THE FREEMAN
Ideas On Liberty

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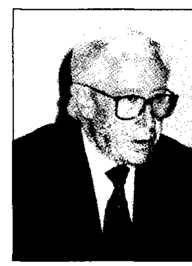
FEATURES



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COLUMNS

BOOK REVIEWS

by Richard M. Ebeling

THE FREEMAN
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What Can Friends of Freedom Learn from the Socialists?

On March 14, 1883, a German philosopher living in exile in London passed away. When he was buried three days later in a modest grave where his wife had been laid to rest two years earlier, fewer than ten people were present, half of them family members. His closest friend spoke at the gravesite and said, "Soon the world will feel the void left by the passing of this Titan." But there was, in fact, little reason to think that the deceased man or his long, turgid, and often obscure writings would leave any lasting impression on the world of ideas or on the course of human events.

That man was Karl Marx.

Advocates of liberty often suffer bouts of despair. How can the cause of freedom ever triumph in a world so dominated by interventionist and welfare-statist ideas? Governments often give lip service to the benefits of free markets and the sanctity of personal and civil liberties. In practice, however, those same governments continue to encroach on individual freedom, restrict and regulate the world of commerce and industry, and redistribute the wealth of society to those with political power and influence. The cause of freedom seems to be a lost cause, with merely temporary rear-guard successes against the continuing growth of government.

What friends of freedom need to remember is that trends can change, that they have in the past and will again in the future. If this seems farfetched, place yourself in the position of a socialist at the time that Marx died in 1883, and imagine that you are an honest and sincere advocate of socialism. As a socialist, you live in a world that is predominantely classical liberal, with governments in general only intervening in minimal ways in commercial affairs. Most people—including those in the "working class"—believe that it is not the responsibility of the state to redistribute wealth or nationalize industry and agriculture, and are suspicious of government paternalism.

How could socialism ever be victorious in such a world so fully dominated by the "capitalist" mindset? Even "the workers" don't understand the evils of capitalism and the benefits of a socialist future! Such a sincere socialist could only hope that Marx was right and that socialism would have to come—someday—due to inescapable "laws of history."

Yet within 30 years the socialist idea came to dominate the world. By World War I the notion of paternalistic government had captured the minds of intellectuals and was gaining increasing support among the general population. Welfare-statist interventionism was replacing the earlier relatively free-market environment. And the socialist ideal of government planning was put into effect as part of the wartime policies of the belligerent powers beginning in 1914.

Socialism triumphed during that period because while socialists advocated collectivism, they practiced a politics of individu-

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alism. They understood that "history" would not move in their direction unless they changed popular opinion. And implicitly they understood that this meant changing the minds of millions of individual people.

So they went out and spoke and debated with their friends and neighbors. They contributed to public lectures and the publishing of pamphlets and books. They founded newspapers and magazines, and distributed them to anyone who would be willing to read them. They understood that the world ultimately changes one mind at a time—in spite of their emphasis on "social classes."

They overcame the prevailing public opinion, defeated powerful special interests, and never lost sight of their long-term goal of the socialist society to come, which was the motivation and the compass for all their actions.

The Superiority of Freedom

What do friends of freedom have to learn from the successes of our socialist opponents? First, we must fully believe in the moral and practical superiority of freedom and the free market over all forms of collectivism. We must be neither embarrassed nor intimidated by the arguments of the collectivists, interventionists, and welfare statists. Once any compromise is made in the case for freedom, the opponents of liberty will have attained the high ground and will set the terms of the debate.

FEE's founder, the late Leonard E. Read, once warned of sinking in a sea of "buts." I believe in freedom and self-responsibility, "but" we need some minimum government social "safety net." I believe in the free market, "but" we need some limited regulation for the "public good." I believe in free trade, "but" we should have some form of protectionism for "essential" industries and jobs. Before you know it, Read warned, the case for freedom has been submerged in an ocean of exceptions.

Each of us, given the constraints on his time, must try to become as informed as possible about the case for freedom. Here, again, Read pointed out the importance of self-education and self-improvement. The more knowledgeable and articulate we each become in explaining the benefits of the free society and the harm from all forms of collectivism, the more we will have the ability to attract people who may want to hear what we have to say.

Another lesson to be learned from the earlier generation of socialists is not to be disheartened by the apparent continuing political climate that surrounds us. We must have confidence in the truth of what we say, to know in our minds and hearts that freedom can and will win in the battle of ideas. We must focus on that point on the horizon that represents the ideal of individual liberty and the free society, regardless of how many twists and turns everyday political currents seem to be following. National, state, and local elections merely reflect prevailing political attitudes and beliefs. Our task is to influence the future and not allow ourselves to be distracted or discouraged by who gets elected today and on what policy platform.

Let us remember that over the last hundred years virtually every form of collectivism has been tried—socialism, communism, fascism, Nazism, interventionism, welfare statism—and each has failed. There are very few today who wax with sincere enthusiasm that government is some great secular god that can solve all of mankind's problems. Statist policies and attitudes continue to prevail because of institutional and special-interest inertia; they no longer possess the political, philosophical, and ideological fervor that brought them to power in earlier times.

There is only one "ism" left to fill this vacuum in the face of collectivism's failures. It is *classical liberalism*, with its conception of the free man in the free society, grounded in the idea of consent, peaceful association, and individual rights. If we keep that before us, we can and will win. □

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PERSPECTIVE

Science versus Science

The question of whether economics is a science arose last summer when The Royal Society, Britain's prestigious scientific academy, elected to fellowship its first modern economist, Sir Partha Sarathi Dasgupta of Cambridge. The Royal Society was founded in 1660 and boasts among its previous fellows Isaac Newton, Charles Darwin, and Albert Einstein.

Dasgupta's election caused some excitement because economists have been considered social scientists and thought to be ineligible for fellowship. But that is not quite clear. The Royal Society says its definition of science has expanded to encompass economics because of its "advanced math and analytical techniques." But according to a Cambridge spokeswoman, Dasgupta was "nominated before these changes were made." He was cited for "uniquely outstanding contributions to several areas of environmental biology and ecology."

Contributing to the confusion is the fact that Adam Smith (1723–1790), the professor of moral philosophy who is often regarded as the first economist, was elected a fellow in 1767, nine years before he published *The Wealth of Nations*. He was cited as "a lover of Natural Knowledge."

Regardless of the confusion, we may still ask, is economics a science? While the social philosophers in Smith's day studied the consequences of people's conduct, this was a descriptive, not a normative, endeavor. As Ludwig von Mises later wrote, that a legal price ceiling on milk will, other things equal, create shortages is not *in itself* an argument against the policy. The economist's role, Mises said, is simply to teach that price controls will make milk less, not more, accessible. Although economics is about the pursuit of values, it is nonetheless value-free, in the sense that economic laws, like physical laws, operate independent of our wishes.

Similarly, for F. A. Hayek economics is scientific in an older sense of the word because it features "the general spirit of disinterested inquiry." But the word "science" narrowed during the nineteenth century and essentially came to mean physics. In addition, the "hard" sciences were accorded a prestige as especially rigorous that was denied to other disciplines. These two developments, Hayek notes, unfortunately led others to imitate the physicists in order to win respect as real scientists.

The problem is that not all phenomena are open to the methods of physics, for example, how people improve their lives through production and exchange. When we study molecules, all we can do is watch, from the outside, what happens under natural and experimental conditions.

Human action we know from the inside. We understand that when people act, they choose ends and the means suited to achieve them. We know they act entrepreneurially: with imperfect knowledge, they imagine preferred future conditions and undertake risks to make them real.

This insider knowledge permits us to understand social phenomena in a way that we can never understand "natural" phenomena. But although we have this general knowledge, we cannot know the many specific factors that motivate people. That's why economic planning always fails.

Mises emphasized that human action expresses inequalities. A person acts because he prefers one condition over another. Thus elaborate mathematical equations would seem to have limited pertinence, if that, to an inconstant social world.

If that is so, then The Royal Society's justification for according economics the status of science—advanced math and analytical techniques—leaves one underwhelmed. Yet proper economics does yield truths about the world.

Maybe we should disinter the older sense of "science."

* * *

Ludwig von Mises maintained that socialism was not just a bad idea but "impossible." Richard Ebeling elaborates.

In June a long-hoped-for event occurred: a private spacecraft was launched. Is this the start of a new space age? Raymond Keating undertakes an exploration.

The burdens of regulation are not abstractions. They are real, and they hit home—and church—hard. William Anderson explains.

Rising gasoline prices predictably elicit bad proposals. Maybe, David Laband and Christopher Westley suggest, the worst idea of all is higher government fuel standards.

If we didn't know better, we might think that the wealth resulting from the division of labor was due to magic. Manuel Ayau demonstrates how we can get more stuff out without putting more stuff in.

Entrepreneurs earn profits in the marketplace by catering to consumers. It sounds unobjectionable, but particular kinds of services draw objections anyway. Matthew Hisrich has an example.

The member states of the European Union have been writing a constitution, but as Norman Barry reports, it is likely to be a waste of time.

Uruguay was once a thriving country. Then it slid backward into poverty. If things turn around, Luisa Peirano writes, a good deal of credit should go to a lone classical-liberal thinker.

Here's what catches the fancy of our columnists: Richard Ebeling tells us that advocates of the freedom philosophy can learn from the successes of their socialist opponents. Lawrence Reed wants to know why America needs czars. Thomas Szasz finds similarities between foreign aid and state-sponsored mental-health services. Robert Higgs traces the evolution of a government program. Guest columnist James Dorn looks at China's resistance to political freedom. And George Leef, encountering the argument that states should have unlimited power in the name of federalism, protests, "It Just Ain't So!"

Books coming under scrutiny this month examine an Indian free-marketeer, F. A. Hayek, illiberal democracy, and the latest complaint against capitalism.

—SHELDON RICHMAN

Federalism Means Carte Blanche for States?

It Just Ain't So!

Federalism is an important concept in the political structure of the United States—or at least it is *supposed* to be. Under the Constitution the national (or as it is now almost invariably called, federal) government was given certain responsibilities. Beyond those limited functions the federal government was not to go. The Tenth Amendment makes the plan for a division of governmental authority clear: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

Under that plan, the state governments are less restricted than is the federal, but they still must abide by constitutional limits on their power. No state may, for example, enter into a treaty with a foreign government, make anything but gold or silver coin legal tender, or pass any law impairing the obligation of contracts. Those (and other) restrictions on the states were written into Article I, Section 10. The ratification of the Fourteenth Amendment in 1868 further circumscribed the authority of the states with this language: "No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

Since the 1930s, the idea of federalism has been kicked around like an old can. Congress has passed statutes that undoubtedly trespass far into terrain denied to it under the Tenth Amendment, and through executive orders, presidents have exercised power that they were never meant to have. Those developments were, however, cheered by "liberals," who scoffed at the idea of limitations on the powers of Congress and the presidency to do good. When arguments rooted in federalism were raised against such unconstitutional legislation as the National Labor Relations Act or Medicare, "liberals" hastily brushed them aside, saying that progress demanded that Congress and the president have sweeping authority.

Now that the old "liberal" coalition no longer holds sway in Washington, we find that its adherents are having second thoughts about the merits of federalism. Writing in the December 7, 2003, issue of the *New York Times*, Adam Cohen attempts to argue that federalism and progressivism are really allies. He does so by placing on a marble pedestal a dissenting opinion by one of the Supreme Court justices most revered by "liberals," Louis Brandeis. Cohen's article, "Brandeis's Views on States' Rights, and Ice-Making, Have New Relevance," centers on the 1932 case *New State Ice Co. v. Liebmann.*

The facts of the case: Oklahoma's legislature had enacted a law that prohibited any person from entering the ice-making business unless he had a certificate from a state commission. Existing ice-making businesses were "grandfathered" in, thus creating a cozy cartel for them. Liebmann had purchased land in Oklahoma City and invested a large amount of money in a new ice business, but when he began selling ice without the required certificate, one of the existing firms sued to stop him.

What the court record does not say, but which anyone familiar with state legislatures would understand, is that this statute was promoted by ice-making firms eager to stifle competition. Since medieval times, producer guilds have sought legal favors from governments that would prevent or restrict competition. The rhetoric for such favors, at least in democratic governments, is always couched in "public interest" terms, but such window-dressing should fool no one.

It didn't fool the Court's majority, which saw the Oklahoma law as unjustifiably infringing on Liebmann's liberty. In Justice George Sutherland's opinion, the statute merely secured though legislation an objective that the producers could not obtain voluntarily—cartelization. The statute was unconstitutional, Sutherland wrote, because "[t]here are certain essentials of liberty with which the state is not entitled to dispense in the interest of experiments. . . . The opportunity to apply one's labor and skill in an ordinary occupation . . . is no less entitled to protection [than freedom of the press]."

The Brandeis Dissent

Brandeis, however, dissented. He argued that the Depression had brought about an emergency, calling for experimentation by government. Perhaps, he argued, Oklahoma's scheme would eliminate "unnecessary duplication of facilities," thereby improving economic conditions somehow. The freedom of people to enter into a lawful business was of no significance to Brandeis, and his willingness to accept Oklahoma's rationale for the suppression of economic liberty stands in stark contrast to his famous skepticism over governmental claims of the need to regulate speech or invade citizen privacy in other cases.

Cohen extols Brandeis's view that (in Cohen's words) "government has an affirmative duty to seek out new approaches to the problems of society." He presents Brandeis's *New State Ice* dissent as a pathway to a rebirth of federalism, allowing states to experiment with "solutions to social problems," such as e-mail spam. (Congress has written into its anti-spam legislation language designed to pre-empt the states from passing their own laws.)

I'm glad to hear "liberals" talking about federalism, but to jurists with the philosophy of Brandeis and writers like Cohen, federalism doesn't mean undoing decades of unconstitutional "progressive" legislation that to a great extent shackles Americans to the authoritarian notions of Washington politicians and bureaucrats. It is merely another avenue for statists to impose their will on the populace. Just as Brandeis naïvely believed that Oklahoma's cartelization of the ice-making business might improve the state's depressed economy, so do contemporary "liberals" believe that state politicians will manage to solve problems that now plague us, such as unwanted communications or corporate mismanagement. The legislation they favor almost never entails the repeal of existing laws that get in the way of the ability of free people to find solutions to problems. Instead, they dream up new laws that further encroach on the freedom that the Constitution is supposed to protect.

Professing to be concerned about federalism without taking seriously the Constitution's limits on governmental power—both federal and state—is disingenuous. Yes, the federal government has usurped power it was not intended to have, but it does not follow that state governments should be given carte blanche to engage in legislative experiments that deprive people like Liebmann of the essential of liberty.

If someone advocated a state law that experimented with, say, a mandatory state religion, there would, quite appropriately, be gasps of horror. Yet when "liberals" propose laws that compel employers to provide workers with paid leave or comprehensive medical insurance, there are no protests from their camp. Like Brandeis in 1932, they regard economic freedom and property rights as worthy of no constitutional protection.

Justice Brandeis's dissent in *New State Ice* was not visionary. It was absurd, and had his "federalist" view prevailed, there would have been less freedom in Oklahoma and higher prices for ice. If you're serious about constitutional doctrines like federalism, you also have to take seriously the idea that people and their property are not mere pawns in a great political chess game.

—George C. Leef
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Why Socialism Is "Impossible"

by Richard M. Ebeling

In the nineteenth century, critics of socialism generally made two arguments against the establishment of a collectivist society. First, they warned that under a regime of comprehensive socialism the ordinary citizen would be confronted with the worst of all imaginable tyrannies. In a world in which all the means of production were concentrated in the hands of the government, the individual would be totally and inescapably dependent on the political authority for his very existence.

