THE
FREEMAN
IDEAS ON LIBERTY

VOLUME 59, NO 10 DECEMBER 2009

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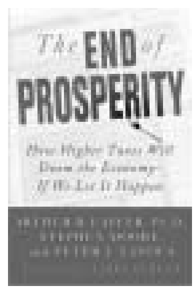

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Published by
The Foundation for Economic Education
Irvington-on-Hudson, NY 10533
Phone: (914) 591-7230; E-mail: freeman@fee.org
www.fee.org

FEE The Foundation for Economic Education (FEE) is a nonpolitical, nonprofit educational champion of individual liberty, private property, the free market, and constitutionally limited government.

The Freeman is published monthly, except for combined January-February and July-August issues. Views expressed by the authors do not necessarily reflect those of FEE's officers and trustees. To receive a sample copy, or to have *The Freeman* come regularly to your door, call 800-960-4333, or e-mail mnolan@fee.org.

The Freeman is available on microfilm from University Microfilm International, 300 North Zeeb Road, Ann Arbor, MI 48106.

Cover by Tim Kelly

Perspective

Monsieur Bastiat, Call Your Office

In September I lectured at the Liberty Weekend Dedicated to the Life and Legacy of Frédéric Bastiat, sponsored by the Polish-American Foundation for Economic Research and Education (PAFERE) in Warsaw. Preparing for my visit, I reread Bastiat's great book *The Law*. Oh do we need Bastiat today! *The Law* is the kind of book you can read a couple of times a year to great advantage. It's amazing how much Bastiat packed into that little book. Each time I read it, I come across some point that is particularly relevant to our time and find myself thinking, "I didn't remember that!"

This time it happened on p. 31, where Bastiat writes, "Socialists look upon people as raw material to be formed into social combinations. This is so true that, if by chance, the socialists have any doubts about the success of these combinations, they will demand that a small portion of mankind be set aside *to experiment upon*. . . . And one socialist leader has been known seriously to demand that the Constituent Assembly give him a small district with all its inhabitants, to try his experiments upon."

Two things occurred to me as I read this. First, you don't have to be socialist to believe that people are raw material to be experimented upon. And second, in modern America, doubts or no doubts about success, experiments can be run on the entire country at once. No need to try things out first on a small district.

As for point one, I have in mind the current administration. The word "socialist" (as well as "fascist") is thrown around too glibly today, and everyone ought to be more careful. Lots of bad things are being proposed that would interfere with the market process, but no one in power is proposing to replace the market with central planning. Ludwig von Mises called the philosophy behind the mixed economy "interventionism," and we ought to be working to make that word the pejorative we know it deserves to be.

Point two, of course, refers to the Obama administration's experiments on the health-insurance, financial, and energy industries. Without getting into details here, I want to emphasize the sheer presumptuousness of those experiments. Those are our lives they are fooling with.

Bastiat brimmed with controlled outrage at the French politicians and writers who so blithely presumed that other people's lives were theirs to dispose of in grand experiment. He dissected the classical notion, popular among the pundits of his day and ours, that individuals are inert until a wise leader comes along and invests them with a principle of motion—"They assume that people are susceptible to being shaped by the will and hand of another person—into an infinite variety of forms, more or less symmetrical, artistic, and perfected," he wrote.

This superior attitude is palpable throughout the Obama administration. One sees it in the words and tone of the President, Geithner, Summers, Emanuel, Sebelius, Clinton, and their allies in Congress. In a profound way, *they* are the anti-egalitarians. *They* know better than we. *They* exercise powers that we mere individuals outside of government can never possess. *They* dictate to us, but we can't dictate to them. *They* get to determine our lives in important ways—which means that in those respects we don't.

Yes, they claim to represent us. It's a baseless claim! They are not our representatives. They do not know us, and they cannot really care about us. They are our rulers, gratifying their ambitions to "make a difference"—whether we want it made on our lives or not. If we don't comply, they can take our liberty, our property, even our lives.

Depriving them of that power is a long and arduous educational process requiring a philosophical sea change. In the meantime, those of us who know that we, and not they, own our lives, need a battle cry. In dedication to Bastiat, I propose this:

We shall not be experimented upon!

* * *

When President Obama intervened in the bankruptcies of GM and Chrysler, longstanding financial-legal precedents went by the wayside. What consequences will this have for the future? Richard Epstein ponders this question.

The numbers are in on Cash for Clunkers. Despite the program sponsors' and participants' euphoria, it was a bad deal all around. Bruce Yandle has details.

New Nobel laureate Elinor Ostrom explained how people voluntarily coordinate to solve problems. Peter Boettke says every freedom-lover should rejoice in her prize.

When it opened its doors in 1914 the Federal Reserve System was supposed to bring stability to the U.S. economy. It didn't quite work out that way. Chidem Kurdas explains why.

Why don't we ever hear older people reminisce about how tough life was during the depression of 1920–21? Maybe it's because that one, unlike the Great Depression, was what W. S. Gilbert might have called a short sharp shock. Robert Murphy describes the depression history forgot.

Mexico's violent drug trade has spilled across the border, creating concern throughout the United States. There's an easy way to stop it, Paul Armentano writes: End the war.

Belief in manmade climate change once led to large-scale economic and personal dislocation. That was in the nineteenth century. Will it happen again? Tyler Watts reminds us that we can learn from history.

Here's what's been on our columnists' minds lately: Lawrence Reed recalls the influence that a movie had on him long ago. Thomas Szasz remembers those whom the criminal justice system has forgotten. Robert Higgs looks at the case for slavery. John Stossel finds it curious that big pharmaceutical and big insurance companies like Obama's healthcare plans. Charles Baird analyzes the latest papal encyclical on labor unions. And Art Carden, confronting the claim that profit has no place in the healthcare system, responds, "It Just Ain't So!"

Our reviewers test-drive books on the effect of higher taxes, the bloated presidency, the dollar, and Paul Krugman's view of the economy.

Capital Letters features readers' reactions to past articles.

It's December, which means the issue wraps up with the year-end index, prepared by Managing Editor Michael Nolan.

—Sheldon Richman
srichman@fee.org

The Sound of Freedom

BY LAWRENCE W. REED

When I have the chance, I often pose this question to people who have become advocates for liberty: "What was it that first turned you on to these ideas?"

It's an important question that always produces revealing answers and sometimes some fascinating stories. Liberty, keep in mind, is not automatic or guaranteed. Few people who have lived have actually possessed it; most have been serfs, slaves, or "subjects" of one sort or another. It's not exactly a message that rolls off the tongues of most university professors, government school teachers, or media personalities these days. It takes a lot of work to get the message out. Like the seeds in the New Testament parable about the sower, ideas don't always fall on fertile ground.

I've heard plenty of answers over the years: parents, a book, instinct, an article, a friend. And yes, on occasion, even a teacher or a professor. Maybe I'm unusual (I've been accused of much worse!) but for me it was a movie. Here's my story.

> *The Sound of Music* was a rude awakening. Something sparked inside me, and it has stayed lit ever since.

My family never showed much interest in politics or philosophy. I don't know of anybody on either my mother's side (English and German) or my father's side (Scot-Irish) who ran for office, wrote a book, or raised a public fuss of any kind. As far as I know, going back more than a century, my relatives were mostly farmers and small shopkeepers who worked hard, kept quiet, and minded their own business. The only time I can recall my dad making a political statement during my childhood was when the school principal called to tell him he couldn't take me out of school for a week to visit relatives in Florida. He told the principal, "He's my son, not yours, and he's going to Florida. Don't call here again!" Click.

In the summer of 1965, as I was nearing my 12th birthday, my mother announced one day that she was taking my younger sister and me to a theater in Pittsburgh, 40 miles from our home, to see a new film called *The Sound of Music*. I knew nothing of it other than that a lot of singing was involved. To my mind, that was a good enough reason to stay home. I went reluctantly—and was enthralled. The music and the scenery were memorable, but it was the plot and message that changed my life. I think it must have been the first time I really had to think about the fact that the freedom I took for granted was not the norm in the world.

The movie quickly became the box office king of 1965. An American movie aimed primarily at an American audience, it loosely told the story of the von Trapps of Austria and how the family escaped Hitler's grasp. The beauty of the Alpine mountains and the village of Salzburg spurred a pilgrimage of American tourists to Austria that continues to this day. Todd S. Purdum of the *New York Times* refers to the film as "the last picture show of its kind, a triumph of craftsmanship and the apogee of the studio system that produced the kind of entertainment that dominated mid-20th-century mass culture."

For me, *The Sound of Music* was a rude awakening. This wasn't a school telling me that I couldn't take a vacation. This was a foreign regime absorbing a peaceful, neighboring country and a father facing orders to abandon his family and serve in its military. Something sparked inside me, and it has stayed lit ever since. I wanted to know more about the history of that

Lawrence Reed (lreed@fee.org) is the president of FEE.

period, and I began reading everything I could get my hands on, including William L. Shirer's classic *The Rise and Fall of the Third Reich*. Stories of people yearning for freedom and going to great lengths to secure it captivated me. Socialism, communism, fascism, and all the collectivist *isms* became anathema. They reduced to A pushing B around because A thinks he's got a good idea.

