human liberty as those found among the French classical liberals of the nineteenth century, a group that included Jean-Baptiste Say, Frédéric Bastiat, Charles Dunoyer, Charles Comte, Gustave de Molinari, Paul Leroy Beaulieu, Emile Faguet, and Yves Guyot, to name a few. Benjamin Constant (1767–1830) was one of the brightest stars in this constellation of thinkers.

The great tragedy is that up until recently few of Constant's works were available in English. During World War II his *The Spirit of Conquest and Usurpation* (1814) appeared in an abridged translation. His novel, *Adolphe*, has also been translated. But the few essays of his that appeared in English during his lifetime seem never to have been reprinted in the twentieth century.

Only in 1988 was a volume of his *Political Writings* published by Cambridge University Press; it contained a new and complete translation of *The Spirit of Conquest and Usurpation* and his superb 1819 lecture, "The Liberty of the Ancients Compared with that of the Moderns." That volume also included an abridged translation of Constant's 1815 treatise, *Principles of Politics Applicable to All Governments.*

Now Liberty Fund of Indianapolis has published a new and full translation of *Principles of Politics* that contains all of Constant's extended appendices in which he elaborates on the principles of individual freedom, civil liberties, economic liberalism, and the role of government.

Principles of Politics was written in the immediate aftermath of Napoleon's rule over France and much of Europe. It is a defense of all forms of freedom against despotism. Constant considered natural rights to be a superior foundation for liberty than Bentham's utilitarianism. "Right is a principle; utility is only a result," Constant said. "Say to a man: you have the right not to be put to death or arbitrarily plundered. You will give him quite another feeling of security and protection than you will by telling him: it is not useful for you to be put to death or arbitrarily plundered."

Yet, in fact, Constant's arguments for freedom and limitations on government are both rights-based and utilitarian, or consequentialist. He asks us to think not only of the inherent rightness of freedom, but also of its positive effects and the harm from its abridgment. It is not possible to summarize and do justice to all of his analysis. But some of his themes can at least be touched on.

He warned of the "proliferation of laws" that go far beyond the protection of life, liberty, and property. This proliferation generates disrespect, avoidance, and corruption, which undermines the legitimacy of and obedience to all law, including those meant to secure freedom. Similarly, Constant warned of laws passed to prevent potential crimes, which can lead to arbitrary arrest, imprisonment without due process of law, and brutal treatment simply because some bureaucratic enforcer might conjure up suspicions in his own mind.

This led Constant to point out the dangers from all government restrictions on freedom of speech, written expression, and religion. Censorship creates a society of hypocrites who utter what the government wants, while their minds harbor different thoughts and beliefs. Furthermore, the very ideas that the government wishes to repress become the focal point of underground fascination for those wanting to read the forbidden words. The government's banning of some religious faiths, while sponsoring or subsidizing others, results in a growing number of people revolting against all religious belief under the compulsion of having to give allegiance to a theology not of their own choosing. Thus, it can throw all religion into disrepute—the opposite of what the proponents of a state-sponsored faith want to achieve.

What is required is establishment of an impartial rule of law. This means an independent judiciary, due process for all, and elimination of cruel and unusual punishments. Constant also emphasized the need for securing and protecting private property rights, which not only guarantee freedom, but also foster a peace of mind that enables a spirit of savings and investment, and supports a society of voluntary, mutual consent in all human associations.

Inconsistent, therefore, with protecting private property and freedom of individual decision-making are all privileges, protections, and subsidies that benefit some at the expense of others. Central to Constant's criticism of all government interventionism is his awareness that no regulator has the wisdom, ability, or disinterestedness to succeed at it. "How will the government judge, for each province, at a huge distance, and remote from others, circumstances which can change before knowledge of them get to it?" he asked. "How will it stop fraud by its agents? How will it guard itself against the danger of taking momentary blockage for a real dearth, or a local difficulty for a universal disaster? . . . The men most lively in recommending this versatile legislation do not know how to go about it when it comes to the means of carrying it out."

Constant also pointed out that such interventions in the market "create artificial crimes [that] encourage the committing of these crimes by the profit which they attach to the fraud which is successful in deceiving them." It also corrupts the whole political process and undermines the spirit of enterprise and the desire for freedom. "In a country where government hands out assistance and compensation, many hopes are awakened," Constant warned. "Until such time as they have been disappointed, men are bound to be unhappy with a system which replaces favoritism only by freedom. Freedom creates, so to speak, a negative good, although a gradual and general one. Favoritism brings positive, immediate, personal advantages. Selfishness and short-term views will always be against freedom and for favoritism."