The socialist state would be the single monopoly provider of employment and all the essentials of life. Dissent from or disobedience to such an all-powerful state could mean material destitution for the critic or opponent of those in political authority. Furthermore, that same centralized control would mean the end to all independent intellectual and cultural pursuits. What would be printed and published, what forms of art and scientific research permitted would be completely at the discretion of those with the power to determine the allocation of society's resources. Man's mind and material well-being would be enslaved to the control and caprice of the central planners of the socialist state.[1]

Second, these nineteenth-century anti-socialists argued that the socialization of the means of production would undermine and fundamentally weaken the close connection between work and reward that necessarily exists under a system of private property. What incentive does a man have to clear the field, plant the seed, and tend the ground until harvest time if he knows or fears that the product to which he devotes his mental and physical labor may be stolen from him at any time?[2] Similarly, under socialism man would no longer see any direct benefit from greater effort, since what would be apportioned to him as his "fair share" by the state would not be related to his exertion, unlike the rewards in a market economy. Laziness and lack of interest would envelop the "new man" in the socialist society to come. Productivity, innovation, and creativity would be dramatically reduced in the future collectivist utopia.[3]

The twentieth-century experiences with socialism, beginning with the communist revolution in Russia in 1917, proved these critics right. Personal freedom and virtually all traditional civil liberties were crushed under the centralized power of the Total State. Furthermore, the work ethic of man under socialism was captured in a phrase that became notoriously common throughout the Soviet Union: "They pretend to pay us, and we pretend to work."

The defenders of socialism responded by arguing that Lenin's and Stalin's Russia, Hitler's National Socialist Germany, and Mao's China were not "true" socialism. A true socialist society would mean more freedom not less, so it was unfair to judge social-

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ism by these supposedly twisted experiments in creating a workers' paradise. Furthermore, under a true socialism, human nature would change and men would no longer be motivated by self-interest, but by a desire to selflessly advance the common good.

In the 1920s, 1930s, and 1940s, the Austrian economists, most notably Ludwig von Mises[4] and Friedrich A. Hayek,[5] advanced a uniquely different argument against a socialist society. They, Mises in particular, accepted for the sake of argument that the socialist society would be led by men who had no wish to abuse their power and crush or abrogate freedom, and further, that the same motives for work would prevail under socialism as under private property in the market economy.

Even with these assumptions, Mises and Hayek devastatingly demonstrated that comprehensive socialist central planning would create economic chaos.[6] Well into the twentieth century, socialism had always meant the abolition of private property in the means of production, the end of market competition by private entrepreneurs for land, capital, and labor, and therefore the elimination of market-generated prices for finished goods and the factors of production, including the wages of labor.

Yet without such a competitively generated system of market prices, Mises argued, there would be no method for rational economic calculation to determine the least-cost methods of production, or the relative profitability of producing alternative goods and services to best satisfy the wants of the consuming public. It may be possible to determine the technologically most efficient way to produce some good, but this does not tell us whether that particular method of production is the most economically efficient way to do it.

Mises explained this in many different ways, but we can imagine a plan to construct a railway through a mountain. Should the lining of the railway tunnel be constructed with platinum (a highly durable material) or with reinforced concrete? The answer to that question depends on the value of the two materials in their alternative uses. And this can be determined only through knowing what people would be willing to pay for these resources on the market, given competing demand and uses.

Prices Encapsulate People's Valuations

On the free market, private entrepreneurs express their demand through the prices they are willing to pay for land, capital, resources, and labor. The entrepreneurs' bidding is guided by their anticipation of the demand and prices consumers may be willing to pay for the goods and services that can be produced with those factors of production. The resulting market prices encapsulate the estimates of millions of consumers and producers concerning the value and opportunity costs of finished goods and the scarce resources, capital, and labor of the society.

But under comprehensive socialist central planning, there would be no institutional mechanism to discover these values and opportunity costs. With the abolition of private ownership in the means of production, no resources could be purchased or hired. There would be no bids and offers expressing what the members of society thought the resources were worth in their alternative employments. And without bids and offers, there would be no exchanges, out of which emerges the market structure of relative prices. Thus socialist planning meant the end of all economic rationality, Mises said—if by rationality we mean an economically efficient use of the means of production to produce the goods and services desired by the members of society.

Given that nothing ever stands still—that consumer demand, the supply of resources and labor, and technological knowledge are continually changing—a socialist planned economy would be left without the rudder of economic calculation to determine whether what was being produced and how was most cost-effective and profitable.

Neither Mises nor Hayek ever denied that a socialist society could exist or even survive for an extended period of time. Indeed, Mises emphasized that in a world that was only partly socialist, the central planners would have a price system to rely on by proxy, that is, by copying the market prices in countries where competitive capitalism still prevailed.[7] But even this would only be of approximate value, since the supply-and-demand conditions in a socialist society would not be a one-to-one replica of the market conditions in a neighboring capitalist society.

Socialist and even some pro-market critics of Mises have sometimes ridiculed his supposed extreme language that socialism is "impossible."[8] But by "impossible" Mises simply meant to refute the socialist claim in the nineteenth and early twentieth centuries that a comprehensive centrally planned economy would not merely generate the same quantity and quality of goods and services as a competitive market economy, but would far exceed it. Socialism could not create the material paradise on earth the socialists had promised. The institutional means (central planning) that they proposed to achieve their stated ends (a greater material prosperity than under capitalism) would instead lead to an outcome radically opposite to what they said they wanted to achieve.

Mises emphasized that a socialist society also would lack the consumer-oriented activities of private entrepreneurs. In the market economy, profits can be earned only if the means of production are used to serve consumers. Thus in their own self-interest, private entrepreneurs are driven to apply their knowledge, ability, and "reading" of the market's direction in the most effective way, in comparison to their rivals who are also trying to capture the business of the buying public.

Certainly incentives motivate the private entrepreneur. If he fails to do better than his rivals, his income will diminish and he may eventually go out of business. But the private entrepreneur, as much as the central planner, would be "flying blind" if he could not function within a market order with its network of competitive prices.

Thus for Austrian economists like Mises, economic calculation is the benchmark by which to judge whether socialist central planning is a viable alternative to the free-market economy. Without market prices there can be neither economic calculation nor the social coordination of multitudes of individual consumers and producers with their diverse demands, localized knowledge, and appraisements of their individual circumstances.

Central Planning versus Rational Planning

The pricing system is what gives rationality—an efficient use of resources—and direction to society's activities in the division of labor, so that the means at people's disposal may be successfully applied to their various ends. Central planning means the end to rational planning by both the central planners and the members of society, since the abolition of a market price system leaves them without the compass of economic calculation to guide them along their way.

In the Soviet Union, for example, the older criticisms of collectivism were verified. The Total State did create a cruel, brutal, and murderous tyranny. And the abolition of private property resulted in weakened and often perverse incentives, in which individual access to wealth, position, and power came through membership in the Communist Party and status within the bureaucratic hierarchy.

In reality, the rulers of the communist countries had other ends than that of the material and cultural improvement of those over whom they ruled. They pursued personal power and privilege, as well as various ideologically motivated goals. They artificially set prices for both consumer goods and resources at levels that had no relationship to their actual demand or scarcity. As a consequence, the degree of misuse of resources was such that virtually all manufacturing or industrial projects in the Soviet Union used up far more raw materials and labor hours per unit of output than anything comparable in the more market-oriented Western economies.

The chaos of the Soviet economy was centered in the lack of a real price system and therefore a method of economic calculation. There could not be a real price system in the Soviet Union because it would have required the reversal of the very rationale for the socialist system, on which the Soviet rulers' power was based—government control and central planning of production. And they could not set their network of artificial prices at levels comparable to those in some Western countries, because it would have made clear just how misguided their entire planning and distribution process actually was.

Thus along with the inherent irrationality of the central planning system due to the lack of real prices were the weakened incentives for the ordinary Soviet citizen to be industrious and creative in the official economy, as well as the perverse incentives of the political system in which personal gain was achieved through a near-total disregard for the interests of the wider society.[9] That the Soviet planners had agendas other than serving consumers only further distorted the system. Just how misdirected and inefficient the use of resources were under socialism only became clear after the Soviet Union collapsed and a limited market economy emerged in Russia.

The End of Civilization

In his arguments against socialist central planning, Mises often couched his reasoning in rhetoric that warned of the end of civilization as we know it if the collectivist road were followed. In the 1930s and 1940s, when Mises most forcefully raised these fears, he was far from being alone in this dire warning, given the brutality and violent tyranny then being experienced in Nazi Germany and Stalin's Soviet Union.[10]

But Mises's more fundamental point was that the very nature of a socialist system threatened the economic and cultural standard of well-being that Western man had come to take for granted over the preceding hundred years. With every passing day a socialist system would be less like the market society that preceded it. The allocation of resources, the utilization of capital, and the employment of labor would have to be modified and shifted from previous uses to new ones. If nothing else, the "priorities" of the "workers' state" would be different from those under decentralized, profit-oriented decision-making. Should a new public hospital be constructed in a particular location, or should the limited resources be assigned to building additional public-housing complexes in a different part of the country? Should a piece of land in a particular area be used for a new "people's recreational facility" or should it become the site of a new industrial factory?

If a new housing complex is chosen for construction, should it be made mostly of brick and mortar, or of steel and glass? Should the efforts of some scientists be employed for additional cancer research or for possible development of a tastier and longer-lasting chewing gum? What represents the more highly valued use for various resources that can be employed making different types of machines, which could then be used either to produce more books on religion and faith or to increase the productivity of workers in agriculture? Would a new technological idea be worth the investment in time, resources, and labor, even though its payoff may be years away (assuming it worked as initially conceived)?

Without prices for finished goods and the factors of production to provide the information and signals to guide the decision-making, each passing day would mean more such decisions were made in the dark. It would be analogous to sea travelers in the ancient world before the invention of the sextant or the compass. Every movement out of sight of land—the known and the familiar—would be into uncharted waters with no way of knowing the direction or the consequences of the course chosen. Better to stay close to the shore than to explore unknown seas. And if the journey on the open sea under cloud-covered skies is undertaken, it is uncertain where it will lead or whether the shortest and best course has been selected.

It is for reasons such as this that Mises referred to economic calculation as "the guiding star of action under a social system of division of labor. It is the compass of the man embarking upon production."[11] Thus even if the rulers of a socialist state were completely benevolent and concerned only with the well-being of their fellow men, without economic calculation a collectivist society potentially faced what Mises titled one of his books, planned chaos.

Thus, the establishment of a comprehensive system of socialist central planning would be equivalent to going back in time, before the institutions of private property and market competition had enabled the utilization of prices for rational decision-making.[12]

Luckily, the attempt to create socialism in the twentieth century made enough of an impression that it seems unlikely that such a dramatic abolition of the fundamental institutions of the market economy will be tried again any time soon. The dilemma of our own time is that governments, through regulation, intervention, redistribution, and numerous controls, prevent the market and the price system from functioning as they should and could in a free society. □

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1. Francis A. Walker, *Political Economy* (New York: Henry Holt, 1888), p. 522.

2. John R. McCulloch, *The Principles of Political Economy, with Some Inquiries Reflecting Their Application* (New York: Augustus M. Kelley, 1965 [1864]), pp. 25–36.

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No More Czars, Please

For hard-pressed, taxpaying citizens who believe in limited government, April is not a favorite month. But something really good and worth noting happened a couple days before our taxes were due this year. On April 13 in Michigan, a Democratic governor chided a Republican legislature for trying to create a state "manufacturing czar."

In fact, this year Governor Jennifer Granholm vetoed two bills passed by a GOP-controlled legislature that would have created two different czars, one for small business and one for manufacturing. She argued that we didn't need a state manufacturing czar because the state already has its Michigan Economic Development Corporation and a Department of Labor and Economic Growth, which both have their own monarchs, or whatever their leaders are called.

It isn't as though Granholm opposes czars. She had earlier called on President Bush to name a manufacturing czar (or czarina) at the federal level. Back home in Michigan, it's not as though we don't know why our state is losing manufacturing jobs. High taxes, burdensome regulations, poor inner-city schools, and a generally unfriendly, union-heavy labor environment are major factors. To genuinely fix the problem, the governor and legislature have been handed dozens of proposals by my organization and others, including abolishing compulsory unionism, ending corporate welfare, cutting taxes and spending, and privatizing things the state shouldn't be doing. But instead of exhibiting real leadership and getting those things done, the politicians too often would rather hire yet another leader, a "czar" no less.

In the land of the free, czardom has become a bipartisan fetish. Both major political parties have given us drug czars, energy czars, trade czars, AIDS czars, counterterrorism czars, and more, and they seem intent on blessing us with more such coronations in the future. We now even have a federal "privacy czar," for crying out loud! The politicians give us tough talk about getting some problem resolved, but when they anoint a czar to deal with it, it's usually because they don't know what should be done or they're afraid to accept responsibility themselves.

The media not only lap it up, but they dish out more of their own—often conferring the "czar" title on officials whom even the government isn't brash enough to label that way. While browsing the Internet, I came across an article from the January 20 *Berkeley Daily Planet* with a headline that caught my eye: "Bush Homeless Czar Pays a Visit." It wasn't about a government official without a home. It was about the President's *homelessness* czar, in town to promote "the development of 10-year plans to end chronic homelessness." Other stories I found referred to a "timber czar," a "cybersecurity czar," a "health care czar," and a "regulatory czar," to cite but a few examples.

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My problem with all of this goes beyond the notion of hiring yet another bureaucrat. It's the use of the term "czar" itself to refer to anybody at all in what is supposed to be a free society. Jefferson, Madison, Franklin, and the others who risked their lives to fashion a constitutional republic must be turning in their graves. Just as George Washington rejected a suggestion he be named a king, so should any self-respecting, freedom-loving American citizen eschew any offer to be a "czar" over anything or anybody.

In his book *Freedom in Chains: The Rise of the State and the Demise of the Citizen*, James Bovard laments what this czarist fetish says about the state of American thinking: "Americans of earlier generations would be as shocked by the current adulatory use of the term 'czar' as contemporary Americans should be shocked of the use of 'fuehrer' as a compliment for a political leader." Bovard cites an attorney who, in an 1895 case, condemned a particular tax as granting sweeping powers to the federal government "worthy of a Czar of Russia proposing to reign with undisputed and absolute power. . . ."

Czar, as in Caesar

The origin of the word is "Caesar" from the ancient Roman autocrat Julius Caesar, who arrogated great power to himself and helped bring an end to the Roman republic. Later emperors embraced his name as their title; to be a "Caesar" was to possess almost limitless, life-and-death authority over the rest of society. In more modern times we think of a "czar" as a tyrant of pre-1917 Russia. Look it up in any thesaurus and you'll find synonyms such as "usurper," "despot" and "oppressor."

Words say a lot about a culture. Americans of 1900 never referred to one of their own as a "czar" because they understood the term. Because they generally embraced liberty and limited government, they knew that it was pejorative. No respectable American of that day would have accepted the title, and no job at any level of government at that time even pretended to bestow czarist-like authority. Americans of today haven't forgotten what the term means. Sadly, they simply put far more faith in powerful, centralized government than did their ancestors. Their acceptance of the term "czar" is symptomatic of the same shift in thinking that has given us a government that commands a share of our lives and personal income many times what it claimed in 1900.

One hopeful sign of the prospects for liberty would be a widespread revulsion at the very thought of a fellow citizen possessing either a position or a title such as the one we're discussing here. Let's pray for the day when Americans tell their leaders in no uncertain terms: "Give us no more czars! Give us no pharaohs, emperors, shoguns, sheikhs, sachems, commissars, or potentates of any kind! Just give us good and limited government, and leave the rest to us!" □

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Has a New Era of Space Venture Arrived?

by Raymond J. Keating

Will 2004 go down in history as the dawn of a new space age?