Then came the "Prague Spring" of early 1968. It wasn't Austria, but it was right next door. The news of the stirrings of liberty in communist Czechoslovakia dominated the newspapers and television. I cheered as the Czechs boldly rattled their Soviet cage. When Moscow crushed Czech liberties with troops and tanks, I was outraged and eager to say so. Within days, a blurb in the local newspaper mentioned that an organization called Young Americans for Freedom would be holding a rally in Mellon Square in downtown Pittsburgh to protest the invasion. I bought my first bus ticket. We burned a Soviet flag and carried placards calling for the liberation of Czechoslovakia.

In those days, YAF provided its new recruits with a wealth of books, magazines, and articles—most notably for me, F. A. Hayek's *The Road to Serfdom*, Henry Grady Weaver's *The Mainspring of Human Progress*, Henry Hazlitt's *Economics in One Lesson*, and a subscription to *The Freeman*. The message was simple: If you want to be an effective anticommunist, you had better know something about philosophy and economics.

Reading all that material taught me some critically important things:

- Ideas rule the world. Tyranny rests on bad ideas; freedom depends on good ones, such as personal responsibility and limited government.
- Freedom is never automatic. You have to work at it, endure setbacks and assaults, and resist the temptation to let somebody else fight freedom's battles for you.
- Government unchecked is freedom's greatest enemy. Expecting too much from government and too little from ourselves is the surest path to tyranny, even though the government's promises of welfare and security may sound attractive.

> Ideas rule the world. Tyranny rests on bad ideas; freedom depends on good ones.

Those ideas, and many of their corollaries, led me to pursue an economics degree at a place that teaches the values of liberty: Grove City College in Pennsylvania. From there I went on to be a teacher myself, first at Northwood University and then as president of the Mackinac Center for Public Policy. Liberty has been a common theme of my political thought through all those years.

If my mother had not insisted on making the trek to Pittsburgh to see *The Sound of Music*, maybe I would have become a promoter of freedom by some other route. But in hindsight, I have my doubts. It seems more likely that I'd be a photographer or a veterinarian today. Those are respectable and fulfilling professions, to be sure, but they're not what I chose.

So I owe much of my last 40 years to a couple of hours in front of the big screen. Some say *The Sound of Music* was corny, but for me it was an epiphany. It's my favorite film, and it always will be. FEE

Profit Is Bad for Your Health? It Just Ain't So!

BY ART CARDEN

Many self-styled healthcare "reformers" favor a "public" (read: government) insurance option. The advantage of the government plan, President Obama said, is that "there wouldn't be a profit motive involved." Some supporters hoped the public option would be a step toward a single-payer government-run system in which the profit motive would disappear entirely from healthcare decisions.

Suspicion of profit runs deep. In an *Atlanta Journal-Constitution* op-ed, Cynthia Tucker spoke for many last summer when she wrote, "The for-profit health insurance industry is in the business of maximizing profits for their shareholders, and *the only way* they can do that is to hold down the payments they make for medical care" (emphasis added).

It just ain't so. Holding down payments unreasonably or in violation of contract would give a company a bad reputation. Firms with bad reputations would have a difficult time attracting future customers in a competitive market, George Mason University economist Bryan Caplan argues (www.tinyurl.com/lwd88j). What would happen to profits then? Reputation provides a powerful incentive against the conduct Tucker fears. However, reputation would be a more potent force if people bought their insurance directly rather than through their employers. Nevertheless, the potential for profit does not lie simply in minimizing the payment of benefits.

Health insurance competition is sparse because, among other things, the federal government forbids interstate competition.

But, Tucker argues, "There is no real competition among insurance companies, as recent research has shown." She's right. Competition is sparse, however, not because of any inherent market failure but because, among other things, the federal government forbids interstate competition. The purpose of the prohibition is to prevent consumers from finding better deals than those permitted by their state insurance regulators. The protectionist limit on competition is fine with the insurance companies, confirming *Freeman* contributing editor Steven Horwitz's First Law of Political Economy: "No one hates capitalism more than capitalists."

Admirably, Tucker takes Republicans to task for not doing something about competition when they could have. But the failure to repeal a bad policy hardly justifies piling a new bad policy on top of the old.

Profit: the Cure, not the Disease

Some people are repulsed that doctors and insurance companies profit from illness; indeed, Michel de Montaigne wrote a famous essay in which he argued that "the profit of one man is the damage of another." Illness, however, isn't the source of profit. Rather, as FEE web columnist William Anderson points out, it's the ability and opportunity to make someone well (www.tinyurl.com/mfttw4).

In a *Freeman* article last year, Horwitz went further (www.tinyurl.com/m4nd2j): "Profit is not just a motive;

Art Carden (art.carden@gmail.com) is an assistant professor of economics and business at Rhodes College in Memphis, Tennessee.

it is also integral to the irreplaceable social learning process of the market. Critics may consider eliminating the profit motive the equivalent of giving the Tin Man from Oz a heart; in fact it's much more like Oedipus' gouging out his own eyes."

Advocates of government-run health care argue that the profit-driven U.S. system is inferior to its Canadian and European counterparts. There is plenty of reason to doubt that claim, but more fundamentally, a system with government-subsidized consumption (Medicare, Medicaid, and tax-advantaged employer-based insurance) and government-constricted markets is not the system free-market advocates have in mind.

Some also argue that private for-profit insurance has higher administrative costs than the government's nonprofit Medicare program. But lowering such costs is no free lunch. Economist Greg Mankiw points out that "Low administrative costs are not to be confused with high administrative efficiency" (www.tinyurl.com/mcw6e5) and cites his colleague Malcolm Sparrow, who argues that "health care fraud and abuse [cost] hundreds of billions of dollars per year. . . . The rule for criminals is simple: if you want to steal from Medicare, or Medicaid, or any other health care insurance program, learn to bill your lies correctly. Then, for the most part, your claims will be paid in full and on time, without a hiccup, by a computer, and with no human involvement at all" (www.tinyurl.com/yzfdjuk). If anything, this suggests that administrative costs for Medicare and Medicaid might be too low.

> The profit-and-loss system is as badly needed for medical services as it is for any other product or service.

A Learning Process

It's a misconception that profit is something tacked onto the price of goods and services. If that were so, why would profits change from year to year and why would companies go out of business? Profit and loss are indispensable to consumer well-being because resources are scarce and have alternative uses. How do we decide how much to devote to making people well and how much to devote to feeding, clothing, entertaining, and educating them? It isn't merely that this is a difficult question to answer. It is literally impossible to answer in any meaningful way without market prices, profits, and losses.

Profit rewards the entrepreneur who takes a risk in transforming resources into products she correctly thinks consumers will value more than those currently being made with those resources. Entrepreneurs get needed feedback from profits and losses. If they create value, profits are the reward. If they destroy value, losses are the punishment. In a free market no entrepreneur may rest on her laurels. Profits attract competition and are competed away before long. So the incentive to innovate and economize is strong.

Contrast this with government. On several online networks I asked for examples of successful and sustainable government programs giving away 12- and 13-figure pots of money. The best examples were infrastructure and basic research (www.tinyurl.com/m3svcb), but even these aren't disciplined by the market. Without market prices—and the possibility of profit and loss—we can't calculate the opportunity cost of any given project. Our experiences with the Cash for Clunkers and ethanol debacles do little to inspire confidence.

Profits and losses provide crucial information that enables producers to engage in rational economic calculation in the service of consumers. Grasping this is one of the most important contributions economics has made to our understanding of the world. Thus the profit-and-loss system is as badly needed for medical services as it is for any other product or service. It is true that health care is unique in some ways, but this strengthens rather than weakens the case for subjecting it to entrepreneurial profit and loss. Health care is not "too important to be left to the market." It is too important not to be. FEE

Political Bankruptcies: How Chrysler and GM Have Changed the Rules of the Game

BY RICHARD A. EPSTEIN

The topic of corporate bankruptcy law scarcely titillates the imagination of ordinary citizens, even those with a deep interest in constitutional and public affairs. Harried people treat bankruptcy almost dismissively as a useful way of winding up firms that cannot keep their financial heads above water. In practice they sense rightly that the corporate bankruptcy system cleanses the economy of weak players by their liquidation, reorganization, or sale, hopefully to allow their assets to be released to more productive uses. Explaining how bankruptcy works isn't a fit subject for polite company.

Those perceptions have changed now that the Chrysler and GM bankruptcies have set a new standard for the fast resolution of some complex if dubious transactions. So troublesome questions arise: Did these transactions comply with the rule of law? Were the property rights of the secured creditors fully protected in the expedited proceedings? Will the process bring confidence to the credit markets? No, no, and no again. Those three "nos" come as no surprise. The basic classical liberal position is right to insist that the government cannot sensibly occupy the roles of market participant and market regulator simultaneously. All else is detail.

> Did these transactions comply with the rule of law? Were the property rights of the secured creditors fully protected? Will the process bring confidence to the credit markets? No, no, and no again.

The Downward Spiral

The Chrysler and GM bankruptcies have both remote and proximate causes. The backstory starts 50 years ago with two major developments that sealed the long-term fate of the domestic automobile industry. First the strong union contracts negotiated under the National Labor Relations Act of 1935 enabled the unions to parlay strike threats into rich deals during the 1970s that promised a bonanza to their then-present and -retired workers. Similarly, the large dealer network of the former Big Three, which may have made sense in the 1950s, became entrenched by state dealer-franchise statutes. The joyride could not last. Detroit's foreign competitors have lean dealer networks and no unions. It was only a matter of time before those foreigners flexed their economic muscle, at which point the Detroit companies lost market share, shed employees, and accrued massive retiree obligations.