Constant was also fearful of war, and the rationales for it, as a threat to freedom. In the wake of revolutionary France's wars of "liberation" throughout Europe, he explained that such foreign interventionism undermines the very cause for which it is undertaken. "To give a people freedom in spite of itself is only to give it slavery. Conquered nations can contract neither free spirits nor habits. Every society must repossess for itself rights which have been invaded, if it is worthy of owning them. Masters cannot impose freedom. For nations that enjoy political freedom, conquests have furthermore, beyond anything else we might hypothesize, this most clearly insane feature, that if these nations stay faithful to their principles, their triumphs cannot help but lead to their depriving themselves of a portion of their rights in order to communicate them to the conquered."

Almost 200 years have passed since Benjamin Constant penned his *Principles of Politics Applicable to All Governments.* But its insights and arguments still ring true for our own time.

Richard Ebeling is president of FEE.

Breaking Free: Public School Lessons and the Imperative of School Choice

by Sol Stern

Encounter Books • 2003 • 248 pages • $25.95

Reviewed by George C. Leef

"Liberals mugged by reality" is the (increasingly) common expression used to describe people like Sol Stern. As a young man, he was a Berkeley radical espousing the leftist cant about capitalist oppression and the need for solidarity among its opponents. As the father of two children in the New York public-school system, however, Stern got a hard lesson in the results of the schools' being turned over to leftist ideologues and their teacher-union allies. Whatever Stern's other political views may be, he is now a vigorous proponent of school choice and no doubt ranks high on the list of enemies at the National Education Association.

While *Breaking Free* recounts the author's experiences in battling the stultifying effects of union domination and the concomitant "dumbing down" of the schools his sons attended, the book addresses a problem that is national in scope. The educational product offered by the government school cartel is of poor quality, and people need to have other choices.

The most valuable service Stern renders is to rip to shreds the "good public schools" mystique. He lives on Manhattan's elegant Upper West Side and enrolled his son Jonathan in P.S. (Public School) 87, the "hot" elementary school in his district. Stern assumed that P.S. 87 would live up to its reputation as a good school, but was soon disabused of that notion:

> Change was evident when I stepped in P.S. 87's "child-centered" classrooms. My first shock was that there were no desks lined up in rows. From kindergarten through fifth grade, children sat in little clusters, either on the floor or at tables. The young teachers were often dressed in jeans and T-shirts. They spent very little time in front of the room offering instruction; instead, they wandered around the room, observing the children working on their assignments in small groups. Reading was taught through the "whole language" or "holistic" method rather than the traditional phonics approach. On my first visit to P.S. 87, one teacher told me that she was helping the children "construct" their own knowledge.

Stern had encountered the world of "progressive" education theory. Education theorists have managed to pull the wool over the eyes of parents and taxpayers, leading them to believe that this easy-going approach is a great improvement over old-fashioned "drill and kill" teaching methods. Many Americans, like Stern before his eyes were opened, think that because their children attend schools that are clean and attractive, employ only state-certified teachers, and have above-average standard-test results, they must therefore be "good" schools. Stern's experience with elite New York schools showed him that a school can look excellent in all those respects, but still give students a feeble academic program that's more babysitting than learning.

An example: In third grade, Jonathan's teacher devoted the year in math to creating a Japanese garden. When Stern would ask him what they did in math class, Jonathan would reply, "We measured the garden." Asked about the appropriateness of spending so much time on that project rather than learning the multiplication tables, the teacher replied that the garden project gave students "real life" mathematical practice.

Besides painting a startling picture of the dysfunctionality of New York's "elite" schools, Stern also gives the reader an excursion through inner-city schools that work remarkably well despite having minuscule budgets and run-down facilities. He visited several Catholic schools in New York and discovered a world of discipline and educational progress vastly different from that of the far more costly government system.