Many notable dates exist in the short history of mankind's reaching for the stars. The Soviet Union launched *Sputnik*, the first artificial satellite to orbit the Earth, on October 4, 1957. Soviet cosmonaut Yuri Gagarin made the first manned space flight on April 12, 1961. The date most remembered probably is July 20, 1969—the day Neil Armstrong set foot on the moon. The space shuttle *Columbia* took off on April 12, 1981, to become the first reusable spaceship.

What do these and other key moments in space exploration have in common? They were government ventures.

But something different happened last June 21. *SpaceShipOne*, the brainchild of Burt Rutan, financed by billionaire Paul Allen and piloted by Mike Melvill, reached an altitude of 62.2 miles, marking the first time a privately built vehicle took a human being into space. The dream of proponents of free-market space-faring was beginning to come true.

After the flight, Rutan held up a sign saying: "SpaceShipOne. Government Zero." The *Los Angeles Times* reported that one of the 20,000 people in Mojave, California, watching the launch powered by rubber and laughing gas declared: "We're going to space and the government isn't invited." The Space Frontier Foundation (SFF), an advocate of private space enterprises, declared the flight to be "a clear sign that a New American Space Age has begun." SFF founder Rick Tumlinson said this was "one of the most important moments in history" because it marked the start of "an age when the people begin to enter space on their own, without governments."

Is space exploration really moving from a purely government endeavor to also being a profit-seeking private undertaking? By supporting private space ventures, are billionaires like Allen, Elon Musk, Jeff Bezos, Richard Branson, and Dennis Tito simply rich guys getting carried away because they watched too much "Star Trek" or *Star Wars* in their younger days? Or are they visionary risk-takers blazing new trails into the heavens for free enterprise? It is certainly worth keeping in mind that many of the things we do with computers today were considered science fiction only a short time ago.

Elon Musk's venture features the Falcon rocket and is shooting for a per-kilogram cost to orbit of $2,850, according to economist Sam Dinkin. If accomplished, that would be less than 20 percent of the cost of the space shuttle—and would signal a dramatic change in costs that have remained stagnant for decades during the government space age. That's an example of the potential for private entrepreneurship and innovation.

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Of course, to assure that *SpaceShipOne*'s flight serves as a launching pad for business opportunities in space, more than engineering know-how and invention will be needed. It will also require investors willing to put up substantial amounts of capital. (Amazingly, the *SpaceShipOne* venture only cost Allen about $20 million—cheaper than some luxury yachts. Compare that to the cost of similar government undertakings.) Capital will flow to sound business plans, but only when government unshackles outer space.

The Economist of June 24 observed: "The big unknown (and one that is bothering potential investors) is the cost of compliance with government regulations." A week before the flight, Charles Lurio, a space consultant, told the *New York Times*: "Without timely legislation, the flight might be a mere passing stunt instead of the herald of a new era."

Does government get it? Do policymakers understand? There are a couple of reasons for some hope.

Just five days before the *SpaceShipOne* flight, President George W. Bush's Commission on Moon, Mars, and Beyond issued its report. What is significant is its emphasis on shifting away from the centralized Cold War/Apollo government model for NASA to an agenda emphasizing opportunities in the private sector.

For example, regarding NASA operations, the commission recommended that:

> NASA recognize and implement a far larger presence of private industry in space operations with the specific goal of allowing private industry to assume the primary role of providing services to NASA, and most immediately in accessing low-Earth orbit. In NASA decisions, the preferred choice for operational activities must be competitively awarded contracts with private and non-profit organizations and NASA's role must be limited to only those areas where there is irrefutable demonstration that only government can perform the proposed activity.

A bit later the report noted:

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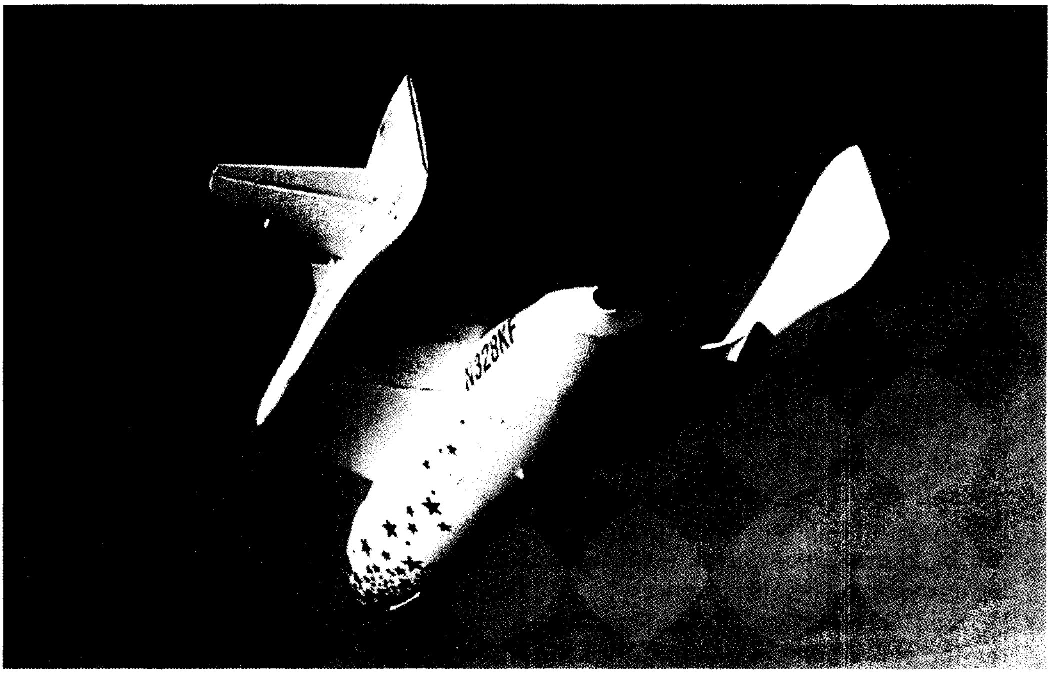
Burt Rutan and Paul Allen

> Today an independent space industry does not really exist. Instead, we have various government-funded space programs and their vendors. Over the next several decades—if the exploration vision is implemented to encourage this—an entirely new set of businesses can emerge that will seek profit in space. This new space industry will reduce the cycle-time for critical technology innovation. It will immeasurably augment NASA's ability to explore the universe.

Despite the unfortunate fact that the commission envisions private industry as the servant of NASA, the report highlighted four ways that government could encourage commercial space activities. One was prizes, patterned along the lines of the Orteig prize, which was won by Charles Lindbergh for his solo flight over the Atlantic, and the $10-million, privately funded X-Prize, which will be awarded to the first privately financed team that takes three people—or the equivalent—into space twice within two weeks. The Rutan-Allen team, and others, are pursuing the X-Prize. In late July, Rutan announced that his group would make its attempt in late September and early October.

Taxation, Regulation, Property Rights

More important, though, were the three other proposals. If a real economy is going



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SpaceShipOne

to flourish in space, then taxation, regulation, and property rights must be addressed.

The commission's report started down this path. It called for tax incentives, including perhaps making "profits from space investment tax free until they reach some pre-determined multiple (e.g., five times) of the original amount of the investment."

The value of regulatory relief was also recognized. The commission pointed out: "A key issue in the private space flight business is liability. There is a pressing need for a change in liability laws to set a reasonable standard for implied consent. . . . [I]t is not reasonable to impose governmental risk standards on people who are willing and eager to undertake dangerous or hazardous activities." The commission also suggested reviewing occupational and environmental laws "to make sure that the government is not burdening new space industry unduly with irrelevant or unobtainable compliance requirements."

Finally, the importance of property rights was acknowledged. The report noted that the 1967 UN Treaty on Peaceful Uses of Outer Space, which the U.S. government signed, prohibits claims of national sovereignty on any extraterrestrial body. Moreover, the 1979 Moon Treaty disallows any private ownership on the moon. The commission reported that the United States "has not ratified the 1979 Moon Treaty, but at the same time, has not challenged its basic premises or assumptions." As a result, "the legal status of a hypothetical private company engaged in making products from space resources is uncertain." The commissioners observed: "Potentially, this uncertainty could strangle a nascent space-based industry in its cradle; no company will invest millions of dollars in developing a product to which their legal claim is uncertain." The report concluded that if property rights are not addressed appropriately, "there will be little significant private sector activity associated with the development of space resources, one of our key goals."

Of course, as noteworthy as it might be, a report like this easily could sit on a shelf, relegated to being quoted some day by space geeks or examined by future historians as another example of lost opportunities. However, Congress earlier this year signaled that the need for change was being taken seriously. In March, the House of Representatives passed the Commercial Space Launch Amendments Act of 2004 (H.R. 3752) by a whopping vote of 402-1.

Its key measures, as noted in a release from the House Committee on Science, were meant to:

- "eliminate any confusion about who should regulate flights of suborbital rockets carrying human beings by explicitly locating all commercial space flight authority under the Federal Aviation Administration (FAA) Office of Commercial Space Transportation (AST);"
- "make it easier to launch new types of reusable suborbital rockets by allowing AST to issue experimental permits that can be granted more quickly and with fewer requirements than licenses;"
- "extend government indemnification for the entire commercial space transportation industry (including licensed, non-experimental commercial human space launches) for a period of three years, but the bill will not grant indemnification for flights conducted under experimental permits, which will be more lightly regulated."

It should be noted that providing indemnity—that is, legal exemption from penalties or liabilities tied to one's action—is improper and unnecessary. Such issues can and ought to be covered through private contracts.

Licensing Would Be Eased

The legislation specifically directs the secretary of transportation "when issuing permits, in order to encourage the development of a commercial space flight industry and to the greatest extent practicable, [to waive licensing requirements] not necessary to protect public health and safety, safety of property, and U.S. national security and foreign policy interests."

While this bill does not address the issues of taxation and property rights, it's something of a beginning on the regulatory front. Dennis Tito, for example, seemed ready to invest if this bill became law. After passage in the House, Tito said that this is "precisely the kind of legislation Congress should enact in order to give investors like me confidence that our space tourism ventures will be regulated in a fair and streamlined manner. I hope the Senate takes up this bill soon and sends it on to President Bush for his signature."

Of course, much more must be done. One has to ask: why is government involved in outer space, beyond any national-security and law-enforcement needs? Space travel certainly is exciting, and the expansion of knowledge of the universe is a worthy endeavor. But these facts do not mean that taxpayers should be forced to pick up the tab. Leave these adventures and inquiries to private groups, allow the government to undertake appropriate defense matters in space, and close down NASA.

Treaties must be reworked explicitly to allow for and protect private property claims in space. Regulation must be rolled back, with laws limited to dealing with outright fraud or theft. Liability should not be an issue as long as the risks of space flight are explicitly spelled out and abided by contractually.

Finally, why not make space free of taxes? Zero taxes on income and capital gains earned in space, for example, would serve as powerful incentives for space entrepreneurs and investors.

The laws of economics are not suspended in the weightlessness of space. If government enforces private property rights and does not regulate or tax heavily, then businesses in space will only be limited by mankind's ability to invent, innovate, and take risks. Get government out of the way, and June 21, 2004, very well could mark the end of the government space age and the start of the free-enterprise space era. □

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A Tale of Regulation

by William L. Anderson

When we speak of regulation, we often apply the lessons on a macroeconomic scale ("regulation costs the economy X billions of dollars a year") or examine how it affects a particular industry, like oil. However, regulation is not merely something imposed on the large firms or spread evenly across the economy; it is something that robs *individuals* of money, property, and even their freedom.

The church that my family and I attend has learned something about the current regulatory regime. Our congregation is small: morning attendance of more than about 70 people is rare, and no more than 25 come to the Sunday evening service. Most members and others who attend regularly are people of modest means, although a few medical doctors are among us.

For many years we managed church dinners and Sunday-school classes in a large room adjoining the sanctuary. To accommodate the four different classes, along with the nursery, we used large sliding dividers that, while blocking some sight lines, hardly kept out the noise. Thus Sunday school was a cacophony, particularly to one not used to the situation.

After enduring this state of affairs for a number of years, the congregation decided last year that it was time to expand the building. The addition was to be a rather simple affair—about 1,800 square feet that would house a nursery and some new classrooms.

At one time this project would have been completed easily and with relatively small expense. The church would have raised upfront money, gained financing (or paid cash), hired a contractor, and had a few congregational meetings. Then construction would have begun, with the building finished soon afterwards. The modern regulatory process, unfortunately, ensures that such a happy ending is not the normal state of affairs.

It is difficult to know where to begin, since we were able to experience the combined local *and* federal regulatory hell (a fitting word even if this is about a church expansion). The town of LaVale, Maryland, where our church is located, requires that a state-licensed architect be retained for the construction of any building larger than 100 square feet. This is the equivalent of requiring a vascular surgeon to deal with a cut finger, but no doubt architects love this regulation.

Our church had a gravel parking lot for the three decades of its existence. The new addition was being built to serve the current membership, and although we hoped that it would help bring in new members, no one thought the sanctuary would be filled each Sunday morning. However, our local zoning board, armed with dictates from Congress and the Environmental Protection Agency, declared that with the building of a new structure—

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small as it would be—we also would have to bring our parking lot into conformity with the federal Clean Water Act and the local code. In short, the governments' actions would cost the church at least $120,000 over what was required for the building.

To bring the lot up to snuff, we were ordered to pave it and surround it with a large concrete curb to channel rainwater into catch basins. This was to keep water from rushing directly into street drains and flowing "unfiltered" into nearby Braddock Run. To put this in perspective, by the time Braddock Run reaches our neighborhood, it usually is reddish brown, having carried silt and other material from some abandoned coal mines. Our parking lot's contribution of rainwater would have no effect on the quality of the creek.

To satisfy the local zoning code, the regulators ordered us to make the lot large enough to accommodate 120 cars, which they estimated would carry 600 people. That's the magic number the authorities calculated could fit into every room (excluding bathrooms) and the narthex of the newly expanded church. While we were optimistic that the new wing would make the church more attractive, we did not share the city government's optimism that the building would be crammed with people every day. The existing lot could hold 30 cars, more if some double-parked. That would have meant expanding it by 90 spaces for the phantom worshipers. (The other morning I counted 35 cars, including those parked in front of the building.)

Plowing Up the Lawn

While we finally were able to persuade the regulators that their order was unreasonable, we still had to double the lot size, requiring us to plow up our lovely lawn, install expensive new lights, and put up with more mud than had accumulated on our parking lot in all the years of the church's existence. Those of us with young children attracted to mud had to engage in the ritual of washing the Sunday clothes again and again.

The regulatory maze delayed occupation of the addition three months past the Christmas target date, and the parking lot was still a quagmire in late March, thanks to the cold winter and late snowfall. But the concrete curbing that supposedly will protect Braddock Run from pollutants was finished. This painful portion of our church life is finally in the past.

Of course, there is the bill. We will have to pay it for years to come, and the extra costs due to regulation are substantial. Perhaps the original cacophony was not so bad after all, given that it was preferable to the cacophony of orders and regulations coming from individuals who are permitted by the state to sit on high and make life harder for everyone else—all in the name of protecting people, the environment, whatever.

In reality, they have protected no one and no thing except their own power. Perhaps that is the real reason we have so much regulation in modern society. We do not need such legal harassment, but those who do the harassing certainly need the employment and the trappings of power. It would be illegal outside the protection of state employment to burden anyone like that.