Businesses this fragile cannot survive any external shock, especially the huge meltdown of September 2008. By March 2009 GM had about 61,000 unionized employees in the United States and over 500,000 retirees and their dependents in their various pension and healthcare plans. The liquidation value of its assets was estimated at about $8 billion against

Richard Epstein (repstein@uchicago.edu) is the James Parker Hall Distinguished Service Professor of Law at the University of Chicago, director of the Law and Economics Program, and the Peter and Kirsten Bedford Senior Fellow at the Hoover Institution.

stated debts of $172 billion. Not viable. Chrysler was also under water but less so. Neither the Bush nor the Obama administration, however, was prepared to bite the bullet and let the bankruptcy courts slim down these bloated dinosaurs. Instead both administrations opted for billions in cash infusions in the desperate hope of keeping the bankruptcy wolves from the door. The unions for their part gave back some of their perks, including full pay for workers sitting idly on call in stuffy waiting rooms for jobs that would never return. Alas, the rigid bargaining structures with unions made these concessions both too little and too late. But once the Troubled Asset Relief Program (TARP) kicked in, Treasury doled out about $50 billion to keep GM afloat and about $4 billion to do the same for Chrysler.

The Bankruptcy Maneuvers

By early 2009 it was clear that more desperate measures were needed. Two political bankruptcies were the answer. The Chrysler and GM deals have much in common, but the Chrysler deal was more complex and more high-profile, so let's start with it. Once it became clear that Chrysler could not operate as a stand-alone company, Treasury wooed the Italian automaker Fiat to take a stock position in the company, not for cold cash but for access to small-car technology and some international markets. For these intangibles it received between 20 and 35 percent of New Chrysler, depending on whether New Chrysler reaches certain milestones.

> The highly unusual step of tying the sale of Chrysler assets to the assumption of some of Chrysler's union liabilities drove away all legitimate bidders.

On many points, however, the two deals moved roughly in common. One key action was to keep the United Auto Workers' (UAW) retiree benefits in play but to cut down on the dealership contracts. Some jujitsu was needed. Recall that the three basic bankruptcy options are liquidation, reorganization, and sale. The Chrysler numbers tell the story. A government expert witness testified that Chrysler was worth only $800 million if liquidated but could be worth as much as $2 billion if sold off intact to another firm. Under the standard bankruptcy rules the proceeds of that sale would be distributed according to a strict priority by claim type. Secured creditors, including the bondholders, come ahead of unsecured creditors, including union health and retirement funds. Without some fancy high-stepping it followed that a simple sale of the assets of the company for the indicated $2 billion would leave the secured creditors a bit under 30 cents on the dollar for their $6.5 billion in aggregate claims but wipe out all future contributions to the union retiree funds. Not good, thought the Obama administration.

To boost the UAW's fortunes, Chrysler had to be "sold." But under what rules? By conscious design the bidding was organized in a unique way. The UAW was given a seat at the table to figure out the conditions that would attach to a permissible bid. One of those conditions was to assume the liabilities needed to finance the union health funds at sums in excess of the stated asset values of the corporation. To keep the union benefits alive, the parties created Chrysler VEBA—its Voluntary Employment Benefit Association—which ended up receiving a 55 percent equity interest in the New Chrysler corporation plus a $4.587 billion unsecured note from that company. New Chrysler was not asked to take over any liabilities for the dealers or indeed for the unsecured tort creditors (persons who were injured by Chrysler products).

When the dust settled, the government noted with some pride that its $2 billion bid was the only one. That sobering fact should not be taken as a sign of its business acumen but as an open confession of its suppression of any sensible auction. The correct process requires the sale of *unencumbered* assets, which for all we know could have been worth more than $2 billion if extricated from the losing union entanglements.

The GM deal had larger numbers but the same protection scheme for the GM VEBA. Under the previous deals between Old GM and the UAW, the company was liable for about $20 billion in unsecured retirement trust contributions. New GM offered GM VEBA 17.5 percent of its common stock, a new note for $2.5 billion, up to $6.5 billion in preferred stock, and a warrant that allowed New VEBA to purchase an additional 2.5 percent of New GM equity. GM's other unsecured creditors were owed $27 billion, for which they received far less—somewhere between 10 and 12 percent of New GM, plus warrants. The unsecured creditors who started with more ended up with less. Once again the supposed bankruptcy sale that linked assets and liabilities allowed this financial inversion to go through.

The conscious decisions in both cases to tie the liabilities to the assets, however, totally transformed the proposed sales by cutting out all private bidders. How does an outsider bid for a business known to be underwater? Easy, for a *negative* value. It offers to take the company off the government's hands if the government pays it a sum equal to the difference between the stated liabilities and the net asset value. Such negative bids are used whenever the Federal Reserve seeks a new owner for a failed bank whose liabilities exceed its assets' negative value: The bank that demands the smallest government guarantee wins.

The bottom line was another brand of UAW favoritism.

Of course, the Federal Reserve did not run these auctions, each of which had only one bidder. By design the Treasury put forward a bid for Chrysler that had to win. It was willing to pay the $2 billion to buy a business that had a net worth of minus $4.2 billion, computed as follows: Once the government paid off $2 billion to the secured creditors, it then executed its prearranged master plan to invest, in an "unrelated transaction," an additional $6.2 billion to keep New Chrysler afloat. It now becomes painfully evident that the highly unusual step of tying the sale of Chrysler assets to the assumption of some of Chrysler's union liabilities drove away all legitimate bidders. No one knows whether the government's $2 billion valuation of Chrysler is fact or fancy. A government bid of a penny would have won as well, so long as retiree liabilities had to be assumed.

So why on earth should the bankruptcy court allow this novel step? To Bankruptcy Judge Arthur Gonzalez, the answer was easy:

> New Chrysler views the skilled workforce as essential to its future operations and, as a natural consequence, has engaged in negotiations with their representative. As part of those negotiations, New Chrysler and the workers have reached agreement on terms for collective bargaining agreements with the UAW. As part of those negotiations, the parties also agreed to modify the funding arrangements for VEBA, the trust which funds benefits for employees and retirees.

Not credible. The onerous union contracts were one key reason for Chrysler's steady decline before the financial crisis of 2008. No sane bidder affirms losing contracts. Ron Bloom, the administration's automobile czar, submitted testimony at congressional hearings held in Detroit last July (www.tinyurl.com/l6wxo4) which stressed that the President prudently approved the deal only after the union made deep concessions. But why just ask for concessions? New Chrysler could have gotten a better deal still by starting with a clean slate that only comes from purchasing unencumbered assets. Suppose that thereafter New Chrysler wants to keep some of these workers; the sensible business approach is to hire back only those workers it wants under market-rate contracts in separate transactions. Other positions can be filled by new workers hungry for jobs in a falling economy. Worse still, it is completely inexplicable why New Chrysler wants to pay billions to present retirees in exchange for future work never to be performed. This giveaway corrupted the bidding process. The whole sale should have been set aside and a new sale of assets only should have been ordered.

GM presented somewhat different issues because the only secured creditors were the U.S. and Canadian governments, which ran the transaction. Even the U.S. government cannot shortchange itself, and here it did not look as though anything could ever be left over for unsecured creditors. But even so, there is no explanation as to why this deal favored the UAW unsecured creditors over the unsecured bondholders. The bottom line was another brand of UAW favoritism.

Sale or Reorganization?

The GM case did not provoke any follow-on litigation, so let's concentrate on Chrysler, which did provoke a legal challenge by the outgunned Indiana Police Pension Fund with its tiny (under 1 percent) interest in Chrysler's secured debt. How did Treasury deal with these pesky bondholders? Largely by running them out of court without ever letting them expose the soft underbelly of the arbitrary government bid. The key legal maneuver was a determination that the Indiana Pension Fund did not have standing to challenge a transaction in which it had received its fair share of the $2 billion sale value that represented the full asset value. Whatever else happened in the transaction was of no special concern to it, so it could not protest.

Lo and behold, that conclusion is correct *if* the transaction is a bona fide sale. But the transaction wasn't bona fide because any bidder could only buy the assets by agreeing to take over the liabilities. It also wasn't a sale because the UAW pension and health funds kept their interest in New Chrysler. At this point, as my NYU colleague Barry Adler explained in his testimony before a congressional committee, the deal looks more like a "reorganization" that let previous stakeholders in Chrysler retain an interest in the surviving entity. In this case it is easy to "step" the initial sale to the government with the subsequent deal with Fiat and the Chrysler VEBA into one continuous transaction whose result was to realign the interest of existing players. When the dust settled the UAW's interest as an unsecured creditor of Old Chrysler was converted into an unsecured note from New Chrysler coupled with its new controlling shareholder position. A clean sale leaves no retained interest for any stakeholder in the sold business.

Unlike sales, reorganizations must meet explicit nondiscrimination requirements that require all unsecured creditors to be treated alike. The Indiana Pension Fund was unsecured to the extent that there was a shortfall in Chrysler assets. So it was right to say it should have been treated on a par with the UAW retirement funds, which were also unsecured creditors.