Vital to the success of the Catholic schools is the freedom of principals to set budgetary priorities, hire teachers on the basis of teaching ability rather than paper credentials, and require that students and teachers follow the rules. Of course, there is one more ingredient in this recipe: the possibility of failure. Without any guarantee of enrollments and revenues, the Catholic schools have to serve the desires of the parents. When dealing with the public-school bureaucracy and unions, Stern was merely an annoyance who could be brushed aside with a haughty "we're the experts" attitude. Nongovernment schools can't afford to ignore and alienate their customers, so they don't.

The villains of *Breaking Free* are union officials who will say and do anything to protect their cushy deal, and even more so the politicians who pose as "friends of education" while invariably siding with the interests of the education establishment. People like Senator Edward M. Kennedy come in for richly deserved scorn. "With support from Kennedy and others," Stern writes, "the unions have built a Berlin Wall that protects the public education system from competition and prevents poor children from leaving bad schools." Exactly.

Breaking Free is an incendiary book, the kind of exposé that should make people angry. □

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Free Trade Under Fire

by Douglas A. Irwin

Princeton University Press • 2003 • 257 pages • $17.95 paperback

Reviewed by Phil Murray

According to Douglas Irwin, free trade is under fire because some groups believe that they do not participate in the accumulation of wealth that trade brings. Others oppose it because they believe that trade agreements subvert national sovereignty and threaten to harm workers and the environment. Irwin, professor of economics at Dartmouth and long-time advocate of free trade, intends with this book to show the benefits of free trade and evaluate the arguments against it.

A common argument against free trade is that imports destroy jobs. Irwin admits that "imports do indeed destroy jobs in certain industries." But imports are necessary to finance exports, he argues. Irwin observes that "all of the dollars that U.S. consumers hand over to other countries in purchasing imports . . . eventually return to purchase either U.S. goods (exports) or U.S. assets (foreign investment)." Therefore, "the overall effect of trade on the number of jobs in an economy is best approximated at zero."

When protectionists advocate import restrictions, they disregard their hidden costs. One cost is the jobs lost in export industries and industries that buy imported inputs to make final goods. "According to one study," reports Irwin, "import quotas in the Steel Revitalization Act . . . would protect 3,700 steel jobs but cause the loss of anywhere from 19,000 to 32,000 jobs in the steel-consuming sector." Blocking imports to save jobs is also wrongheaded because it raises prices to consumers. Here Irwin cites a study concluding that consumers pay an extra $140,000 yearly for each job protected by textile-import quotas.

Nor does Irwin have any patience with policies designed to "soften the blow" of import competition. The government provides income assistance, but the displaced workers who receive it merely lengthen their spell of unemployment. As for training programs, Irwin bluntly says that "there is little evidence that any government training program works well."

Irwin also analyzes the legal attacks against free trade. One strategy is to accuse foreign exporters of "dumping" goods in U.S. markets. The Commerce Department finds dumping whenever the price of an import is "less than fair value." Read Irwin's description of how the department computes "fair value" and prepare for a case of nausea. It has nothing to do with whatever buyers and sellers voluntarily negotiate. The department almost always decides that the foreign exporter is dumping and levies "countervailing duties."

Industries struggling against competition from imports also seek protection through the "escape clause," which provides "a temporary exception to any negotiated tariff reduction." "Temporary" protection tends to become permanent. For example, Irwin notes that "The steel industry has received nearly continuous protection for over thirty years and is still seeking limits on imports." He concludes that some businessmen will resort to protection whenever it is to their advantage. The government should stop aiding them.

Irwin devotes a chapter to the World Trade Organization (WTO). The controversial feature of the WTO is the "dispute settlement mechanism." Although some conservatives suspect that the WTO is a form of world government, Irwin finds that fear to be unwarranted. He notes that "WTO panels merely determine whether disputed policies conflict with WTO rules and, if they do, recommend that members bring those policies into conformity." It neither undermines national sovereignty nor interferes with trade.

Mostly, the WTO riles leftists, who charge that it undermines environmental regulation. In one case the WTO decided that standards for clean gas set by the Environmental Protection Agency (EPA) violated trade rules because they did not apply equally to domestic and foreign refineries. But the WTO cannot undermine EPA regulations. Irwin explains that, "The EPA could have resolved the case by raising the domestic standard, rather than lowering the standard applied to imports."

The environmentalists' gripe with the WTO and free trade is misdirected. "Environmental damage results from poor environmental policies, not poor trade policies," Irwin maintains.