Those who justify the sort of intrusive government regulation that we endured this past year say that it improves our quality of life. The amount of pollutants that could have flowed into Braddock Run had a monsoon hit while we were having church services has now been reduced at the margin, they would say. (That's debatable.) Instead of gravel, we have the privilege of walking and driving on a paved surface. Furthermore, we won't have to depend on streetlights as we make our way to the church on Sunday evening.

Yet people forget that had we wanted those things we would have been willing to include them in our original plans—and pay for them. Instead, the local government told us that if we wanted a new building, we had to have these unwanted extras. That's equivalent to forcing everyone who purchases a new automobile to buy a Mercedes Benz instead of a Chevy Lumina. □

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Psychiatric "Services"

The standard political-philosophical justification for the state is the need of the community for protection from criminals at home and enemies abroad. The community is now believed to be threatened by another group as well: the mentally disordered. Liberals and conservatives take for granted that coercing these persons is also the duty of the government.

Psychiatry is usually thought of as a healing art, a type of health-care service. Sometimes it is. However, mostly and most importantly, psychiatry is a type of social control, a legal-medical system of coercion unconstrained by the rule of law.

British psychiatrist John Crammer states the need for psychiatry thus: "The need to restrain the antisocial person leads governments to intervene both administratively and legally with these [mental] disorders." This is not true. Governments do not "intervene with disorders." They imprison persons whom psychiatrists identify as proper subjects for such disposition.

Crammer's rhetoric is characteristic of the modern psychiatrist as loyal agent of the state. First, he denies the ubiquity of psychiatric coercion: "It has not been true for 50 years that patients in mental hospitals are mostly shut up against their will." Then, he distances contemporary psychiatry from it by characterizing the practice as passé and tries to exonerate the psychiatrists from responsibility for depriving innocent persons of liberty: "Nor till recently did doctors have much to say about what went on in them [mental hospitals]; they were the servants of magistrates or county councillors." Today, they are creatures and servants of the state more than ever.

There is no war without military action, no operation without surgical action, and no psychiatry without psychiatric action. The paradigmatic psychiatric actions are civil commitment and the insanity defense, each a euphemism for depriving persons of liberty. Civil commitment—the paradigm of preventive detention—deprives the innocent individual of liberty directly, on the ground that he is "mentally ill and dangerous to himself or others." The insanity defense—the paradigm of the diversion of the defendant from the criminal-justice system to the mental-health system—deprives the person accused of lawbreaking of liberty indirectly, on the ground that he lacks "criminal responsibility." Imputing mental unfitness to stand trial to the defendant is a variation on this tactic. Both interventions deprive the subject of the opportunity to assert his right to trial, prove his innocence, or receive a finite prison sentence instead of an indefinite sentence in a mental hospital.

Regarding the injustice intrinsic to preventive detention, British historian Lord Macaulay (Thomas Babington, 1800–1859) observed: "To punish a man because we infer from the nature of some doctrine which

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he holds, or from the conduct of other persons who hold the same doctrines with him, that he will commit a crime, is persecution, and is, in every case, foolish and wicked."

Foreign Aid and Psychiatric Aid

There is a good deal of similarity between my critique of mental-health policy and Peter Bauer's critique of foreign-aid policy. This is not surprising. Each rests on perceiving and defining the "problem" in terms of a "need" for which the needy are not responsible and which they cannot relieve unaided—and a "duty to relieve" it, which is the moral responsibility of the state and its specialized agents.

Much of what Bauer said about foreign aid holds true and applies even more powerfully to psychiatric aid: "To call official wealth transfers 'aid' promotes an unquestioning attitude. It disarms criticism, obscures realities, and prejudges results. Who can be against aid to the less fortunate? The term has enabled aid supporters to claim a monopoly of compassion and to dismiss critics as lacking in understanding and compassion." He defined foreign aid as "an excellent method for transferring money from poor people in rich countries to rich people in poor countries."

The rhetoric of psychiatric aid is perhaps even more deceptive. We don't call getting a speeding ticket "receiving police services"; getting audited by the Internal Revenue Service "receiving tax services"; or being indicted for a crime "receiving legal services." But we call being involuntarily diagnosed as mentally ill and incarcerated in a mental hospital "receiving mental-health services." Paraphrasing Bauer, we could define psychiatric aid as an excellent method for transferring money from relatively poor taxpayers to relatively rich psychiatrists and other practitioners of psychiatric-psychological disablement.

Bauer scoffed at what he called "the axiomatic case for foreign aid," that is, "the unanimous opinion of all foreign-aid experts that the total amount of development aid is grossly inadequate for even the minimum needs of the developing countries." If we replace the phrase "the unanimous opinion of all foreign-aid experts" with "the unanimous opinion of all psychiatric experts," "the total amount of development aid" with "total amount of public funds spent on psychiatric services," and "the minimum needs of the developing countries" with "the minimum needs of the mentally ill," we arrive at the axiomatic case for psychiatric aid. Not surprisingly, every respectable public organization, national and international, supports both foreign aid and psychiatric aid.

Foreign aid, Bauer pointed out, is not a form of assistance given by a donor to recipient; instead, it "is paid by governments to governments," ostensibly to help the needy. The actual result is that the intermediary—typically, an African despot—uses some of the funds to line his own pockets and the rest to purchase the goods and services necessary to subjugate and terrorize his people.

The situation in the case of publicly funded psychiatric services is similar. The donors are the taxpayers. The recipients are psychiatric institutions and organizations, which use some of the funds to enrich their members and employees, and the rest to purchase the goods and services necessary to subjugate and frighten the denominated and would-be beneficiaries.

Bauer noted that foreign aid is ineffective as an instrument for raising general living standards and promoting long-term economic development in poor countries. The experience of more than 200 years has demonstrated the utter ineffectiveness of public psychiatry in reducing the incidence or severity of the conditions psychiatrists call "mental diseases."

After decades of neglect, by the end of Bauer's life, in 2002, his views gained the support of libertarian economists and some conservative politicians. Still, it is important to recognize that the forces he was up against are similar to the forces a critic of psychiatric services is up against, and that these forces continue to gain strength. ☐

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How *Not* to Respond to Higher Gasoline Prices

by David N. Laband and Christopher Westley

Mix together surging gasoline prices, a conflict in the Middle East, and a presidential election year, and what do you get? Given the sorry state of economic education among our political elites, you are likely to find bad energy-policy proposals and an increased willingness to intervene in the very market forces that are necessary to promote trade, peace, and wealth creation.

This likelihood is exemplified in the recent calls for raising the Corporate Average Fuel Economy (CAFE) standards. These 1970s-era regulations require the average car produced by an automobile manufacturer to meet a prescribed fuel-efficiency target in terms of miles per gallon.

They have always been popular with the left. Presidential candidate John F. Kerry's web site calls for increasing "our fuel economy standards to 36 miles per gallon by 2015." An Episcopal Church Public Policy Network "White Paper" argues that the "biggest single step we can take to save oil and curb global warming is to raise [CAFE] standards for both cars and light trucks." Newspapers from the *Seattle Times* to the *Birmingham News* have editorialized this year in favor of raising CAFE standards.

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This knee-jerk proposal becomes popular every time gas prices spike at the pump, and we couldn't disagree more. Not only would raising CAFE requirements restrict individual choice and weaken the property rights of manufacturers, but the costs to drivers almost certainly outweigh the benefits, on average. This means that the cure would be worse than the disease.

CAFE standards were raised significantly from 1975 to 1984, a period when we experienced much higher gasoline prices, in real terms, than we are experiencing now. In 1980, for example, the price of gasoline hit \$1.50 per gallon in Blacksburg, Virginia. Adjusted for transportation-related inflation from February 1980 to February 2004, the current price per gallon of that gasoline would be approximately \$2.98. People responded to that dramatic price increase by changing their behavior in ways that reduced the overall cost of driving: they carpooled more; they planned their shopping more carefully to reduce the number of driving trips taken; and they bought more fuel-efficient cars. Oh, and by the way, the federal government raised CAFE requirements.

The high price of gasoline not only motivated changes in driver behavior, which led to decreased demand for gasoline; it also stimulated substantial new oil exploration and development of new reserves. The combination of reduced demand and increased supply had a predictable, if not inevitable, effect on gasoline prices. Starting in the mid-1980s, gasoline prices started coming down

. . . and down . . . and down. Just three years ago, we were paying well under a dollar per gallon in many parts of the country.

Much more than CAFE regulations caused such a welcome fall in prices. In fact, the regulations themselves can have the unintended effect of increasing gasoline demand if they encourage drivers to spend additional time on the road in more fuel-efficient cars than they would in less fuel-efficient cars. If this effect results in no net change in gasoline consumption, then CAFE is inherently self-defeating in its stated purpose.

Despite this possibility, the price of gasoline tumbled in the 1990s because of market forces, not because of CAFE standards (which, after all, have been set at 27.5 miles per gallon for the new passenger car fleet since 1990). This result is hardly surprising. Price signals dispersed among millions of independent economic actors play a much more significant role in affecting gasoline prices than commands from a few bureaucrats holed up in Washington, D.C.

Such economic history suggests that gas prices have both risen and fallen *in spite of* CAFE standards. Indeed, there are compelling reasons to believe that such standards only intensify the recent increase in the real cost of driving for motorists. Technologically, automobile manufacturers can meet higher standards in two principal ways. They can improve engine processing of the fuel and reduce the weight of vehicles (since a gallon of gasoline can push a lighter vehicle farther than a heavier vehicle).

Automobile firms, which have paid over a half a billion dollars since 1983 in CAFE-related civil fines, have a strong incentive to implement some combination of these solutions. Historically, they did so by lightening the vehicles, replacing steel with aluminum. Because steel construction offers more protection, lightening the vehicles dramatically increased the safety risk and financial costs of being in an accident. (A 2001 study done by the Transportation Research Board, an "independent adviser to the federal government," concluded that lighter and smaller cars were likely responsible for 1,300–2,600 additional highway deaths in 1993.[1])

Air Bags Required

In response to this unintended consequence of government intervention in the market, air bags were required in the new-car fleet, another costly result of CAFE because federal safety rules do not allow for air bags to be reused. "Add the cost of labor, more than $1,000 for each air bag, and even more for the sensors, and the result is a totaled car," writes Eric Evarts in the *Christian Science Monitor*.[2] Insurance-premium inflation, anyone?

Two points should be remembered the next time we read about traffic deaths on our highways. First, the lighter and less safe fleet of cars, thanks to CAFE, distorts the automobile market by causing some individuals to keep older and heavier cars longer than they otherwise would, and by increasing the demand for sports-utility vehicles, which escape such regulations. In the absence of more stringent mileage standards, at least some of these individuals would gladly pay more for gasoline (per year) in order to drive less fuel-efficient, but safer cars. There simply is no defensible reason to deny those people the opportunity to make the relevant implicit tradeoffs themselves, rather than trusting that the supposed savings in gasoline prices would, in fact, exceed the benefit from safer vehicles.

Second, CAFE standards inevitably lead to significantly higher vehicle costs *and* higher risk costs with little evidence that they are responsible, by themselves, for lowering gasoline prices. This implies that the social costs of raising CAFE standards substantially exceed the social benefits.

As the saying goes, the road to hell is paved with good intentions. We'd like to see lower gasoline prices. Thanks to the laws of supply and demand, the existence of higher-than-average prices virtually guarantees that prices will come down. Raising CAFE standards hinders this process and puts us on a road we don't want to be driving. □

1. "Effectiveness and Impact of Corporate Average Fuel Economy (CAFE) Standards." See Finding 2 at http://books.nap.edu/books/0309076013/html/3.html#pagetop.

2. "New Cars Are Getting Too Expensive to Fix," *Christian Science Monitor*, April 19, 2004.

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The Most Elusive Proposition

by Manuel F. Ayau

"In a hypothetical world in which the division of labor would not increase productivity, there would not be any society."
—LUDWIG VON MISES[1]

Most explanations of the division of labor are actually explanations of increased productivity due to specialization. The most common example is Adam Smith's pin factory in *The Wealth of Nations*, where each worker becomes better at his job because that's all he has to concentrate on.

But the increase in wealth from the division of labor *per se* has to be explained on its own merits, that is, assuming no increase in individual productivity. What has to be explained is how the division of labor *itself* increases collective, not individual, productivity, be it of hunter-gatherers or an industrial society. Also needing explanation is how the division of labor came about spontaneously and flourished without a prior coherent explanation, and what mechanisms inform and induce people toward optimizing their well-being through the division of labor in the family, the group, the city, and the world. (Spontaneous generation and belated understanding are common to many other economic phenomena that, like money, have not until lately been explained by economists even though they have gone on for millennia.)

A frequently repeated explanation of the division of labor is Smith's statement of the "natural propensity to truck, barter, and exchange" Arguably, the human propensity is just the opposite: that people would prefer to be independent and self-sufficient, and that they trade because they perceive that they will be better off. They subjectively value what they receive more than what they give up. Thus people accept the disadvantage of becoming more dependent on others as a tradeoff for being better off. If people thought they would be worse off by trucking, bartering, and exchanging, we would not detect any such propensity. In other words it is correctly perceived self-interest that drives exchange.

The explanation of the division of labor that refers to *comparative cost* has been used in mainstream economic texts almost exclusively to explain international trade. But international trade is only a special case of this principle, which explains many things, including the emergence of society itself. Because of its many neglected implications, the law of comparative cost is a principle

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that deserves more attention, especially in the economics texts, for, after all, the essence of the rest of the textbooks is no more than an elaboration of how this division of labor is spontaneously coordinated by market prices, money, and so on. It is unfortunate that in the overwhelming majority of textbooks, the division of labor is largely taken for granted. So, unsurprisingly, it is a rare student who can explain how people gain by exchange, without recourse to the increased productivity of specialization.

Some explanations of trade rely on the fact that people differ in their subjective valuations and so when they trade, they relinquish something they value less than what they get in return. True enough. But in this explanation, the amount of physical output does not increase; it only changes hands. We are not told how the division of labor itself increases real, valued output without an increase in individual productivity. So let's give it a try with simple numbers.

Assume two parties in the worst case: one participant is less productive than the other in everything. This assumption is necessary to explain why the more productive party cooperates with the less productive party. (As will become clear, the sole exception would be the case in which the former is equally better endowed in every task.)

Peter and Paul require only bread (B) and garments (G). Peter makes bread twice as fast and garments three times as fast as Paul. Note that Peter's superiority over Paul is greater in making garments than it is in making bread. That is what is meant by comparative (as opposed to absolute) advantage.

Let's now see what their respective cost differences for the two products leads them to do. In looking at the results, we assume that their productivity does not increase as a result of the division of labor, or specialization. We will indicate the productivity of each according to how many loaves of bread and how many garments they can make in 24 hours. (As Mises wrote: "The theorem of comparative cost . . . does not deal with value or with prices. . . . [W]e can content ourselves with comparing only physical input and physical output."[2])

PRODUCTION *WITHOUT* DIVISION OF LABOR

Peter		Paul	
12 hrs.	12 hrs.	12 hrs.	12 hrs.
12 Bread	6 Garments	6 Bread	2 Garments
Total Production: 18 B + 8 G			

Note that their rate of substitution (or opportunity cost) is different: for Peter, one garment equals two loaves of bread; that is, in the time it takes him to make one garment he can make two loaves, or the opportunity cost of one garment is two loaves. By the same standard, Paul forgoes three loaves for every garment he makes. That difference in opportunity costs represents a potential for gains from trade for each party.

Now let's look at the results of Peter and Paul's cooperation.