The Fund also had a second line of argument for its position as a secured creditor—that is, to the extent that some assets in Old Chrysler were available to satisfy claims. The Fund insisted that all non-TARP secured lenders should be treated as their own class. This point matters under reorganization rules because a majority of members in each distinct class must give their approval for the reorganization to go through. The Fund argued that its interests diverged from the TARP lenders, who only voted for this disadvantageous plan in response to veiled Treasury threats to go along. Why did 99 percent of the secured creditors approve a transaction that subordinated their financial interests to unsecured creditors anyhow? Was their consent voluntary—or coerced? In his testimony before the Detroit congressional hearing, Indiana State Treasurer Richard E. Mourdock hinted darkly that undue pressure was placed on the TARP lenders—JP Morgan Chase, Citigroup, Goldman Sachs, and Morgan Stanley—to vote in favor of the sale/reorganization or else. What counts as the "or else" is hard to say because everyone was mum on these communications. No evidence of that sort was presented at trial, even after several other early non-TARP objectors to the reorganization (whoops, sale) mysteriously folded their tents. But how could the 900-pound government gorilla in the closet not have made a difference? Do we really think that investment bankers can't subtract liabilities from assets to determine net value? Draw your own conclusions of whether TARP banks operate with independent judgment when placed under government oversight.

Why did 99 percent of the secured creditors approve a transaction that subordinated their financial interests to unsecured creditors? Was their consent voluntary?

Taxpayer Standing

There is still one other loose end. The TARP program was intended to aid *financial* institutions, which does not seem to include Chrysler or GM. But who can challenge this transaction if in fact it did not come within the scope of the TARP program? Clearly, someone should be allowed (in principle) to say that taxpayer money was improperly used to lard New GM and New Chrysler with sufficient dollars to help fund the UAW benefit plans. Why, one might ask, are the retired workers from Chrysler worth special treatment relative to the retired police officers in Indiana, who had to settle for 30 cents on the dollar? But those questions will never be resolved for the simple reason that under modern American constitutional law *no taxpayer* ever has standing to challenge a transaction that affects all taxpayers. We thus never get to the merits of the deal. This taxpayer-standing rule has been in effect for close to 90 years, and throughout its history it has aided the expansion of State power by shielding dubious transactions from judicial review. The far better rule is to follow the corporate practice whereby *any* shareholder can challenge the legality of a transaction that affects all.

Why allow the Obama administration to pay off its political debts by manipulating bankruptcy forms? And why did the courts go along with what seem to be transparent ruses?

The Future?

Now that the taxpayer-standing rule removed the last legal obstacles to these two reorganizations, how best to assess the damages from these exceptional procedures? The obvious question is, why allow the Obama administration to pay off its political debts to Big Labor by manipulating bankruptcy forms? And why did the two district courts and the Second Circuit Court of Appeals go along with what seem to be transparent ruses? This does not bode well for those like me who hope that courts will step up to control these political machinations.

What the ultimate damage is, no one can say for sure. My hope is that the collateral damage will be contained on the simple ground that since extraordinary remedies are only sought in extraordinary cases, routine bankruptcy practice will remain unscathed. But it is too early to be so sanguine. At least two major bankruptcies appeared to deviate from the rules; others may follow, but only if the United States government is prepared to put substantial dollars on the table, which it won't in most bankruptcies. But the specter of indirect effects remains. The entire structure of large credit markets, for example, depends on following the rules of the game to the letter. We have already seen that market melt down. Add in bad bankruptcy rules and the risks get larger. Memories are long in credit markets, and in the worst-case scenario the pricing of every major deal could be impacted if deviant bankruptcies become the norm. Let's hope that Chrysler and GM prove to be one-off concoctions borne of desperation. But don't bet on it yet. FEE

Cash for Clunkers Was a Loser

BY BRUCE YANDLE

President Obama's Cash for Clunkers program, inspired by the Consumer Assistance to Recycle and Save Act, ended August 25, 2009. As I drove through a major shopping area that day, I passed a large and highly successful Toyota dealer. Just past the sparkling showroom and sparsely populated lot of new cars, "clunkers" sat in a securely fenced half-acre field. There among the older Chryslers, Buicks, and Chevys were stout Ford F-150 pickups, Jeep Wagoneers, and a few other almost-indestructible vehicles. Along with these, some still-shiny two- or three-year-old gas-sippers stood in the ranks of the condemned, awaiting the injection that would freeze their engines and reduce the entire machine to scrap.

"Nudged" by federal policy, the previous owners accepted a handsome payment from the rest of us for ridding the nation of older, more heavily carbon-emitting vehicles and replacing them with shiny new machines that required a lot of energy to produce but would, on average, yield lower carbon exhaust and greater fuel efficiency. The clunker statute gave consumers $3,500 vouchers if they purchased vehicles that yielded a four- to nine-miles-per-gallon (MPG) improvement in fuel economy, and $4,500 if the yield was ten or more MPG.

In all, according to Bloomberg, some $2.88 billion in tax money helped buy some 700,000 vehicles made up of the popular Ford Focus, Toyota Corolla, Camry, and Prius, along with some Hummers and Ford F-150 and F-250 trucks. These and a wide variety of other cars and trucks moved quickly from dealer lots to the homes of the blessed. In fact, the speed of the transactions was more than government could handle. The program was wildly popular.

Taken together the trade-ins had an average fuel economy of 15.8 MPG, while the replacements averaged 24.9 MPG. And according to Ford Motor Company, this kind of fuel-economy improvement translates to a reduction of five to ten million barrels of oil consumed over the next five years. (The nation currently consumes nine million barrels a day.) This will be oil that some other people can enjoy.

President Obama cheerfully termed the program "successful beyond anybody's imagination." Secretary of Transportation Ray LaHood, who administered the program, said the effort was "a lifeline to the automobile industry, jump starting a major sector of the economy and putting people back to work." LaHood quickly added that while all this happened, "[W]e've been able to take old, polluting cars off the road and help consumers purchase fuel-efficient vehicles." Economist John Lott surmised that "Only in Washington could a program that is spending money 13 times faster than was planned be labeled a 'success.'"

Bruce Yandle (yandle@bellsouth.net) is professor of economics emeritus at Clemson University.

Long-Term Costs

Obama's Council of Economic Advisers (CEA) predicted the economy would be spurred as the auto industry geared up to meet inspired demand. The program was predicted to raise third-quarter GDP 0.3–0.4 of a percentage point and lift year-end employment by 42,000. August auto sales did indeed reach to the sky, but September sales plunged back into the basement again. The program stole sales from the future; it did not fertilize future sales.

Considering final costs, there's serious doubt that the program was successful even in the short term. The doubt arises for at least three reasons. First, the program got political support primarily for its much-touted environmental benefits. Carbon emissions would be reduced—but at about ten times the cost of alternate ways of removing carbon. Second, there is Bastiat's parable of the broken window to consider. And third, there is a serious matter of eroding social norms for conserving wealth. A crushed clunker with a frozen engine is lost capital.

> Using politics to pay people who destroy valuable vehicles teaches a lesson of anti-matter and wealth destruction.

Let's consider each of these points.

University of California-Berkeley economist Christopher Knittel developed a rigorous assessment of the implied cost of carbon emissions under the clunker program ("The Implied Cost of Carbon Dioxide Under the Cash for Clunkers Program," www.tinyurl.com/mrmtuy). Knittel made plausible assumptions about the average life remaining in vehicles removed from the road, the average fuel economy associated with those vehicles, and the resulting levels of carbon emission that would have survived in the absence of clunkers. Eventually, of course, the clunkers would have died a natural but less dramatic death. Knittel then estimated the carbon reduction gained by replacing the large fleet of clunkers with a new fuel-efficient fleet. When he ran the numbers, Knittel found the cost per ton of carbon reduced could reach $500 under a set of normal values for critical variables. That fell to $237 per ton under best-case conditions. And what does this tell us? The much celebrated Waxman-Markey cap-and-trade carbon-emission control legislation estimates it costs $28 to reduce a ton of carbon across U.S. industries. Yes, we are getting carbon-emission reductions by way of clunker reduction, but we are paying a pretty penny for it.

Frédéric Bastiat's brilliant parable of the broken window reminds us that a street hoodlum throwing a brick through a window generates a series of job-generating transactions that might raise GDP by a trivial amount, if it could be measured. Indeed, the idea seems so compelling that people today often speak of the silver lining found in the clouds that create hurricanes. Think of the roofers that become employed. But Bastiat's key lesson is that a window has been destroyed—and it had value. Before touting the total benefits of the program we must take account of the destroyed vehicles and engines that represented part of the wealth of the nation. As Tony Liller, vice president for Goodwill, put it: "They're crushing these cars, and they're perfectly good. These are cars the poor need to buy."

Finally, over the eons, human communities have contrived all kinds of devices to transmit critical survival skills and compatible behavioral norms. One of these has to do with conservation of wealth. "Waste not, want not," we are told. "A penny saved is a penny earned," we are reminded. Using politics to pay people to destroy valuable vehicles, or to hold crops off the market, or to produce ethanol that may use more energy in production than it adds when burned, teaches a lesson of anti-matter and wealth destruction. Considering all this, Cash for Clunkers sounds like a sorry idea that should not be the model for future policy.