Although protectionism will never die, Irwin believes that the traditional opposition to free trade based on economic interests is waning. One reason is that corporate executives "have found that international diversification or joint ventures with foreign partners are a more profitable" alternative. The new and grave danger to free trade comes from nongovernmental organizations (NGOs) such as Ralph Nader's Global Trade Watch. Their call for "human rights, corporate responsibility, and sustainable development" appears innocuous, but that agenda is an anti-capitalist Trojan horse. Sadly, many politicians are taken in by it.

With all the complaints about free trade, forthright defenders like Douglas Irwin are to be applauded. Everyone who buys *Free Trade Under Fire* will acquire a valuable resource on the economics, history, law, and current events of this critical subject. □

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Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity

by Raghuram G. Rajan and Luigi Zingales

Crown Business • 2003 • 314 pages • $29.95

Reviewed by Gary M. Galles

In an era of misguided attacks on capitalism, *Saving Capitalism from the Capitalists* has about the most promising beginning imaginable: "Capitalism, or more precisely, the free market system, is the most effective way to organize production and distribution that human beings have found." The authors—Raghuram Rajan (newly named as the International Monetary Fund's chief economist) and Luigi Zingales (of the University of Chicago's Graduate School of Business)—also recognize that capitalism is blamed for a host of ills, both by those who do not understand it and those with an agenda of deflecting blame or capturing the political apparatus for their own benefit.

Capitalism often serves as a scapegoat for economic distress because, the authors observe, "the forms of capitalism that are experienced in most countries are far from the ideal. They are a corrupted version of it in which vested interests prevent competition from playing its natural healthy role. Many of the accusations against capitalism . . . relate to the corrupted, uncompetitive systems that exist rather than a true free enterprise system."

Rajan and Zingales argue that once a government has been largely restrained from violating property rights and the institutions of capitalism have begun to develop, the greatest threat to the system comes from those who already have positions of economic power ("the incumbents"). With no interest in enabling competition that would erode their dominant market positions, they use their concentrated interests to control the rules in their favor. Those are the capitalists capitalism needs saving from.

Dominant domestic producers use their clout to create protectionist policies to control competition, particularly from those outside the country, who have little if any domestic political power. This is why the authors emphasize free international trade as a constraint on inefficient government restrictions to protect domestic incumbents. This problem is particularly troublesome in recessions, when the incumbents channel the anger of the distressed to achieve their protectionist ends through legislation and regulation, which can then persist for many years after the immediate crisis is over. (This persistence argument is so reminiscent of Robert Higgs's *Crisis and Leviathan* that I cannot understand its absence from the book's bibliography.)

The authors emphasize that it is even more important to keep incumbents, particularly in an underdeveloped financial system, from freezing out improved institutions and innovations; the denial of access to capital is the most general barrier to entry and competition. Moreover, it is easier to undermine potential rivals' access to capital by thwarting the development of the institutions necessary for arm's-length markets than by promoting more visible and therefore harder-to-justify barriers to free trade.

Rajan and Zingales use many examples to illustrate the importance of the external competition they emphasize, particularly in finance. These range from the erosion of banking restrictions and the evolution of the market for corporate control in the United States to the role of the gold standard and the collapse of the Bretton Woods system in international trade and finance. They also include many illustrations from other countries and times, such as the undermining of the Japanese Bond Committee and the destruction of the Knights Templar as early bankers.

Unfortunately, however, when the authors turn from their useful contributions on the importance of free competition in product and financial markets to how they propose to protect capitalism from its vulnerability to political abuse, they seem to lose their bearings. They propose policies ranging from added government safety nets to heavier inheritance taxes and substituting property taxes for income taxes. Alas, they fail to see that such proposals themselves undermine the property rights that form the necessary basis for capitalism.

Further, their proposals are inconsistent with their analysis. For example, if incumbents, who control most of the existing property, dominate political competition in a country, how could it successfully convert from income to property taxes and impose steeper inheritance taxes, given that those changes would directly target those incumbents?

Saving Capitalism from the Capitalists is valuable for recognizing the importance of free trade, especially open competition in financial markets, not just for their direct benefits, but for the damper they put on governments' ability to protect incumbents against the potential entrants and innovators who most threaten their interests. It is also valuable for its wide range of international, as well as domestic, illustrations. Unfortunately, the book overstates the government role necessary for financial markets to develop, and its proposals to save capitalism are highly suspect.