PRODUCTION *WITH* DIVISION OF LABOR

Peter		Paul	
8 hrs.	16 hrs.	24 hrs.	0 hrs.
8 Bread	8 Garments	12 Bread	0 Garments
Total Production: 20 B + 8 G			

Not bad: production under a division of labor increased by two loaves of bread, without changing individual productivity or total time. The only change was in the way they allocated their time according to comparative advantage. Peter now has more garments than before and Paul has more bread, leaving them opportunities for exchange. Paul can now trade five of his loaves for two of Peter's garments, leaving them each with the same number of garments as *before* they divided the labor, but with an *additional loaf of bread*—for the same amount of effort. Thus each is better off than before.

We can also look at this picture in terms of time gained. To Peter, the extra loaf of bread represents one hour—the time it would have taken him to bake it. To Paul, the loaf represents two hours. They can now put that time toward purposes they had to forgo previously. And if we express the time gained in terms of garments, Peter will have gained one-half G and Paul one-third G. Notice that the respective gains change according to how we measure them: if we measure them with bread, the gain is equal. If we measure them in hours, Paul gains more, and if we measure them in garments, Peter gains more. Is there an "objective" measure of gain?

Obviously, trade does not come about because people go through this exercise. But they intuitively do what goes by the name of cost-benefit analysis, for they are quite conscious of what they must forgo to acquire whatever they get in exchange. In our example, with the same expenditure of time and without increasing individual productivity, the productivity of the combined effort increases the wealth of the group, creating the opportunity for exchange with mutual gain.

The coordinating mechanism is, of course, the relative prices of things with which demand and supply are expressed, the study of which is called *price theory*. With prices, it is easy for someone to do a cost/benefit analysis, to figure whether it is worthwhile for him or her to make or to save a buck. No woman would buy a skirt if she could make it with less effort than it takes to earn the necessary money. And no woman would make a skirt if she could obtain it with less work making something else and trading for the skirt (unless she values skirt-making for its own sake, say, as a hobby).

The law of comparative cost may be best illustrated by the secretary who intercepts her boss on his way to the copy machine and suggests that she make the copies. When he informs her that he knows how to make copies better than she does, she replies, "Yes, but you earn more than I do, so your opportunity cost is higher."

Among the important implications of the law of comparative cost is that the "wealth gap" in a market economy, the concern of so many people and such international organizations as the World Bank, does not mean that the rich are responsible for poverty. In the market, one can make a fortune only by trading with and by enriching others. This realization torpedoes the claim to the moral high ground of the wealth redistributionists.

Finally, comparative cost also helps us understand other "mysteries," such as how all social and even professional activities and resources, including land—however slowly—tend to be allocated by the market process (the invisible hand) in a socially optimum manner. These and other insights have important implications for tax, social, and economic policies that, given due consideration, would avoid many undesirable and unintended consequences. □

1. Ludwig von Mises, *Human Action*, 4th rev ed. (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1996), p. 144.
2. Ibid., pp. 161–62.

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The Payday-Loan Controversy

by Matthew Hisrich

Popping up in shopping centers across the country, payday-loan stores, or cash-advance shops, are one of the fastest growing phenomena of the financial sector. At the same time, they are reviled by many as parasites that feed on the poor and, along with instant bingo and dollar stores, signal the decline of quality retail in many communities.

This contempt is prompted by the high interest rates these stores charge for short-term loans. The question is, are these businesses taking advantage of people who have fallen on hard times or who place a higher value on the present than the future, or are they providing a valuable service that others are unwilling to offer?

To be sure, the interest rates charged for taking out a payday loan are sobering. As financial writer Michelle Leder points out, with an annual interest rate of up to 500 percent, taking out a $200 loan can require a person to pay back $240—assuming, that is, the loan is paid back in a week.[1] It is easy to see how someone could spiral deeply into debt under such circumstances. Nonetheless, the mere risk of engaging in a business transaction hardly justifies eliminating it as an option.

This is especially the case when conventional banks don't offer such services. Major banks clearly recognize the profit potential of cash advances; they are backing the initial public offering of at least one of the main payday-loan chains. The problem is, as Leder points out, they have their good names to protect. So while competing against the loan stores might reduce interest rates, the banks stay out of this market for fear of being labeled predatory lenders. For those with poor credit or in a financial tight spot, this means there may be no better alternative.

Rather than assuming that consumers are unable to make informed financial decisions on their own, those opposed to the stores' spread ought to consider the numbers behind the numbers. Even at the current high interest rates, Leder notes that consumers may still find cash advances cheaper than credit-card late fees or bounced-check bank fees.

Indeed, payday-loan stores may be expanding so rapidly precisely because consumers are performing such calculations. According to Leder, last year there were over 20,000 loan stores in the United States, twice the number of three years earlier. The Ohio-based Check 'n Go, one of the nation's top three chains, opened 100 storefronts last year and plans to do the same this year.

Another aspect worth considering is the role these firms play in bringing out in the open what was once the exclusive province

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of organized crime. What many who wish to advance social agendas through legislation fail to understand is that removing a legal option does not remove the demand. To the extent that "mainstreaming" this service has eliminated the many negatives of loan sharking, payday-loan stores have achieved a significant success.

The role of the entrepreneur in providing services demanded by the public is crucial to the economic advancement of everyone. Claims that this particular service is predatory belie this fact and discount the benefits obtained by those who use it. As John L. Rabenold, a Check 'n Go spokesman, explained, "Our customers don't think they're making a bad financial decision."[2]

John Stuart Mill warned that efforts to "save people from themselves" through legislation are fraught with peril. "[T]he strongest of all arguments against the interference of the public with purely personal conduct," Mill said, "is that when it does interfere, the odds are that it interferes wrongly, and in the wrong place."[3]

In his book *Liberalism*, Ludwig von Mises went even further. Not only are efforts at intervening in the marketplace ineffective, but also they necessitate either a repeal of the initial action or further intervention to address the failures that follow. According to Mises, "There is simply no other choice than this: either to abstain from interference in the free play of the market, or to delegate the entire management of production and distribution to the government. Either capitalism or socialism: there exists no middle way."[4]

Strong words, to be sure. But the debate over payday-loan stores raises large questions about the role of government in our everyday lives. In the name of defending the poor, those seeking a regulatory clampdown may do little more than take away another option from those who have few to begin with. □

1. Michelle Leder, "How the Other Half Banks," *Slate*, May 10, 2004, http://slate.msn.com/id/2100276.
2. Ibid.
3. John Stuart Mill, *On Liberty* (New York, N.Y.: E.P. Dutton & Co., 1957), p. 140.
4. Ludwig von Mises, *Liberalism: The Classical Tradition* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1996), p. 79.

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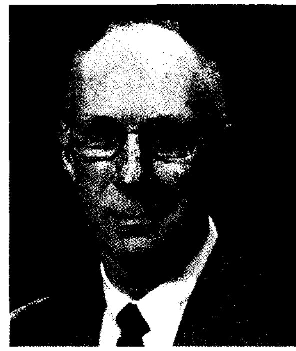
From Wartime Expedient to Permanent Pork Barrel: WFC to RFC to SBA



When the U.S. government mobilized the economy to support its participation in World War I, it intervened in the market system in many ways. Yet private capital markets continued to operate. They did not always operate, however, as the government wished. Some enterprises that the government considered essential to its mobilization program—especially in lumbering, coal mining, public utilities, and certain types of manufacturing—found themselves unable to sell their bonds or to obtain loans from private financial institutions. The problem, like so many others, was of the government's own making: massive government borrowing had "crowded out" private borrowers.

To remedy the problem, Treasury Secretary William Gibbs McAdoo recommended the creation of a government lending agency to fill the gaps opened by the Treasury's absorption of loanable funds. Congress responded in April 1918 by creating the War Finance Corporation (WFC), endowing it with a capital stock of $500 million and the authority to borrow as much as $3 billion by issuing bonds.

With Eugene Meyer, Jr., a wealthy and ambitious capitalist, as its managing director, the WFC began business as "a rescue mission for essential war-disrupted industries." In the six months that it operated during the war, it lent some $71 million to commodity-producing firms and to financial institutions making government-approved loans. It also took over from J. P. Morgan and Company the big job of stabilizing the market for government bonds.[1]

When the war ended, the WFC refused to die, notwithstanding the evaporation of its original rationale. So pregnant with political utility was this all-purpose financial rescue mission that it was destined to be revived (eventually under new names) again and again.

The first revival occurred almost immediately. With the cessation of U.S. government loans to the Allies after the armistice, European countries could not finance a continuing large-scale importation of American commodities. U.S. exporters viewed the situation with understandable horror. To forestall "confusion and despair on both sides of the Atlantic," Meyer proposed to use the WFC to finance U.S. exports, and in March 1919 he nursed through Congress a bill to authorize the expenditure of a billion dollars for this purpose. When that law expired in May 1920, he resigned from the WFC.[2]

He did not stay away long, however. Supported by bankers, businessmen, and journalists concerned about mounting problems in the agricultural economy, in late 1920 Meyer pleaded with Congress to revive the WFC, and it soon did so, overriding the president's veto and directing the secretary of the treasury to resume the WFC's funding for export-financing loans. Meyer returned as the revamped agency's managing director in March 1921. Later that year, the Agricul-

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tural Credits Act officially transformed the WFC into "a rescue mission for the nation's distressed farmers." In this phase, which lasted until January 1925, the WFC lent some $300 million to agricultural cooperatives and rural banks.[3]

As the Great Depression worsened in the early 1930s, business failures mounted, and many banks and other financial institutions went bankrupt. The clamor for government bailouts grew, and Eugene Meyer played cheerleader for another revival of the WFC, using his many contacts and his skills as a political manipulator to advance the proposal. In the circumstances, it was not hard to sell, and in January 1932 President Herbert Hoover signed into law an act "to provide emergency financing facilities for financial institutions . . . [and] to aid in financing agriculture, commerce, and industry" by means of a Reconstruction Finance Corporation (RFC), an agency plainly patterned after the WFC.[4] Naturally, Meyer became the chairman of the new agency's board of directors.

Congress provided the RFC with $500 million from the Treasury and authorized it to borrow another $1.5 billion (increased to $3.3 billion six months later). The RFC extended loans to financial intermediaries, railroads, and state governments, as well as (via the secretary of agriculture) to farmers. As Meyer's biographer notes, however, in mid-1932 "sentiment was mounting on Capitol Hill to make the RFC a sort of general relief agency,"[5] and that is precisely what it quickly became.

Fifty Billion Dollars

Jesse H. Jones, the Texas wheeler-dealer who became the RFC's chairman in May 1933 and remained in charge of it until March 1945, observed that the RFC "grew to be America's largest corporation and the world's biggest and most varied banking organization."[6] His memoirs, titled *Fifty Billion Dollars*, recount a plethora of bailouts for banks, farmers, railroads, cities and states, insurance companies, building and loan associations, exporters, and many others. All of that financial skullduggery occurred, however, before the agency achieved truly monstrous dimensions during World War II, when it financed the stockpiling of raw materials, the construction and equipping of defense plants, the building of housing for war-plant workers, and many other projects. Jones was not just huffing and puffing: $50 billion dollars was a gargantuan amount of money to dole out. Small wonder that he was widely regarded as the second-most-powerful man in the government.[7]

No surprise, either, that all that loot attracted boatloads of political schemers. Allegations of political favoritism swirled about the RFC from the very beginning and became especially unsavory during the Truman administration. "In 1949, the Hoover Commission on government reorganization advocated an end to direct lending by government, because it 'invites political and private pressure or even corruption,'" and when the Republicans captured the presidency and the Congress in 1952, they moved quickly to abolish the RFC. Not wishing to appear "the party of big business," however, they cut a deal in 1953 in which elimination of the RFC was linked with creation of the Small Business Administration (SBA).[8] The SBA has been squandering taxpayer dollars ever since. ☐

1. William Gibbs McAdoo, *Crowded Years: The Reminiscences of William G. McAdoo* (Boston: Houghton Mifflin, 1931), pp. 440–42; Merlo J. Pusey, *Eugene Meyer* (New York: Knopf, 1974), pp. 157–63 (quotation from p. 163).
2. Pusey, pp. 164–70 (quotation from p. 164).
3. Ibid., pp. 171–84 (quotation from p. 178).
4. 47 U.S. Stat 5–12, at p. 5 (for a clear statutory connection to the WFC, see Section 6, at p. 8).
5. Pusey, p. 225.
6. Jesse H. Jones, *Fifty Billion Dollars: My Thirteen Years with the RFC (1932–1945)* (New York: Macmillan, 1951), p. 3.
7. "The War Goes to Mr. Jesse Jones," *Fortune*, December 1941, p. 91.
8. Jonathan J. Bean, *Big Government and Affirmative Action: The Scandalous History of the Small Business Administration* (Lexington: University Press of Kentucky, 2001), pp. 8–9 (quotation from p. 8).

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The European Constitution: A Requiem?

by Norman Barry

At the end of last year, the much-heralded and grandiose scheme for a European constitution—an impenetrable 330-page document—came to a temporary end when Poland (admitted to European Union last summer) and Spain combined to reject a feature proposed by the European Convention even before detailed provisions of the document could be debated. M. Valéry Giscard d'Estaing, the former French president and chairman of the Convention, had boasted that this was Europe's Philadelphia, an equivalent to America's debate on the country's political future in 1787–88.

The whole enterprise foundered on an apparently technical point on voting rights in the Council of Ministers, the legislative body of the European Union (EU). However, Euroskeptics should not relax. The European constitution seemed doomed until dramatic events in Spain led to its resuscitation. The bombings in Madrid produced the surprising election of the socialists. They are very much "old Europe" and are keen to ally themselves with France and Germany, with their crypto-socialistic, heavily interventionist model. Spain immediately withdrew opposition to the constitution and was quickly followed by Poland. With June's intergovernmental conference out of the way, it's now up to the member states to ratify the constitution. But it will take a long time, and there is every chance it won't happen.

It is opportune then to step back and look at where we are now and examine critically the principles that have driven the European experiment in the last 47 years. As we shall see, from not-unpromising beginnings it has proceeded toward a new superstate at an even faster pace than America departed from its equally auspicious origins.

Originally, the most significant event was the founding Treaty of Rome (1957). European countries, nearly ruined by two world wars, wanted to put all this nationalistic bellicosity behind them, especially the deadly rivalry between France and Germany, and establish an international rule of law to make the world safe for commerce. Equally important, they wanted to face the Soviet menace while not openly conceding they were free-riding on American defense.

The first name for the new venture was the European Economic Community and that is what it was: an attempt to break down trade barriers between European countries. Though Europeans have had little interest in world free trade, it was a step in the right direction. Whatever success it had was due almost entirely to the fact that it did not have a constitution. Also, because of the unanimity rule in the Council of Ministers,

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there could be little centralization of laws and regulations. Any country could veto proposed laws. There was unformulated jurisdictional competition.

But the subsequent history of Europe is the story of inexorable centralization, significantly court driven, under the superficially alluring aegis of "ever closer union." Ironically, some of this had theoretically free-market credentials. In the early years some member states had used jurisdictional competition to hold up the advance to free markets; they had imposed limits on the movement of capital and labor. Apparently, the market had to be promoted by European-wide law, and therefore the Single European Act was adopted by treaty in 1986. At the time, most free marketeers, myself included, were under the illusion that liberty was best advanced by constitutionalism, despite evidence to the contrary from America. And the Single European Act, true to form, so far from freeing the market, licensed the imposition of strict regulations across the continent, and the veto was significantly reduced.