Even though a sorry idea, the Obama administration will soon go forward with a cash for old refrigerators program. Unlike the clunkers program, the appliance plan will not require destruction of the old refrigerators and other items involved. The transaction costs are just too high. Nevertheless, let's stop Cash for Refrigerators before the idea spreads further. FEE

Why Those Who Value Liberty Should Rejoice: Elinor Ostrom's Nobel Prize

BY PETER BOETTKE

Elinor Ostrom, the first woman to win the Nobel Memorial Prize in Economic Sciences, is also one of the most iconoclastic thinkers to win it. (She shared it with Oliver Williamson.) Professor Ostrom's work focuses on the mechanisms of self-governance that operate in different societies. Her intellectual curiosity led her to study local public economies—in particular the municipal provision of police services, the management of water supplies, fisheries, forestry, and development in the less-developed world. Her framework of analysis builds from a model of *humanly* rational choice to a historically grounded institutional analysis. She studies the rules that govern the behavior of individuals in their interactions both with nature and with one another.

Elinor Ostrom, the first woman to win the Nobel Memorial Prize in Economic Sciences.
Photo: J. Lokrantz/Azote

Her colleagues at Indiana University describe Ostrom as "humble and hardworking," and another Nobel Prize winner, Vernon Smith, calls her a "remarkable scholar" with a passionate drive to understand human societies in all their variety. A former president of the Public Choice Society and the American Association of Political Science, Ostrom is also one of the most beloved teachers in academia. The Workshop in Political Theory and Policy Analysis at Indiana University that she co-directed with her husband, Vincent, is perhaps the ideal model for a research and graduate education center.

But what do we learn from her studies? I would argue that we learn at least three major points of style and substance. First, much of the last century of political and economic discourse has been dominated by a debate between advocates of perfect markets and perfect central planners. The latter strove to demonstrate market failure, then would insist that government would provide the necessary corrective. Ostrom was one of the core thinkers in the social sciences to say, "Hold on. Markets may fail, but government solutions also might not work." One must always remember that Elinor and Vincent Ostrom are foundational contributors to the theory of Public Choice. But the Ostroms went further than simply demonstrating the possibility of government failure.

Peter Boettke is the deputy director of the James M. Buchanan Center for Political Economy, a senior research fellow at the Mercatus Center, and an economics professor at George Mason University. He is the coauthor, with Paul Dragos Aligica, of Challenging Institutional Analysis and Development *(2009), a book about the work of Elinor and Vincent Ostrom.*

Rules In Use

This leads to the second point. In the history of political and economic thought the source of social order has been attributed either to the invisible hand of market coordination (Adam Smith) or the heavy hand of state control (Hobbes). Perhaps one of the best ways to understand Elinor Ostrom's work is to see it as working out a Hobbesian problem by way of a Smithian solution. That is perhaps a bit of a stretch but not by much. Her work on local public economies and common-pool resources focuses on actual "rules in use" (as opposed to the "rules in form") that decentralized individuals and groups rely on to make decisions and to coordinate their behavior in order to overcome social dilemmas. It yields an optimistic message about the power of self-governance to succeed even in difficult situations. As my colleague Alex Tabarrok put it, Ostrom sees how, through various voluntary associations, groups transform the common-pool resource situation from a "tragedy of the commons" to an "opportunity of the commons."

Traditional economic theory argues that public goods cannot be provided through the market. Traditional Public Choice theory argues that government often fails to provide solutions. Ostrom shows that decentralized groups can develop various rule systems that enable social cooperation to emerge through voluntary association.

A point that sometimes trips up readers is that Ostrom often focuses on situations where the technology of parceling property into private plots does not exist. In these situations she studies collective, but non-State decision-making over common-pool resources. While private-property solutions are not employed in such cases, the "rules in use" that do operate accomplish what private property would have accomplished. We find rules that limit access and that make individuals in the group accountable for their misuse of the resource. We also find enforcement of those rules. In short, the analyst must be willing to look at both the form and function of rules in a variety of social situations.

> The foundation of the social order of a free people is self-governance, not governmental authority and centralized power. Decentralized decision making that drills deep into local conditions and knowledge assures that self-governance is effective governance.

Local Solutions for Local Problems

Diverse institutions at work in different societies promote voluntary cooperation. As social scientists, we have to be able to understand them. There are rules that are in use, rules that are stated but not in use, rules that go by one name but that in practice do something else, and rules that tightly fit use, form, and function. Ostrom has insisted that social scientists must understand the rules that govern human behavior—both the way we interact with one another and the way we interact with nature. Some rules systems promote human betterment through the promotion of peaceful social cooperation and wealth creation; others thwart human progress by ensuring violence and poverty. It is actually that simple, and that profound.

The foundation of the social order of a free people is self-governance, not governmental authority and centralized power. Decentralized decision making that drills deep into the local social dilemmas real people face, that mobilizes incentives within a local rule structure, and that utilizes local knowledge is how the process of institutional development assures that self-governance is effective governance, enabling fallible human beings to reasonably manage scarce resources and the relationships among themselves.

The final point I want to stress concerning Ostrom's research comes as a methodological message. Her work is humanistic and scientific. She is trying to understand human societies in all their variety. To do so she had to get up close and personal: from local government in California to irrigation systems in Nepal—

and everything in between. Her field work in economics and political economy is guided by the logic of human choice. She describes her research program as "a behavioral approach to the rational choice theory of collective action." If you take away the academic language, it translates into a research program that begins with human beings and their purposes and plans, and ends with their stumbling and groping to find voluntary solutions to difficult social dilemmas through norms, conventions, and rules.

A Message of Hope

Let me conclude by bringing this back to my title: Why should people who care about liberty rejoice in this choice for the prize? There is an ideological importance to the work of Elinor Ostrom. She has not stressed it in her work, but Vincent has ventured into the field of social philosophy. My favorite book of his is *The Meaning of Democracy and the Vulnerabilities of Democracies* (1997). In that work Vincent inquires into the preconditions for a self-governing citizenry. A self-governing society, he says, must be composed of citizens fully capable of embracing the "cares of thinking and the troubles of living." Unfortunately, the machinations of democratic politics—with interest-group manipulation, logrolling, rent-seeking, and the vote motive—tend to undermine the capacity for self-governance among a people.

> The message is that hope is to be found not in the State but in the people.

Nothing in this should be interpreted as deterministically pessimistic. The message is that hope is to be found not in the State but in the people. A society of free and responsible individuals who are able to form voluntary associations will solve the social dilemmas they confront through various means of self-governance.

A Diverse World of Associations

Nobody has done more than Elinor Ostrom, both in her research and in her teaching/mentor capacity at the Workshop in Political Philosophy and Policy Analysis, to help us understand the self-governing rules and institutions that work to elicit cooperation in a wide variety of societies. And nobody has done more to alert us to the damage governments can do when they attempt to impose alien rules on local peoples from afar—especially when their own systems are already addressing social dilemmas in their own way. Elinor demands that we understand and respect institutional diversity in our world, to see the ingenuity and wisdom in local solutions and in the entrepreneurial creativity and resourcefulness of individuals throughout the developed and less-developed world. Transcending the older debates in social science and public policy, Elinor Ostrom's work emphasizes the richness of the institutional environment and the creative solutions that arise when individuals are free to form associations and work within a network of informal rules that promote individual responsibility and collective accountability.

Supporters of FEE and readers of *The Freeman* are attracted to the vision of a society of free and responsible individuals. Elinor Ostrom's research gives us a window into the diverse world of associations that do not fit neatly into the categories of "market" or "State" but nevertheless are essential to peaceful and prosperous social cooperation. FEE

Financial Crises and the Federal Reserve's Punch Bowl

BY CHIDEM KURDAS

Why did the U.S. financial system nearly collapse last year? People blame Wall Street's excessive greed and risk-taking. But without easy money, the massive risk-taking could not have happened.

To be sure, financial firms leveraged up—that is, they did a lot of business with borrowed money. That juiced up revenues and bonuses in the boom—and exacerbated losses in the downturn. Selling notes based on questionable mortgages as collateral was one method for tapping into the money sloshing around.

Everyone drank up the easy money punch the Fed was dishing out, and now we've got the hangover.
Photo: Jonas N

Without abundant credit, it would not have been possible to borrow so much and in so many different ways. Banks create credit but are subject to myriad controls by the Federal Reserve System. Money was plentiful because of Fed policy.

Politicians, pundits, and the Obama administration want to impose new regulation on the financial system, giving wider powers to government agencies. Depending on how and to what extent they implement that agenda, the Federal Reserve—alongside other agencies like the Securities and Exchange Commission—stands to gain greater authority. Hence the Fed's track record is a timely and pertinent subject.

Although the institution now commands unquestioning acceptance, its inception was controversial. Richard Timberlake, in his history of monetary policy in the United States, quotes a congressman shortly after the 1913 passage of the law that created the Federal Reserve System: "This act establishes the most gigantic trust on earth, such as the Sherman Antitrust Act would dissolve if Congress did not by this Act expressly create what by that Act it prohibited."