But those flaws don't keep the book from standing head and shoulders above most recent "contributions" to the understanding and analysis of capitalism. □

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THE FREEMAN
Ideas On Liberty
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Parting Company Is an Option

My last essay in *The Freeman*, "How Did We Get Here?" (March), provided clear evidence that Congress and the White House, as well as the courts, had vastly exceeded powers delegated to them by our Constitution. To have an appreciation for the magnitude of the usurpation, one need only read Federalist 45, where James Madison, the acknowledged father of our Constitution, explained, "The powers delegated by the proposed Constitution to the Federal Government, are few and defined. Those which are to remain in the State Governments are numerous and indefinite. The former will be exercised principally on external objects, as war, peace, negotiation, and foreign commerce; with which last the power of taxation will for the most part be connected. The powers reserved to the several States will extend to all the objects, which, in the ordinary course of affairs, concern the lives, liberties and properties of the people; and the internal order, improvement, and prosperity of the State."

Short of some kind of cataclysmic event, liberties lost are seldom regained, but there is an outside chance to regain them if enough liberty-minded Americans were to pursue Free State Project's proposal to set up New Hampshire as a free state. Free State Project (www.freestateproject.org) intends to get 20,000 or so Americans to become residents of New Hampshire. Through a peaceful political process, they hope to assume leadership in the state's legislature and executive offices, reduce burdensome taxation and regulation, reform state and local law, end federal mandates that violate the Ninth and Tenth Amendments to the Constitution, and restore constitutional federalism as envisioned by the nation's Founders.

Since there is only a remote possibility of successful negotiation with Congress, the courts, and White House to get them to obey the Constitution, it is my guess that liberty could only be realized by a unilateral declaration of independence—namely, to part company—in a word, secede. While our Constitution is silent about secession, there is clear evidence that our Founders saw it as an option.

On March 2, 1861, after seven states had seceded and two days before Abraham Lincoln's inauguration, Senator James R. Doolittle of Wisconsin proposed a constitutional amendment that said, "No State or any part thereof, heretofore admitted or hereafter admitted into the Union, shall have the power to withdraw from the jurisdiction of the United States." Several months earlier Representatives Daniel E. Sickles of New York, Thomas B. Florence of Pennsylvania, and Otis S. Ferry of Connecticut proposed a constitutional amendment to prohibit secession. One is immediately faced with the question: would there have been any point to offering these amendments if secession were already unconstitutional? Moreover, the ratification documents of Virginia, New York, and

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Rhode Island explicitly said that they held the right to resume powers delegated should the federal government become abusive of those powers.

Madison Objects

There's more evidence. At the 1787 constitutional convention, a proposal was made to allow the federal government to suppress a seceding state. James Madison rejected it saying, "A Union of the States containing such an ingredient seemed to provide for its own destruction. The use of force against a State would look more like a declaration of war than an infliction of punishment and would probably be considered by the party attacked as a dissolution of all previous compacts by which it might be bound."

Professor Thomas DiLorenzo, in his revised *The Real Lincoln*, provides abundant evidence in the forms of quotations from our Founders and numerous newspaper accounts that prove that Americans always took the right of secession for granted. Plus, secession was not an idea that had its origins in the South. Infuriated by Thomas Jefferson's Louisiana Purchase in 1803, the first secessionist movement started in New York, Massachusetts, Connecticut, and other New England states.

The preponderance of evidence shows that states have a right to secede. The Constitution probably would have never been ratified if the states, sovereign nations as per the 1783 Treaty of Paris that ended the war of independence with Great Britain, had not believed they had a right to secede. The only barrier to secession is the brute force of the federal government, as witnessed by the costly war of 1861 that produced only one decent result—the elimination of slavery. Since the issue of secession was brutally settled, it left a devastating legacy for future generations of Americans. The federal government is free to run roughshod over the restrictions and safeguards the Framers imposed on the federal government.

Self-determination is a human right we all should respect. If some people want socialism, that is their right, but it is not their right to use force to make others who wish to be left alone be part of it. By the same token, liberty-minded Americans have no right to impose their will on socialist-minded Americans. A far more peaceful method is for each to simply part company.

One wonders whether the brutality witnessed in 1861 would be repeated if New Hampshire seceded—massive troops along with today's deadly modern military equipment and Americans killing Americans. □