Since then, the centralization of Europe has proceeded apace with the gradual removal of jurisdictional competition. This has reached its apogee with the proposed constitution. A good indication of what its content would be can be found from a glance at the composition of the constitutional convention. The delegates were not in any way representative of the "people," as the men of Philadelphia were, but were European rent-seekers (seekers of wealth through political means). The European Commission (the instigator of European law) was inordinately represented, and there were aging ex-prime ministers, ex-presidents, and ex-ministers of the member states in attendance.[1] All had an interest in greater centralization. They had an agenda before they started their deliberations.

Supreme European Law

The constitution proclaims the supremacy of European law over that of the member states, presaged as long ago as 1964 with the *Costa v. ENEL* decision from the European Court of Justice (ECJ). This, with no authority from the Treaty of Rome, struck down an Italian statute that happened to conflict with an EU regulation on the ground that European law was superior to domestic legislation. It was the beginning of the activism of the ECJ.

But this did not establish unequivocally the priority of European law. There was the problem, for example, of the sovereignty of parliament in Britain and the binding constitution in Germany. Thus in *Macarthys v. Smith* (1979) the British courts held that since Britain's accession in 1973, the country's laws were subservient to Europe, but Lord Denning also said that if parliament deliberately and consistently breached European law, "it would be the duty of our courts to follow the statute."[2] In 1994, although the German constitutional court upheld the (centralizing) Maastricht Treaty, it also said that Europe was a *confederation* of autonomous legal systems and that European law was subordinate to the Basic Law (Germany's constitution).

One might have thought that classical liberals would favor the superiority of the burgeoning international law of the European Union. Hadn't unlimited parliamentary sovereignty been the principle by which socialism was introduced in Britain? But that would be a naïve view of politics and indicative of an unwarranted faith in constitutionalism to constrain the excesses of democracy. Of course, it would be acceptable if a written constitution, embodying property rights as well as civil rights, were to be consistently and accurately interpreted by a dependable judiciary. But we know from American experience that this does not happen. Written documents are no more than "parchment protections" subject always to the fashionable whims that appeal to the judiciary. Americans now have a "living Constitution" in continuous creation by the Supreme Court.

The first victim of this ineluctable process is economic liberty. In a proper federal system, with considerable power devolved to the component units, competition would generate less-restrictive laws and lower taxes. But since 1986, successive European treaties have reduced the effectiveness of the veto at the Council of Ministers, and the proposed constitution carries this process further. Some Euro-fanatics would eliminate the veto altogether and make everything subject to simple majority rule.

The European constitution aims at eliminating legal autonomy, as in Britain and Germany, by making the changes a matter of an international treaty that binds everybody. They also wish to create a Europe with its own legal personality and recognized in international law as a "state." As we shall see below, it is by no means a minimal state. Sovereignty has not been eliminated, it has simply shifted its venue—to Brussels, the "capital" of Europe.

When we come to the substantive content of the constitution, our worst fears are confirmed. The major problem in a federal system is the division of responsibilities between the center and the component units. As the anti-federalists in America rightly feared, once you create a central authority, no matter how limited its powers might be on paper, it will inevitably swallow up the member states. But at least the Founding Fathers made an attempt. The Tenth Amendment of the American Constitution explicitly says: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively or the people."

We all know that that limitation on federal power has been emasculated, culminating in *Garcia v. San Antonio Metropolitan Transit Authority* (1985), but a strict delineation is not even attempted in the European constitution. It is true that a few basic powers are reserved exclusively to the central institutions, but instead of the rest going to the member states, the constitution-makers have invented something called "shared competencies." They, in fact, cover a wide range of public policy and leave the European Commission the freedom to initiate laws binding on all member states. If there is any dispute between the Union and the member states over which has authority to regulate, it will be settled by the ECJ, hardly a reliable protector of economic rights and liberties. The constitution is replete with all sorts of emollient phrases, such as the Union's competence to "coordinate economic and employment policies of the Member States" and the general power to supervise "all objectives set by the Constitution."[3] This will undoubtedly include labor-market regulation precisely because the bigger member states, especially Germany, wish to impose their heavy non-wage labor costs on all the Union. There is also an extremely costly Charter of Fundamental Rights.

What Is a Constitution?

It is important to distinguish here between two concepts of a constitution—it can be understood as a *constraint* or a *license*. If it is the former, it puts specific limits on what the government, or one branch of it, can do. The first ten amendments to the U.S. Constitution embody constraints. It is important to stress that the constraints here apply to the *majority*. In the modern world, the imprimatur of the word "democracy" around any public-policy proposal has allowed an escape route from most constraints.[4] Traditionally, amendments to a constitution require supermajorities. However, if a constitution is interpreted as a license it becomes a document that permits governments to do things. And with activist courts, the list of permissions becomes endless; they can always find something in the wording that allows governments to act.

In America, the constraints are now interpreted as licenses. The original commerce clause (granting Congress the power to regulate interstate commerce) was designed to prevent the states' imposing tariff barriers against one another, but it eventually became the license for the federal government to regulate *intrastate* commerce, that is, to impose common standards across America (see especially, *Wickard v. Filburn*, 1942). Also, the Fourteenth Amendment, although it looks like a constraint, became a license to enforce highly controversial things, such as affirmative action. Perhaps the most permissive license ever known to political man is the phrase "ever closer union," appended to all European treaties. It has become the legal means by which the centralization of Europe has proceeded.

The ostensible reason for the collapse of the European constitution in 2003 was the proposed reduction of the qualified-majority rule at the Council of Ministers from 72.3 to 60 percent. (The rule is fixed according to the populations of the member states.[5]) The rule had been originally introduced in the Single European Act for good public-choice reasons. Under the then-prevailing unanimity rule some member states had resisted the introduction of much-needed free-market reforms.

But the attraction of that original rule change was only superficial because it led to a mania for the "harmonization" of regulations. Harmonization was not used to overcome the holdout tactics of some member states (its original rationale), but to impose uniform standards across the whole of the Union. Poland, in its opposition to the constitution, in effect spoke for all the former communist countries whose only possibility of catching up with the richer European countries was to offer much less restrictive regulations. Some countries, especially Germany, were anxious not to give a competitive advantage to the new states.

In fact, the constitution was unlikely to succeed for other reasons. Britain had already laid down certain "red lines"—mainly to do with tax, social-security, and foreign policy—which could not be crossed. Furthermore, a number of the member states had constitutions that required referendums if the European constitution were to be adopted. In fact, resentment against the European Union had been building up for some time: the pay and other emoluments of politicians and officials were blatant examples of rent-seeking. There were serious allegations that these common political practices had slipped into corruption and crime. The European Commission had been forced to resign *en masse* in 1998 for its failure to clamp down on, and its possible involvement with, dishonesty.

But despite the new confidence of the constitution-makers following events in Spain, they are unlikely to succeed. At least seven member states have referendum provisions, and these have now been joined by Britain. Despite his early trenchant opposition to a plebiscite, Prime Minister Tony Blair has dramatically bowed to public opinion; one will now be held, and he is most unlikely to win it. If one member state rejects the constitutional treaty, it is inoperative. Denmark and Ireland have already rejected treaties by referendum. It is true that the referendums have been rerun until the benighted people got it right, but Blair has already said that the first vote would be decisive. However, it would be unwise to trust politicians.

The Democratic Deficit, Referendums, and Federalism

There is repeated talk in Europe about the "democratic deficit," and indeed, in many areas decisions are made by non-elected bureaucrats. But in present circumstances, the deficit is to be welcomed: at least what remains of the veto can be used to resist the anti-market policies that, ultimately, emanate from the European Commission. And it is absurd to suppose that the European Parliament can control the executive. With a future population approaching 450 million, the "rational ignorance" of the electorate will guarantee that the European institutions—the Council of Ministers, the Commission, and the ECJ—will have virtually a free hand. They will be dominated by pressure groups.

This was a point picked up by the anti-federalists in their objections to the new American constitution.[6] They realized that the new, extended powers given to the federal government would not solve the problem of factions, James Madison's name for pressure groups. His much vaunted "extended republic" proved to be even more vulnerable to them than the several states. Who can say the anti-federalists were wrong given what now goes on in Washington?

In Europe the only way to get round this is by the restoration of decision-making to the member states and repeated use of the referendum. The best hope for the free market is a system of competitive jurisdictions where law and regulation are chosen in the way that soap and cars are. If implemented, the new constitution will more or less eliminate what remains of legal competition in Europe.

In fact, the solution to Europe's problems was right in front of the constitution makers' eyes—Switzerland. It is perhaps the most prosperous and civilized country in Europe, and it is outside the Union. It is the only genuine federal country in the world, with considerable powers retained by its component units, the cantons. They still spend more than the federal government. The achievement of Switzerland in preserving localism is almost entirely due to repeated use of direct voting at the cantonal and the federal level: for example, it requires only 100,000 signatures to challenge a federal law by referendum. The Swiss have resisted every move toward closer involvement with Europe, despite the blandishments of their federal politicians who are no doubt motivated by the rents they will capture if the country were to join the European Union.

It is remarkable, but not surprising, that the Swiss experience had absolutely no influence on the European constitution makers. The Swiss system for closing the democratic deficit will not be at all welcome to the Euro-fanatics; it is not the sort of popular control that they have in mind. □

1. See Paul Robinson, "Historical Lessons for Europe's Future in the Wake of the EU Convention," *Economic Affairs*, March 2004, p. 14.

2. Quoted in Norman Barry, "Sovereignty, the Rule of Recognition and Constitutional Stability in Britain," *Hume Papers on Public Policy*, vol. 2, 1994, p. 19.

3. See Roland Vaubel, "The Constitutional Proposals of the European Convention: an Appraisal and Explanation," *Economic Affairs*, March 2004, p. 29.

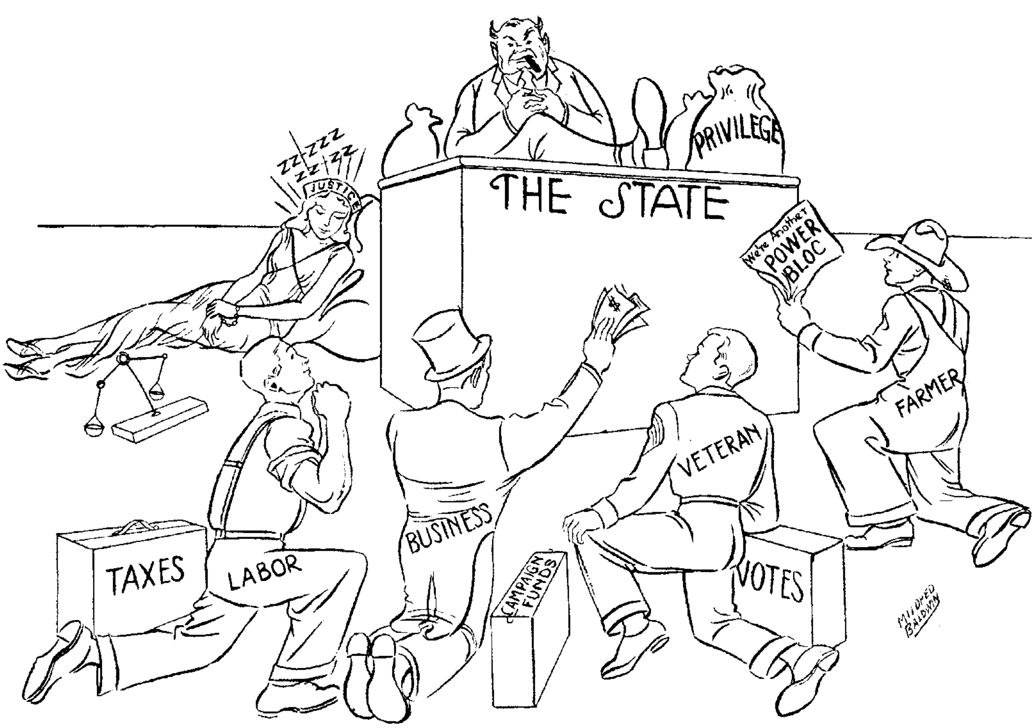
4. See Norman Barry, "What's So Good about Democracy?" *Ideas on Liberty*, May 2003, pp. 44–48.

5. See Vaubel, p. 29.

6. For a discussion of Europe in the context of the American debate, see Norman Barry, "Constitutionalism, Federalism and the European Union, *Economic Affairs*, March 2004, pp. 5–10.

"The state is the great fictitious entity by which everyone seeks to live at the expense of everyone else."

—FREDERIC BASTIAT, "The State"



Adapted from a cartoon that appeared in *analysis*, December 1946

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Ramón Díaz and the Spread of Liberal Ideas in Uruguay

by Luisa Peirano

Uruguay, a country of approximately 68,000 square miles located between two giants, Argentina and Brazil, was one of the most prosperous Latin American countries at the beginning of the twentieth century. Today, its GDP ranks low on the continent, amounting to $11 billion in 2003. A brief overview of its history will explain this decline.

Until the beginning of the nineteenth century, Uruguay was a Spanish colony. It served the military purpose of halting the Portuguese expansion in the River Plate. Curiously, internal armed unrest did not prevent the economic boom that took place between 1852 and 1875. Floods of immigrants, attracted by the possibility of making a fortune, prompted a population growth of 5.2 percent in annual terms. If this rate had continued until today, Uruguay would have a population of 200 million people instead of 3.5 million.

In the late 1800s, legislation led to the development of a free-banking system and the adoption of the gold standard. But the orientation of economic policy changed with the creation of a bank endowed with a monopoly on the issuance of currency. It was one of the first acts of government intervention in the production of goods and services.

The growth of the state in the economy was nurtured by the thought and actions of President José Battle y Ordóñez at the beginning of the twentieth century. Public monopolies were set up for electricity, insurance services, and the provision of mortgages. Battle desired nothing more than to collect economic dividends for the benefit of the state and society. He supported worker strikes and had social legislation passed in an attempt to regulate the labor market. The eight-hour-work-shift law was the first of its kind in the world. High taxes were imposed on the agricultural sector, which produced most of the country's exports.

The two world wars were not favorable to the nation because the increase in the price of commodities was counteracted by transport difficulties. In the period 1913–21 the GDP failed to grow. By then, Uruguay had already abandoned the convertibility of its currency to gold.

In 1931 an exchange-control system began to regulate the foreign currency produced by exports and used for imports. Businessmen devoted time and effort to obtaining import quotas as barriers to markets increased. The introduction of a multiple exchange-rate regime gave the authorities the means to subsidize some activities and tax others. The vested interests created by the system explain its permanence until 1970.

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The performance of the economy can be divided into two periods: 1943–55, in which foreign-trade transactions were minimal and the economy grew inward (also called import substitution) at an annual rate of 4.16 percent, and the years 1955–74, in which the GDP shrank at a rate of –0.01 percent, a period marked by high budget deficits, runaway inflation, and devaluation of currency.

By the mid-twentieth century, the welfare-state tradition was firmly rooted in the country. The "Benefactor State" grew increasingly inefficient. Emir Rodríguez Monegal, a prominent Uruguayan intellectual, pointed out that its paternalism promoted passiveness among the people and weakened the spirit of entrepreneurship.

Furthermore, the 1959 Cuban revolution attracted young Latin Americans, who looked on Cuba as a symbol of social revolution and popular resistance linked to anti-U.S. sentiment. A number of classical-liberal intellectuals tried to start a mass movement for the defense of political autonomy and human rights; they hoped to imbue the culture and media with their ideas. But free-market economic principles were associated with the influence of the developed countries, and being "imported" principles, they were outwardly rejected.

In 1966 the acceleration of inflation and the increase in social tensions led to the adoption of a new constitution. Seven years later, amid increasing economic turmoil, the armed forces closed Congress and established a civilian-military regime, which ended in 1984.