That gigantic trust has correspondingly gigantic effects on the economy, through multiple roles and powers. As overseer of ordinary banks the Fed makes sure they play by the rules. As lender of last resort it can keep banks going through cash-flow problems. Beyond its supervision of individual banks the Fed pursues economy-wide goals.

It operates various levers that reduce or expand the supply of money and credit. In what is generically called monetary policy, the Fed uses the levers to boost a drooping economy—as is happening at present—or cool down an overheated one. In theory those efforts benefit society at large.

In reality—well, let's take a look at the 1930s and our own time to understand the Fed's role in the two most dramatic financial crises of living memory.

Chidem Kurdas (chidem.kurdas@att.net) is a financial journalist in New York. She writes investment analysis on www.HedgeFundSmarts.com and policy news spoofs on www.JenniferKerfuffle.com.

Stability Found and Lost

Two seminal insights emerged from the path-breaking *A Monetary History of the United States, 1867–1960* (1963) by Milton Friedman and Anna Schwartz. They argued that the Federal Reserve worsened the banking collapse of the 1930s and probably killed off a potential recovery by tightening money. In reaction to a drain on U.S. gold reserves, the Fed clamped down on an already shrinking money supply, thereby turning an ordinary recession into what came to be known as the Great Depression.

Current Fed Chairman Ben Bernanke agrees with that conclusion and is certainly not repeating the mistake. He has eased money in every way it can be eased.

But Friedman and Schwartz offered a broader lesson as well. They showed that the stock of money became subject to greater fluctuations after the Fed took over the control of money from the gold standard system.

"The blind, un-designed, and quasi-automatic working of the gold standard turned out to produce a greater measure of predictability and regularity—perhaps because its discipline was impersonal and inescapable—than did deliberate and conscious control exercised within institutional arrangements intended to promote monetary stability," Friedman and Schwartz wrote.

By the late twentieth century it looked as though central bankers had taken this criticism to heart. They had reason to congratulate themselves on what was called the Great Moderation. Since the mid-1980s both prices and output growth had been reassuringly stable. In a 2004 speech Bernanke argued that this was primarily due to improved monetary policy, although economic change and plain old luck also may have played a role, too.

At that time Bernanke was not yet Fed chairman, but he was a member of the board of governors, a position he held from 2002 to 2005. Current Treasury Secretary Tim Geithner was president of the New York Federal Reserve Bank from 2003 until this year. These facts are worth recalling because there is a tendency to concentrate the blame on former chairman Alan Greenspan. But whatever one thinks of Greenspan, the officials who currently make policy were there with him as the Fed sowed the seeds of financial crisis.

Whatever one thinks of Alan Greenspan, the officials who currently make policy were there with him as the Fed sowed the seeds of financial crisis.

In retrospect those seeds were already discernible in the late 1990s. The steep rise in housing prices had started, encouraged by a stock bubble that created the illusion of wealth. In 1998 the Fed eased interest rates several times in response to panic after Russia defaulted on its bonds and the related near-failure of a large hedge fund, Long-Term Capital Management. This policy reassured investors, who subsequently bid up share prices to the stratosphere in 1999 even as the Fed reversed course.

The stock bubble burst in early 2000, and the economy stalled. Interest-rate cuts are prescribed and expected in a recession, so it is no surprise that the Fed took that course. But even after the economy recovered, rates stayed exceptionally low in comparison to what they would have been by the standard of the Great Moderation.

Stanford University economist John Taylor has used a measure known as the Taylor Rule to demonstrate that monetary excess lasted several years, into 2006. The title of Taylor's new book says it all: *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis.*

Not everybody agrees that monetary policy was loose during the Greenspan era. David Henderson and Jeffrey Rogers Hummel argued in the March issue of *The Freeman* that monetary policy was not expansionist from 2001 to 2006 as measured by the declining growth of monetary aggregates. The Taylor Rule, however, allows the comparison of two periods—and the federal funds rate was lower in the 2000s than in the 1980s.

Another explanation of the monetary excess, endorsed by Bernanke and Greenspan, is that there was a global glut of savings. But Taylor shows that worldwide there was no such glut because the surplus savings in Asia and the Middle East were offset by a savings gap in other countries, in particular the United States.

It is fair to say that most of us partook of the Fed's generous punch, whether by running up credit-card debt, buying houses beyond our means, trading with borrowed money, or making 30 percent on exotic debt instruments. Monetary excess meant that borrowing was easy; mortgages were to be had for a song. Housing prices rose at amazing rates year after year. With the hazard of price declines out of sight and out of mind, homeowners, developers, and banks overextended themselves.

It was an extraordinary boom; hence the following bust was also extraordinary. In effect, the stability of the 1980s Great Moderation was over by the time Bernanke credited monetary policy for fostering that stability.

What Failed

The bubble-and-collapse sequence is now attributed to a failure of capitalism, to use the title of a new book by Richard Posner, a judge and prolific author. According to a widely held view, the private financial system is intrinsically unstable, with leverage a central element in its penchant for self-destruction. Had the system been properly regulated and restrained, it would not have gone haywire. Hence whatever is not sufficiently regulated should be nailed down to avoid similar disasters in the future. Much of the media reflects that view.

> The Fed by itself can create systemic risk, even as people call for expanding its powers to control it.

And yet the Fed and the Securities and Exchange Commission (SEC) between them already have massive regulatory powers over banks and broker-dealers, including investment banks. What is more, they and other agencies were part of the President's Working Group on Financial Markets, set up after the crisis of 1998 to deal with systemic risk—the kind of danger that came up so frequently in 2007–2008.

Despite all the regulatory powers, a crisis broke out. Posner may represent current conventional wisdom when he writes that the government's myopia, passivity, and blunders played a critical role in allowing the recession to balloon, but there would have been a crisis anyway regardless of those shortcomings.

The alternative view, represented by Taylor (following in the footsteps of Ms. Schwartz and the late Mr. Friedman), is that monetary policy turned what might have been mild cyclical fluctuations into a big bubble, inevitably leading to a big collapse. No easy money, no crisis.

Regarding the central bank's multiple functions, its stance in the supervision of individual banks appears to have been of a piece with its broader policy. The Fed as overseer of banks could have demanded that they reduce their use of leverage, but the Fed as maker of monetary policy was providing the wherewithal for that leverage.

Hence the let-them-leverage regulatory stance was not accidental or myopic; it was consistent with deliberate monetary policy. If policymakers were concerned about the galloping credit expansion, they should not have let money go loose in 2003–2006. Lacking such concern, the Fed had no reason to get banks to reduce their risk. The whole institution took this track, not just Alan Greenspan.

Controlling or Creating Risk?

There's no question private action results in economic cycles, largely because human beings have mental biases that keep them focused on the near term. The key point, though, is that even the largest private actor does not have the impact of the gigantic banking trust. Monetary policy is system-wide; policy mistakes have ramifications across the economy.

So the Fed by itself can create systemic risk, even as people call for expanding its powers to control the systemic risk posed by market participants like banks and hedge funds.

The Fed actively implemented measures that destabilized the system in the 1930s and again in the 2000s, albeit in different ways. The mistake was different—back then the Fed tightened in a downturn; this time it kept money too loose in an upturn. But there was the same fundamental consequence of financial and economic instability.

Timberlake thus summarized the Federal Reserve's track record: "It comes across as a prototypical governmental institution operating under the rule of men rather than the rule of law." To prevent misguided monetary interventions, the discretion of the people who run the institution should be limited.

Friedman argued for rule-based monetary policy, specifically that the Fed should follow a rule to keep the money supply growing steadily at a fixed rate of 3 to 5 percent a year. This turned out to be difficult to implement, given that the money supply and its relation to the economy are complicated.

This is where the Taylor rule, which describes actual policy during the Great Moderation, comes in. Taking that policy as a template, the Fed can set the short-term interest rate in accordance with a constant formula based on inflation and output.

Compared to Friedman's fixed rate, the formula is more flexible. But it keeps interest-rate policy predictable and transparent. If followed consistently, rule-bound monetary policy, combined with proper enforcement of existing regulations for banks and broker-dealers, would prevent the excesses seen in recent years.

Those calling for greater interventionism tend not to engage the issue of what the government does in reality. There is a presumption that regulation is the cure-all.

Government Intelligence and the Nirvana Fallacy

Instead, what's being advocated is broader activity by policymakers. Posner, for instance, draws the conclusion that "we need a more active and intelligent government to keep our model of a capitalist economy from running off the rails." It is interesting that he sees a need not just for more-active government but more intelligent government. If government action has not been intelligent in the past, why expect it to be intelligent in the future?

We're talking about institutions with overarching powers that have caused a variety of harms, from deliberate Fed policies that created instability to the SEC's inability to detect fraud even after being told about it, misleading investors into believing that all was well with Bernard Madoff. (See my May *Freeman* article on the Madoff case at www.tinyurl.com/ln686j.) If there is more government activity of this sort, there will be even worse disasters.

One way to prevent another round of government-made debacles would be to replace the central bank with market-based money, thereby imposing an impersonal discipline—to use the words of Friedman and Schwartz. But following the Taylor Rule is a more likely solution, since it serves the goal Fed officials themselves say they want to pursue, namely, more predictable and transparent policy.