Seeking a Space for Liberal Ideas

Ramón Díaz played a significant role in opening up a space for the discussion of free-market ideas. Born in Montevideo on May 30, 1926, for many years Díaz taught political and international economy in the state university, the only university in Uruguay until 1985. (The first private university was created in that year.) As a lawyer and an economist he achieved success both in the private and public sectors.

Ramón Díaz

His encounter with the Mont Pèlerin Society, the organization of classical liberals, in 1967 was vital. He was introduced to the economist Arthur Shenfield; Antony Fisher, promoter of liberal ideas and founder of the Atlas Foundation; Milton Friedman; F. A. Hayek; and Alejandro Chafuen, who later became president of Atlas. After this meeting he methodically studied philosophy and history, mainly through books by Edmund Burke and Hayek, whom he greatly admired. He also began to publish books and articles on economic issues.[1]

Meeting foreign intellectuals was important to Ramón Díaz. When he joined the Mont Pèlerin Society he was confirmed in the belief that he was on the right path and that his position was not utopian. After the first meeting he attended in Vichy, he had annual or biannual contacts with liberals from different countries of Europe and America. Later on, at the end of the 1980s, he became president of the Mont Pèlerin Society and did his utmost to follow Hayek's vision of the organization.

Classical-liberal ideas would take a long time to spread in Uruguay, and in the 1960s no one believed that anyone there would embrace them. Any proposal favoring such ideas, especially one suggesting the introduction of market competition, was considered contrary to the welfare of society and disparaged as "capitalistic."

In 1968 Díaz was appointed vice minister of industry, and during his term of office he promoted successful efforts to bring down the rampant inflation. In 1970 he was elected director of the planning and budget office, but he resigned in October because the government, bowing to election-year pressure, refused to support some of his economic proposals. He felt deceived and decided to try other ways to make Uruguayans understand the country's economic problems and possible solutions. He committed himself to creating a new trend in public opinion.

New Journal Founded

In January 1972 Díaz founded the monthly economic journal *Búsqueda* (*Search*) as a medium for spreading liberal ideas. He had proposed the project to a group of economists, but they were skeptical about its chances for success. He went ahead anyway, with the financial support of close friends, editing the publication through 1989. Firmly believing in his mission, Díaz supported the magazine himself when funds were lacking. At the beginning of the journal's life, he and Ramiro Rodríguez Villamil did all the work, including writing the articles. Initially, few cared about the new journal that was supposed to shift the economic opinion of the country. It featured articles based on liberal philosophical ideas and analysis of the consequences of a large, heavy, and clumsy state. In every issue Díaz recorded his thoughts, sometimes signing his articles with an anagram of his own name or Adán Pérez for Adam Smith. *Búsqueda* soon had 1,000 subscribers, who turned out to be the journal's main source of revenue. Although it was supposed to be a monthly publication, *Búsqueda* was not issued on a regular basis until 1980, when the professional journalist Danilo Arbilla joined the staff.

Apart from setting up *Búsqueda*, Díaz devoted time to studying Uruguayan economic history in an attempt to reinterpret it.[2] He brought to light the liberal ideas contained in the first constitution of 1830 and showed how classical-liberal principles inspired economic policy during the first 45 years of the nation's existence.

The first Uruguayan constitution was oriented toward the protection of individual rights, notably the right to property and the freedom to work in any economic activity provided that the general interest was not harmed. Díaz traced the change in thinking to a 1917 constitutional amendment, which added public enterprises to the structure of the state. The idea that private individuals should own only small and medium enterprises and that important industrial enterprises should be owned by government became prevalent in the country.

Díaz also stressed that late-nineteenth century Uruguayan governments strongly favored a stable and healthy currency. This was due to the discipline required to maintain convertibility in the gold-standard regime. During the last quarter of the 1900s, however, the fear of worthless paper money was replaced by the fear of insufficient credit. This marked the beginning of a period in which the state became omnipresent and omniscient.

Continuation of Results

Thirty years after Díaz began working as a journalist and as a university professor, the process he started cannot be stopped. Other voices have joined him, and his ideas have spread throughout the universities and the media in Uruguay. Young professionals study abroad and bring back new ideas of economic liberty. A liberal think tank, the Center for Economic and Social Policy Research, has been established in Montevideo. In 1990–93 Díaz served as governor of the Central Bank of Uruguay during the presidency of a political leader who supported liberalism. Today he teaches the economic history of Uruguay and introductory economics at the University of Montevideo. He is also a columnist for *El Observador* (*The Observer*), a newspaper in Montevideo.

Although the process of changing opinion in a liberal direction has been slower than hoped for, nobody can deny that Ramón Díaz's mission was fulfilled. Today, thanks to his great contribution to the intellectual heritage of his country, more people understand classical-liberal ideas and the benefits of the free market. □

1. Among them: "The Political Economy of Nostalgia" in F. A. Harper, ed., *Toward Liberty: Essays in Honor of Ludwig von Mises on the Occasion of his 90th Birthday* (Menlo Park, Cal.: Institute for Humane Studies, 1971); "Uruguay's Erratic Growth," in Arnold C. Harberger, ed., *World Economic Growth. Case Studies of Developed and Developing Nations* (San Francisco: Institute for Contemporary Studies, 1984); and "Capitalism and Freedom in Latin America," in Michael A. Walker, ed., *Freedom Democracy and Economic Welfare: Proceedings of an International Symposium*, Canada, 1988.

2. Ramón Díaz, *Historia económica del Uruguay* (Montevideo: Taurus, 2003).

Dear Lawyer

The following is a letter sent to A. J. De Bartolomeo of the San Francisco law firm of Girard Gibbs & De Bartolomeo on August 6, 2004, in connection with litigation against PayPal, the Internet payment company. The suit alleged that PayPal's customers have been injured because PayPal "did not provide account statements in the manner required by the Electronic Fund Transfer Act." PayPal denied wrongdoing, but to avoid the cost of litigation, it reached a settlement. It agreed to pay $9.25 million: the law firm gets $3.3 million, and each PayPal customer who joins the suit will get $50.

Dear Mr. De Bartolomeo:

I am replying to your invitation to join, and cash in on, the class-action lawsuit you have filed against the PayPal company. Although I am an affected party and therefore eligible for money, of course I refuse to participate in the proposed settlement. Anyone with a sense of proportion and morality would refuse to be a part of it.

When a private party demands money by threatening to use force we call it extortion. A lawsuit is a demand for money by threatening to use the physical force at the command of a court in the form of policemen and jails. It therefore borders on extortion, however legal it might be. To qualify as non-extortionary, a lawsuit needs to meet two criteria.

First, the defendant should have inflicted an intentional, major injury on the plaintiff. In other words, the defendant has to do something he knew was very wrong, like deliberately driving a bulldozer into his house. If this condition isn't met, the plaintiff's lawyer is no better than a gangster holding a gun who says, "Give me ten G's on account of you wrinkled my suit."

This lawsuit does not meet this test. It does not allege, for example, that PayPal used violence against any of its customers, or that it deliberately defrauded them of their life savings. It says the company failed to implement certain government regulations. I'm sorry, but failing to follow a federal regulation hardly rates as a major wrong. Every American does it, and must do it to survive in our over-regulated society. As a satisfied PayPal customer, I am not aware I have suffered any injury as a result of PayPal's failing to adhere to these regulations (which PayPal contends don't even apply in its case). The fact that plaintiffs are to get only $50 each proves that this is a trivial "injury," one that does not merit using the threatened violence of the state to redress.

The second condition that distinguishes a legitimate lawsuit from extortion is that no one profits from the lawsuit beyond the amount necessary to make the wronged party financially whole. This suit does not meet this criterion. It does not indicate that plaintiffs suffered any monetary loss, certainly not the $9.25 million being awarded. They are just greedily cashing in. And so are you, Mr. DeBartolomeo, lining your own pockets with the obscene fee of $3.3 million.

It's dismaying to think that any of my fellow Americans will join you in this deplorable racket.

Sincerely yours,
James L. Payne

Contributing editor James Payne is the author of A History of Force.

BOOKS

Theoretical Visions and Economic Prophecies

by B. R. Shenoy, edited by R. K. Amin and Parth J. Shah

Centre for Civil Society (New Delhi) • 2004 • 200 pages each • $3.25 each

Reviewed by Richard M. Ebeling

B. R. Shenoy (1905–1978) was the most important free-market economist in India during the twentieth century. Throughout the long period when socialism and economic nationalism dominated public policy in India, Shenoy was a lone voice for individual freedom, limited government, and the market economy.

From 1929 to 1932 he studied at the London School of Economics and had the good fortune to hear F. A. Hayek deliver the lectures on the Austrian theory of money, capital, and the business cycle that were published later as *Prices and Production*. Those lectures greatly influenced Shenoy's thinking on economics for the rest of his professional life.

He also became a devoted advocate of liberty during those years at the London School. As one his biographers pointed out, "During this period he acquired considerable interest in the wider issues of social philosophy and methodology. In this connection, his ideas came to be strongly influenced by Hayekian liberalism and throughout the rest of his life, as an economist as well as a social philosopher and critic, he remained a fiercely uncompromising [classical] liberal."

After leaving England in 1932, he held a number of university teaching positions in Ceylon and India. From 1945 to 1953 Shenoy was employed as a senior economic analyst with the Indian central bank, but returned to academic life in 1954 because he desired greater intellectual freedom. He showed why he wanted such freedom when he became the leading opponent of India's second central plan in 1955–1956, offering a scathing critique of planning in general and in particular the dangers to any chance for Indian economic development from government's intrusive hand. From the 1950s to the end of his life, a time when the Indian government presumed that wealth could be created by simply creating money, Shenoy was an unbending critic of monetary manipulation and inflation.

In 1968 he resigned from his university position and founded the Independent Economic Research Centre in New Delhi, serving as director until his death in 1978. The late Peter Bauer, one of the world's leading free-market experts on development economics, praised Shenoy's "moral courage in dissenting from the Second Five Year Plan and the orthodoxy surrounding it." Bauer said Shenoy "united moral courage, intellectual integrity and technical competence to an exceptional degree."

Shenoy was a prolific writer, and was the author of such works as *Problems of Indian Economic Development* (1958), *Indian Planning and Economic Development* (1963), *Fifteen Years of Indian Planning* (1966), *Indian Economic Policy* (1968), *Indian Economic Crisis: A Program for Reform* (1968), *PL480 Aid and India's Food Problem* (1974), *Food Crisis in India: Causes and Cure* (1974), and *Economic Growth and Social Justice* (1977). A collection of some of his essays was published in 1996 as *Planned Progress or Planned Chaos?*

The Centre for Civil Society in New Delhi has recently published a wide selection of Shenoy's essays in two companion volumes, *Theoretical Visions* and *Economic Prophecies*. The first contains a series of excellent essays in which he explains the essential political and economic institutions for freedom and prosperity. This is followed by five articles on the meaning and nature of savings and capital accumulation, in which he presents an outstanding summary of the ideas of classical economists on the role of savings in economic development, as well as the Austrian theory of savings and capital formation as found in the writings of Eugen von Böhm-Bawerk.

The remaining pieces in this volume detail the causes and harmful consequences of inflation, and the importance of maintaining a sound currency based on a gold standard. Also included are Shenoy's earlier essays from the 1930s, in which he insightfully demonstrated a number of inherent weaknesses and fallacies in the writings of John Maynard Keynes.

The second volume contains 36 essays in which Shenoy defends free enterprise and the entrepreneur, demonstrating how essential they are if India is to have a prosperous future. In meticulous detail he shows the theoretical and institutional disasters caused by central planning in India. In four of the essays he outlines the harmful effects from foreign aid and how it undermined Indian agricultural development.

He also forcefully speaks out against foreign-exchange and export controls, explaining the economic distortions and political corruption they created. In this vein, he discusses the negative effects on incentives and production from government income and wage regulation, especially in the urban and industrial sectors of the Indian economy. This includes the labyrinth of licensing and other controls on private enterprise. Shenoy also demonstrates how private Indian farming is undermined by government planning, state trading in agricultural output, and price controls on farm products.

In one of his last writings in the year before his death, Shenoy explained what is necessary for prosperity in India: "The economic affairs of a free society are controlled, directed and governed by truly sovereign consumers. . . . Consumer control and direction of the economy is effected through a price-regulated market mechanism. . . . Traders interpret these price and turnover signals, and direct producers to adjust their production programs to match the consumer needs thus recorded. . . Available investment resources, i.e. domestic savings and inflows of foreign savings get shifted, through such activity of traders and producers, and via capital markets—which is an integral part of the overall price-regulated market. . . . The full and efficient functioning of a free society demands recognition of the institution of private property, not only in respect of a family house, durable consumer goods in it and a car, but also in respect of capital assets, the means of production."

All this may sound mundane and almost trivial to many readers who appreciate the nature and workings of a free economy. But in 1977 and earlier, when only socialist voices were heard in India and most other parts of the third world, these were radical and dangerous ideas. To speak them was to go against the tide and risk being viewed as an "enemy of the people." B. R. Shenoy would not be silent, and if India has been moving in more free-market directions over the last two decades, it is to a great extent because of the intellectual legacy left by this man of moral courage. ☐

Richard Ebeling is the president of FEE.

Hayek's Challenge: An Intellectual Biography of F. A. Hayek

by Bruce Caldwell

University of Chicago Press • 2003 • 489 pages • $55.00

Reviewed by Gene Callahan

Bruce Caldwell notes that "challenge" describes the career of Austrian economist F. A. Hayek in several senses. Hayek frequently challenged prevailing ideas. He opposed economic planning when its popularity was at its zenith. He rejected the theories of John Maynard Keynes even as the vast majority of economists and policy makers enthusiastically embraced them. He asserted that the social sciences need not ape the methods of the physical sciences, at a time when any other approach was considered "unscientific."

Furthermore, Hayek delved into economics, history, psychology, law, politics, and philosophy, leaving those less intellectually nimble breathless. Since he was always willing to re-consider his earlier ideas, it is often hard to pin down just what he thought on some topic. And the many thinkers offering diverse explanations of what Hayek was *really* getting at do not make matters easier. In fact, Caldwell says the "secret title" of his book is *Caldwell's Challenge.* Nevertheless, he has created a masterful work: thorough, engaging, and itself challenging.

The first section of the book examines Hayek's intellectual forebears, beginning with Austrian school founder Carl Menger. Caldwell's concise, informative historical survey is a wonderful bonus in a book focused on Hayek.

In the next section, "Hayek's Journey," we find our protagonist in Vienna, in the 1920s. Hayek, just out of graduate school, was under the tutelage of Ludwig von Mises, whose writings had converted Hayek from socialism. Hayek worked on elaborating Mises's theory of the business cycle, as well as other aspects of monetary and capital theory.

In the 1930s Hayek moved to the London School of Economics, where he had a profound influence on noted economist Lionel Robbins. He and Mises were at the forefront of what became known as "the socialist calculation debate." While developing their arguments against socialism, they became aware of fundamental differences between their Austrian approach and the emerging neoclassical mainstream.

That dawning awareness opened new vistas to Hayek. Beginning with his 1937 paper, "Economics and Knowledge," he began to explore the themes typically characterized as "Hayekian": the dispersion of knowledge, the evolution of spontaneous social orders, and the limits of human reason.

Caldwell consistently succeeds in highlighting one or two key ideas essential to a particular stage in Hayek's journey. During "The Abuse of Reason Project," Hayek focused on how ignoring the limits of human reason results in "rationally planned" disasters. "Individualism and the Sensory Order" characterizes a period when Hayek revisited his early interest in psychology and sought to differentiate true individualism from its caricatures. "Rules, Orders, and Evolution" refers to the maturation of his ideas on law, morality, institutions, and social order.

The final section of the book surveys the journey from an aerial perspective, both summarizing Hayek's achievements and examining what basis they might offer for further research. Already, others have built on his legacy. Contemporary theorists in cognitive science often have proceeded along Hayekian lines. Hayek's work on complexity and spontaneous order anticipated the contemporary surge of interest in such topics by decades. He is cited as a forerunner of agent-based computational economics, an emerging field studying how complex macroeconomic phenomena can arise from agents following simple rules.

In a few places I disagree with Caldwell's interpretations. For instance, he disputes the common notion that Hayek's paper "Scientism and the Study of Society" marked a "hermeneutic turn" in his theorizing. (The hermeneutic approach to social science focuses on people's own interpretation of their circumstances as an explanation for their actions.) Instead, Caldwell writes, Hayek wanted to refute materialist reductionists and behaviorists on scientific grounds. Therefore, he came to emphasize the distinction between simple and complex phenomena, rather than that between human actions and mechanical occurrences.

It is true that Hayek shifted his emphasis. But I dispute two aspects of Caldwell's account. First, while I agree that the paper "Scientism" did not represent a hermeneutic turn for Hayek, that is because Austrian thought generally has followed a broadly hermeneutic approach, so that we find Hayek emphasizing meaning well before "Scientism." Second, if it is true that meaning is essential to comprehending human action, then there is nothing "scientific" about discounting its importance.

Caldwell also disapproves of Mises's contention that economics is, at its core, an *a priori* discipline, based on insight into universal principles that underlie all action. However, in several other passages Caldwell asserts the primacy of "basic economic reasoning" in the subject. But it was never clear to me how Caldwell's notion differs significantly from Mises's. Is it just that it doesn't contain the offensive term *a priori*?

Despite such quibbles, I highly recommend Caldwell's book. Indeed, I believe it is mandatory reading for anyone attempting to seriously engage Hayek's work. □

Gene Callahan is a free-lance writer and author of Economics for Real People.

The Future of Freedom: Illiberal Democracy at Home and Abroad

by Fareed Zakaria

W.W. Norton & Company • 2003/2004 • 286 pp. • $24.95 hardcover; $14.95 paperback

Reviewed by Gene Healy

Modern political discourse often treats democracy as if it were synonymous with liberty. In *The Future of Freedom*, Fareed Zakaria aims to refute that facile notion and reinvigorate the distinction between the two. As Zakaria puts it, pithily: "The execution of Socrates was democratic but not liberal."

Zakaria's book is an extended brief against the fetishization of democracy, and it's exceptionally well-argued. The author echoes the great classical liberals in arguing that democracy is a means to an end, not an end in itself. *Liberty*, as Lord Acton said, is our highest political end. What we're after—in developing countries and in our own country—isn't a system where anything goes, so long as the majority decides. On the contrary, what we want is, first, liberty and law, and then and only then, majority rule. After the rule of law is established, the political process will, and should, open up. But to imagine that "all we need is free elections" is to fundamentally misconceive the problem of democratic development.

One of the more interesting sections of the book discusses the relationship of economic growth to participatory institutions. As a country gets richer and develops a middle class independent of the state, the prospects that its political process will open up are enhanced. Zakaria cites social-science data showing that, historically, when a country has passed $6,000 in per-capita income (in today's dollars), its chances of successfully maintaining democratic institutions are virtually certain.

Wealth matters—but not just any kind of wealth. In fact, as Zakaria shows, wealth derived from natural resources can impede liberalization and the transition to democracy. Such unearned riches can be a curse, he explains. In autocracies without an independent source of wealth in the form of natural resources, the government has an incentive to provide a framework of neutrally administered laws that facilitate wealth generation, which can in turn provide revenue for the state. The independent middle class that emerges, in turn, has an incentive to hold the state accountable. But in "trust fund states" like Nigeria or Saudi Arabia, the governments have a ready source of revenue, and less incentive to liberalize.

With all that in mind, Zakaria proposes several countries as "the most likely prospects where democracy, if tried, could over time become genuine and liberal": Romania, Belarus, Bulgaria, Croatia, Malaysia, Turkey, Morocco, Tunisia, and Iran. (Although Iran is an oil state, Zakaria includes it because "it has always had a strong non-resource-based economy as well.")

You'll notice a conspicuous omission from that list—Iraq, which Zakaria in a recent speech half-jokingly called "our 51st state." What's surprising, then, is how sanguine Zakaria is about our current quest to transform Iraq from a bureaucratic despotism into a commercial republic. In a passage drafted before the invasion of Iraq in March 2003, Zakaria writes, "Were the United States to dislodge Saddam and—far more important—engage in a serious, long-term project of nation-building, Iraq could well become the first major Arab country to combine Arab culture with economic dynamism, religious tolerance, liberal politics, and a modern outlook on the world."

Yet Iraq fails most of the preconditions Zakaria outlines for successful transition to a liberal, democratic regime. It's a trust-fund state, lacking an independent middle class. It has a level of literacy (58 percent) that's low even for the Arab world. Unlike postwar Japan and Germany, it's really three countries rather than one—fragmented among Sunnis, Shiites, and Kurds. And even within subnational groups Iraqi society is unusually tribal. As John Tierney has reported in the *New York Times*, half of all marriages in Iraq are between first or second cousins, and nepotism is seen "not as a civic problem but as a moral duty."

Throughout *The Future of Freedom*, Zakaria treats liberalization and democratization as an incredibly subtle, complex, and contingent evolutionary process. What's surprising, then, is that, when it comes to Iraq, he proceeds as if liberal institutions are the product of conscious design, easily transferable from one country to another by force and fiat. The rest of the book gives readers little reason to be sanguine about the prospects for turning Iraq into a liberal democracy.

Despite Zakaria's unreasonably optimistic take on Iraq (a view from which he seems to have backed off recently), his book is a welcome reminder of what we should really be after when we talk loosely of "democratization." His aim is not simply a political system in which everyone has a vote and a voice. It's a system in which the most important matters—the security of life, property, and civil rights—are not subject to a vote at all. ☐

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World on Fire: How Exporting Free Market Democracy Breeds Ethnic Hatred and Global Instability

by Amy Chua

Anchor Books/Doubleday • 2002/2004 • 294 pages • $26.00 hardcover/$14.00 paperback

Reviewed by George C. Leef

The list of complaints against laissez-faire capitalism is long, including such contradictory notions as its guilt in impoverishing the masses and its role in enabling the poor to escape their "proper" station in life. In *World on Fire*, Amy Chua adds to the list, arguing that capitalism, when combined with democratization in economically developing nations, produces violence. The reason is that "market-dominant" minorities amass far more wealth than the majority population group does, unleashing resentment against their success.

Understand that Chua is not advocating socialist economic controls. She forthrightly states that "Market capitalism is the most efficient economic system the world has ever known." But her book may be read by opponents of the free market as proving that government policy should be used aggressively to redistribute wealth in order to avoid the kind of violence she describes. For that reason, it is worth examining *World on Fire* to see if Chua makes her case, and if so, what conclusions logically follow.

Chua, a professor at Yale Law School, begins with a painful personal experience. Her aunt was brutally murdered in the Philippines, a victim of anti-Chinese violence. In the Philippines, as in many other nations, ethnic Chinese have been more economically successful than the indigenous population generally. That wealth disparity has been seized on by demagogues eager to exploit the envy of their less successful countrymen. Consequently, many Filipinos have come to believe that violent "retaliation" against Chinese "exploiters" is justified. Chua points to many examples around the world of majority hatred directed against "outsiders" who, by virtue of their superior business acumen, become conspicuously wealthy.

The author's contention is that envy-driven violence against "market-dominant" minorities is apt to occur when a nation moves from political authoritarianism to democracy at the same time it moves from a centrally planned or highly regulated economy to capitalism. That combination, she maintains, leads to rapid accumulation of wealth for a few, but the breaking of the political restraints that had previously held outbreaks of racist envy in check. How to deal with that problem is a question she leaves unexplored.

I don't find Chua's thesis convincing and certainly do not think that the way to avoid outbreaks of racially driven violence against those who prosper the most under capitalism is to maintain socialism.

First, her examples do not provide much support for her contention that the combination of laissez-faire economic policy and political liberalization is an incendiary mix. That is because the world is virtually bereft of instances of significant reforms in both directions. Chua continually writes about nations that have adopted "free-market democracy," but the cases she cites involve no more than small steps in those directions, especially toward capitalism. For instance, she notes the ethnic violence in Zimbabwe, but that pitiable nation remains a state with little freedom of any kind.

Second, it is easy to find instances of the sort of violence against the economically successful occurring without either of Chua's two conditions being met. She cites anti-Jewish violence in Russia as a case in support of her argument, and while it's true that Russia has moved somewhat in the direction of political and economic freedom over the last decade or so, there was a great deal of violence against Jews by majority Russians for centuries under the autocratic rule of the czars. The fact is that even under highly authoritarian regimes, some people—whether they are from a "market-dominant" minority or not—figure out how to become wealthier than most of their countrymen and thereby make themselves targets for violence by those who resent their success. Increases in political and economic freedom don't necessarily have anything to do with envy-based violence.

A third difficulty with Chua's thesis is that she attributes ethnic violence to hatred engendered by economic success of a minority group without considering that the violence may have its roots in simple racism. There was, after all, violence against the Chinese in the United States in the late nineteenth century that cannot be said to have been caused by their "market dominance."

Finally, remember that in journalism, bad news sells. Chua is so eager to create an issue with the alleged danger of "free-market democracy" that she says nothing about the upside of freedom. As Samuel Johnson wrote, man is rarely so innocently employed as when he is making money. What capitalism does is liberate all people from state-imposed restraints and eventually spread prosperity to nearly everyone. Nothing does more to reduce violence and many other social ills than the rising standards of living that capitalism alone makes possible.

All that *World on Fire* proves is that governments cannot be depended on to prevent violence against people who have been, for whatever reason, demonized by others. That's nothing new. □

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China's Future

The threat to China's future development is not lack of resources or technology, but the absence of an institutional framework that limits government and protects property rights. It has been 15 years since the Tiananmen Square massacre in June 1989, and 25 years since Deng Xiaoping embarked on economic reform in 1979. China is now one of the most open economies in the world, with exports plus imports accounting for nearly 62 percent of GDP. Yet little progress has been made in limiting the power of the Chinese Communist Party (CCP) over fundamental human rights.

Freedom of speech and assembly are guaranteed in the Chinese Constitution, but they have no substance in the law. The CCP continues to use its monopoly position to enrich insiders at the expense of the public. Small fish may be caught, but it is rare for high party officials to be ousted or penalized for corrupt behavior. Local leaders impose arbitrary taxes on farmers and confiscate land without just compensation. And developers in urban areas use party connections to fleece long-time property owners who have little recourse for legal action.

While China has normalized its trade relations, its progress in normalizing personal liberties is dismal. That failure will prevent China from realizing its full potential—for unless people are free to pursue their dreams and exercise their natural rights to liberty and property, they cannot fully develop.

The recent amendments to the Constitution, which were approved by the National People's Congress (NPC) last March, look good on paper, but lack any credible enforcement mechanism. There is no independent judiciary or constitutional commission to safeguard either persons or property.[1] "Judicial review" is solely up to party leaders. Even if a constitutional commission or court were instituted, it would be meaningless so long as the CCP has a monopoly on power.

Article 13 of the Constitution, as amended, states, "The lawful private property of citizens is not to be violated," and Article 33 now reads, "The state respects and safeguards human rights."[2] Those two amendments signal the growing importance of the private sector to China's future development. As Wang Zhaoguo, vice chairman of the NPC standing committee said, "With economic development and the rise in living standards, many people have varying levels of private property or factors of production. So they see a strong and urgent need for their properties to be protected."[3]

Unfortunately, the CCP is unlikely to undermine its power by respecting property rights broadly construed. The very essence of the Communist Party is to deny others the rights it claims for itself, and only state property is deemed "sacred." The reality is that inequality of power, not equality of rights, is

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the brand name for the CCP. In the "People's Republic," some are more equal than others. Those who sit on the Politburo Standing Committee are more equal than local officials, and CCP members more equal than ordinary citizens.

The relation between the individual and the state is upside down. As constitutional reformer Cao Siyuan notes, the citizen should be the master and the state the servant, but it is just the opposite.[4] Those who try to turn China's political system right side up will be dealt with harshly, as were the brave leaders of the democracy movement and former Communist Party General Secretary Zhao Ziyang, who is still under house arrest for merely suggesting dialogue rather than force to resolve the standoff in Tiananmen Square.

The Legacy of Central Planning

Prior to 1989, China was beginning to liberalize both its economic and political system. Today, there can be no return to central planning, but the legacy of that era is a political apparatus that is inconsistent with private property rights and individual freedom. According to Li Shuguang, a professor at the China University of Politics and Law, China's civil code reflects the loss of freedom that resulted from the planned economy.[5]

Economic liberalization has no doubt put some cracks into the edifice of the state. Individuals have more personal space than they did before the growth of the nonstate sector, and a nascent civil society is developing outside of political society. Politics does not dominate everyday life as it did during the Cultural Revolution. As Wang Dan, one of the leaders of the 1989 democracy movement, notes, "Since the early 1990s, shoots of civil society have begun to sprout within China. As more Chinese enter the private sector, the state is no longer able to control every aspect of daily life in the way it used to."[6]

State-owned enterprises now account for less than one-third of industrial output-value and employ far fewer workers than even a decade ago. Individuals can own their own homes, travel abroad, use the Internet, work in the private sector, and speak more freely. But all those freedoms are restricted: the state continues to control the media, narrowly limit investment options, and prohibit widespread privatization of state assets.

Beijing's adherence to market socialism is understandable, given the income party officials are able to plunder by continuing to control investment spending and ration funds through politics rather than market interest rates. Allowing capital freedom and widespread privatization would depoliticize economic life and end the party's monopoly on power.

It may be that China has no choice but to open its capital markets and allow freedom of the press if it wants to become a major player in the global financial markets. The forces of globalization and the information revolution may be China's path to freedom. The continued shrinkage of the state sector will eventually make the CCP obsolete.

Political reform will then be from the bottom up, like economic reform.[7] The state can then perform its legitimate role of protecting fundamental human rights and recognize private property as the bedrock of liberty. That is a vision Chinese liberals long for and one all the Chinese people deserve. ☐

Walter Williams's column will return in the January-February issue.

1. See Veron Hung, "China's Constitutional Amendment Is Flawed," *International Herald Tribune*, March 5, 2004.
2. For a useful listing of the new amendments, see "Constitutional Amendments Approved by the National People's Congress in March 2004," Congressional-Executive Commission on China (www.cecc.gov).
3. "China's Landmark Constitutional Change Safeguards Private Property," March 8, 2004, www.channelnewsasia.com/stories/eastasia/view/74416/1/.html.
4. Cao Siyuan is a prolific writer and commentator. He is director of the Beijing Siyuan Research Center for Social Sciences and has been a major advocate of privatization (see www.caosy.com).
5. Jia Hepeng, in an interview with Li Shuguang, reports that Li sees the present civil code, which offers little protection to persons or property, as "a result of the planned economy, giving people few rights." "Constitutional Revision Requires Law Adjustment," *China Business Weekly*, March 8–14, 2004, p. 23.
6. "Fifteen Years after the Massacre," *Wall Street Journal*, June 2, 2004, p. A14.
7. Wang Dan has given up any hope of top-down political reform and now argues, "China's democratization must be a bottom-up process, driven by forces outside the Communist system." Ibid.