Those calling for greater interventionism tend not to engage the issue of what the government does in reality. There is a presumption that regulation is the cure-all, even as we live through the effects of a systemic policy failure. Economist Robert Solow, in a review of Posner's book, writes that Panglossian ideas about "free markets" encouraged lax or no regulation of a potentially unstable financial apparatus.

When you consider the actual role of the Federal Reserve in crises, it is the notion of government activism as the solution to financial uncertainty and fluctuations that comes across as Panglossian. FEE

From 1944 to *Nineteen Eighty-Four*

BY SHELDON RICHMAN

I'm inclined to think of George Orwell and F. A. Hayek at the same time. Both showed great courage in writing the truth, undaunted by the consequences. Both valued freedom, though they understood it differently.

Orwell, a man of the "left," could not remain silent in the face of the horrors of Stalinism. Twice—during the Spanish Civil War and again at the dawn of the Cold War—he refused to permit his comrades to blind themselves to where their collectivism had led and could lead again. For his favor he was called a conscious tool of fascism, a stinging accusation considering he had gone to Spain to fight fascism. (But for a few inches, the bullet that penetrated Orwell's neck in Spain would have denied us the latter warnings, *Animal Farm* and *Nineteen Eighty-Four*.)

Orwell and Hayek both made stands for liberty at great risk; Orwell, however, could never accept free markets.
commons.wikimedia.org

Hayek, a man of the "right," risked ostracism and worse in 1944 by publishing *The Road to Serfdom*. Writing in England at the height of World War II, this Austrian-turned-Briton warned that central economic planning would, if pursued seriously, end in a totalitarianism indistinguishable from the Nazi enemy. That couldn't have been easy to write at that time and place—central planning was much in vogue among the intelligentsia. While a good deal of the reception was serious and respectful, a good deal of it was not. Herbert Finer, in *Road to Reaction*, called Hayek's book "the most sinister offensive against democracy to emerge from a democratic country for many decades"; it expressed "the thoroughly Hitlerian contempt for the democratic man."

Not surprisingly, *The Road to Serfdom* brought Orwell and Hayek together in print. Orwell briefly reviewed the book along with Konni Zilliacus's *The Mirror of the Past* in the April 9, 1944, issue of *The Observer* (www.tinyurl.com/pobelg). The man who would publish *Animal Farm* a year later and *Nineteen Eighty-Four* five years later found much to agree with in Hayek's work: "In the negative part of Professor Hayek's thesis there is a great deal of truth. It cannot be said too often—at any rate, it is not being said nearly often enough—that collectivism is not inherently democratic, but, on the contrary, gives to a tyrannical minority such powers as the Spanish Inquisitors never dreamed of."

But true to his left state-socialism, Orwell could not endorse Hayek's positive program:

> [H]e does not see, or will not admit, that a return to 'free' competition means for the great mass of people a tyranny probably worse, because more irresponsible, than that of the State. The trouble with competitions is that somebody wins them. Professor Hayek denies that free capitalism necessarily leads to monopoly, but in practice that is where it has led, and since the vast majority of people would far rather have State regimentation than slumps and unemployment, the drift towards collectivism is bound to continue if popular opinion has any say in the matter.

Sheldon Richman (srichman@fee.org) is the editor of The Freeman.
A longer version appears at the FEE website: www.tinyurl.com/npxxet.

It's disappointing to see Orwell give such short shrift to Hayek's positive thesis. He is glib and dogmatic, which is unbecoming a serious intellectual such as Orwell. His ignorance of economics leaps from the page.

"[A] return to 'free' competition means for the great mass of people a tyranny probably worse, because more irresponsible, than that of the State." It's hard to believe that someone so familiar with Stalinism could have written that. Even without knowing much economics, could he really have thought that what goes on in market-oriented societies, even during depressions, could be worse than the famine Stalin inflicted on the Ukrainians, the show trials and executions, or the labor camps in Siberia?

"The trouble with competitions is that somebody wins them." In a market producers compete to better serve consumers. The losers in that competition are not exiled or executed. They find other ways to serve consumers, just as producers are trying to serve them.

"Professor Hayek denies that free capitalism necessarily leads to monopoly, but in practice that is where it has led. . . ." Where has monopoly arisen without the aid of the State? We find no market-generated monopoly in England or the United States. There, major business interests actively promoted protectionism and other interventions precisely to tamp down competition and protect their market shares.

Regimentation is the least of the State's crimes.

"[T]he vast majority of people would far rather have State regimentation than slumps and unemployment. . . ." But that's a false choice. Slumps and unemployment, as Hayek and his mentor Ludwig von Mises taught, are products of central-bank manipulation of money and interest rates—that is, of government, not of the free market.

I must pause here to focus on Orwell's disgraceful use of the word "regimentation." I say "disgraceful" because he committed the sin he himself so eloquently condemned in his justly famous essay "Politics and the English Language" (www.tinyurl.com/nsagx): the sin of euphemism. Regimentation is the least of the State's crimes.

One wonders how Orwell avoided despair. He misidentified the free market with state capitalism and rejected it, and he saw the totalitarian tendencies of socialism up close. Yet he could write, "There is no way out of this unless a planned economy can *somehow* be combined with the freedom of the intellect, which can only happen if the concept of right and wrong is restored to politics" (emphasis added).

Hadn't he just read chapter 11 of *The Road to Serfdom*, "The End of Truth," in which Hayek described how a serious commitment to central planning must produce "contempt for intellectual liberty"?

"The word 'truth,'" Hayek wrote, "itself ceases to have its old meaning. It describes no longer something to be found, with the individual conscience as the sole arbiter of whether in any particular instance the evidence (or the standing of those proclaiming it) warrants a belief; it becomes something to be laid down by authority, which has to be believed in the interest of unity of the organized effort and which may have to be altered as the exigencies of this organized effort require it.

"The general intellectual climate which this produces, the spirit of complete cynicism as regards truth which it engenders, the loss of the sense of even the meaning of truth, the disappearance of the spirit of independent inquiry and of the belief in the power of rational conviction, the way in which differences of opinion in every branch of knowledge become political issues to be decided by authority, are all things which one must personally experience—no short description can convey their extent."

But of course Orwell *had* experienced those things in Spain and knew how it was in Russia. He certainly put a heavy burden on that word "somehow." How restoring the concept of right and wrong to politics would make central planning either decent or practical is a mystery no one has solved. Mises had shown long before that socialism could not be practical because without prices arising out of the exchange of privately owned means of production, the socialist planner could not make rational calculations with respect to what should be produced, in what manner, and in what quantities. As for decency, Hayek addressed that in chapter 10, "Why the Worst Get on Top." FEE

The Depression You've Never Heard Of: 1920–1921

BY ROBERT P. MURPHY

When it comes to diagnosing the causes of the Great Depression and prescribing cures for our present recession, the pundits and economists from the biggest schools typically argue about two different types of intervention. Big-government Keynesians, such as Paul Krugman, argue for massive fiscal stimulus—that is, huge budget deficits—to fill the gap in aggregate demand. On the other hand, small-government monetarists, who follow in the laissez-faire tradition of Milton Friedman, believe that the Federal Reserve needs to pump in more money to prevent the economy from falling into deep depression. Yet both sides of the debate agree that it would be utter disaster for the government and Fed to stand back and allow market forces to run their natural course after a major stock market or housing crash.

In contrast, many Austrian economists reject both forms of intervention. They argue that the free market would respond in the most efficient manner possible after a major disruption (such as the 1929 stock market crash or the housing bubble in our own times). As we shall see, the U.S. experience during the 1920–1921 depression—one that the reader has probably never heard of—is almost a laboratory experiment showcasing the flaws of both the Keynesian and monetarist prescriptions.

> The free market would respond in the most efficient manner possible after a major disruption.

The 1929–1933 Great Contraction

Despite what many readers undoubtedly "learned" in their history classes as children, Herbert Hoover behaved like a textbook Keynesian following the 1929 stock market crash. In conjunction with Treasury Secretary Andrew Mellon, Hoover achieved an across-the-board one percentage point reduction in income tax rates applicable to the 1929 tax year.

Hoover didn't stop with tax cuts to bolster "aggregate demand"—though analysts at that time would not have used the term. He also signed into law massive increases in the federal budget, with fiscal year (FY) 1932 spending rising 42 percent above 1930 levels. Hoover ran unprecedented peacetime deficits, which stood in sharp contrast to his predecessor Calvin Coolidge, who had run a budget surplus every year of his presidency. In fact, in the 1932 election FDR campaigned on a balanced budget and excoriated the reckless spending record of the Republican incumbent.

It wasn't merely that Hoover spent a bunch of money. He spent it on just the types of things that we associate today with Roosevelt's New Deal. For example, he signed off on numerous public-works projects, including the Hoover Dam. Of particular relevance today is the Reconstruction Finance Corporation (RFC) established under Hoover, which quickly injected more than $1 billion to prop up troubled banks that had made bad loans during the boom years of the late 1920s—and this was when $1 billion really meant something.

Robert Murphy (rpm@consultingbyrpm.com), an adjunct scholar of the Mises Institute and a faculty member of the Mises University, runs the blog Free Advice (www.consultingbyrpm.com/blog) and is the author of The Politically Incorrect Guide to the Great Depression and the New Deal.

It is true that Hoover eventually blinked and raised taxes in 1932, in an effort to reduce the federal budget deficit. Today's Keynesians point to this move as proof that reducing deficits is a bad idea in the middle of a depression. Yet an equally valid interpretation is that it's horrible to *hike tax rates* in the middle of an economic disaster. After the bold tax cuts pushed through by Andrew Mellon in the 1920s, the top marginal income-tax rate in 1932 stood at 25 percent. The next year, because of Hoover's desire to close the budget hole, the top income tax rate was 63 percent. Given this extraordinary single-year rate hike, it is no wonder that 1933 was the single worst year in U.S. economic history. (For what it's worth, the FY 1933 budget deficit was still huge, coming in at 4.5 percent of GDP. Despite the huge *rate* hikes, federal tax revenues only increased 3.8 percent from FY 1932 to FY 1933.)

So we see that the standard Keynesian story, which paints Herbert Hoover as a do-nothing liquidationist, is completely false. Yet Milton Friedman's explanation for the Great Depression is almost as dubious. Following the stock market crash, the New York Federal Reserve Bank immediately slashed its discount rate—how much it charged on loans—in an attempt to provide relief to the beleaguered financial system. The New York Fed continued to slash its discount rate over the next two years, pushing it down to 1.5 percent by May 1931. At that time, this was the lowest discount rate the New York Fed had ever charged since the establishment of the Federal Reserve System in 1913.

It wasn't merely that the Fed (along with other central banks around the world) was charging an unusually low rate on loans it advanced from its discount window. The entire mentality of central bankers was different during the early years of the Great Depression. Writing in 1934, Lionel Robbins first noted that during previous crises, the solution had been for central banks to charge a *high* discount rate to separate the wheat from the chaff. Those firms that were truly solvent but illiquid would be willing to pay the high interest rates on central-bank loans to get them through the storm. Firms that were simply insolvent, on the other hand, would know the jig was up because they couldn't afford the high rates. Yet this tough love was not administered after the 1929 crash, as Robbins explained: "In the present depression we have changed all that. We eschew the sharp purge. We prefer the lingering disease. Everywhere, in the money market, in the commodity markets and in the broad field of company finance and public indebtedness, the efforts of Central Banks and Governments have been directed to propping up bad business positions."

We therefore see an eerie pattern. When it came to both fiscal and monetary policy during the early 1930s, the governments and central banks implemented *the same strategies* that the sophisticated experts recommend today for our present crisis. Of course, today's Keynesians and monetarists have a ready retort: They will tell us that their prescribed medicines (deficits and monetary injections, respectively) were not administered in large enough doses. It was the *timidity* of Hoover's deficits (for the Keynesians) or the Fed's injections of liquidity (for the monetarists) that caused the Great Depression.

> During the early 1930s, the governments and central banks implemented the same strategies recommended today for our present crisis.

The 1920–1921 Depression

This context highlights the importance of the 1920–1921 depression. Here the government and Fed did *the exact opposite* of what the experts now recommend. We have just about the closest thing to a controlled experiment in macroeconomics that one could desire. To repeat, it's not that the government boosted the budget at a slower rate, or that the Fed provided a tad less liquidity. On the contrary, the government *slashed* its budget tremendously, and the Fed *hiked* rates to record highs. We thus have a fairly clear-cut experiment to test the efficacy of the Keynesian and monetarist remedies.

At the conclusion of World War I, U.S. officials found themselves in a bleak position. The federal debt had exploded because of wartime expenditures, and annual consumer price inflation rates had jumped well above 20 percent by the end of the war.

To restore fiscal and price sanity, the authorities implemented what today strikes us as incredibly "merciless" policies. From FY 1919 to 1920, federal spending was slashed from $18.5 billion to $6.4 billion—a 65 percent reduction in one year. The budget was pushed down the next two years as well, to $3.3 billion in FY 1922.

On the monetary side, the New York Fed raised its discount rate to a *record high* 7 percent by June 1920. Now the reader might think that this nominal rate was actually "looser" than the 1.5 percent discount rate charged in 1931 because of the changes in inflation rates. But on the contrary, *the price deflation of the 1920–1921 depression was more severe*. From its peak in June 1920 the Consumer Price Index fell 15.8 percent over the next 12 months. In contrast, year-over-year price deflation never even reached 11 percent at any point during the Great Depression. Whether we look at nominal interest rates or "real" (inflation-adjusted) interest rates, the Fed was very "tight" during the 1920–1921 depression and very "loose" during the onset of the Great Depression.

Even in the face of massive shocks the best thing the government can do is cut its own budget and return more resources to the private sector.

Now some modern economists will point out that our story leaves out an important element. Even though the Fed slashed its discount rate to record lows during the onset of the Great Depression, the total stock of money held by the public collapsed by roughly a third from 1929 to 1933. *This* is why Milton Friedman blamed the Fed for not doing enough to avert the Great Depression. By flooding the banking system with newly created reserves (part of the "monetary base"), the Fed could have offset the massive cash withdrawals of the panicked public and kept the overall money stock constant.

But even this nuanced argument fails to demonstrate why the 1929–1933 downturn should have been more severe than the 1920–1921 depression. The collapse in the monetary base (directly controlled by the Fed) during 1920–1921 was the largest in U.S. history, and it dwarfed the fall during the early Hoover years. So we hit the same problem: The standard monetarist explanation for the Great Depression applies all the more so to the 1920–1921 depression.

The Results

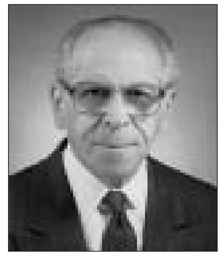
If the Keynesians are right about the Great Depression, then the depression of 1920–1921 should have been far worse. The same holds for the monetarists; things should have been awful in the 1920s if their theory of the 1930s is correct.

To be sure, the 1920–1921 depression *was* painful. The unemployment rate peaked at 11.7 percent in 1921. But it had dropped to 6.7 percent by the following year, and was down to 2.4 percent by 1923. After the depression the United States proceeded to enjoy the "Roaring Twenties," arguably the most prosperous decade in the country's history. Some of this prosperity was illusory—itself the result of subsequent Fed inflation—but nonetheless the 1920–1921 depression "purged the rottenness out of the system" and provided a solid framework for sustainable growth.

As we know, things turned out decidedly differently in the 1930s. Despite the easy fiscal and monetary policies of the Hoover administration and the Federal Reserve—which today's experts say are necessary to avoid the "mistakes of the Great Depression"—the unemployment rate kept going higher and higher, averaging an astounding 25 percent in 1933. And of course, after the "great contraction" the U.S. proceeded to stagnate in the Great Depression of the 1930s, which was easily the least prosperous decade in the country's history.

The conclusion seems obvious to anyone whose mind is not firmly locked into the Keynesian or monetarist framework: The free market works. Even in the face of massive shocks requiring large structural adjustments, the best thing the government can do is cut its own budget and return more resources to the private sector. For its part, the Federal Reserve doesn't help matters by flooding the shell-shocked credit markets with green pieces of paper. Prices can adjust to clear labor and other markets soon enough, in light of the new fundamentals, if only the politicians and central bankers would get out of the way. FEE

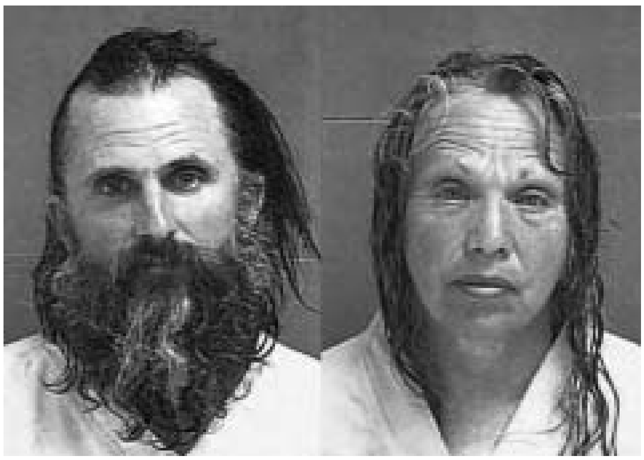
The Shame of Medicine: Conviction by Psychiatry



BY THOMAS SZASZ

In the predawn hours of June 5, 2002, Brian David Mitchell entered the bedroom of 14-year-old Elizabeth Smart and her nine-year-old sister Mary Katherine and left the house with Elizabeth. They walked to a camp site four miles behind her wealthy parents' spacious Salt Lake City home where they joined Wanda Barzee, Mitchell's wife. Nine months later—after spending months at the campsite, traveling to California, and returning to Utah with her alleged captors—Elizabeth was discovered in nearby Sandy. Charged with aggravated kidnapping, aggravated sexual assault, and aggravated burglary, Mitchell and Barzee disappeared into America's psychiatric Gulag.

The bare facts of the story, as reported in the press, are as follows. For nine months the trio hid in plain sight, made frequent trips to the city, was seen at a grocery store and a restaurant, and for about a week lived one block from the Salt Lake City police headquarters. A freelance photographer has a picture of the trio dressed in white robes.



Eccentric, certainly, but also denied their right to trial.
mugshots.blogspot.com

In March 2003, when the police found her, Elizabeth was wearing a gray wig and dark glasses, and her head and face were covered. Approached by officers, Elizabeth identified herself as Augustine, claiming to be Mitchell's daughter. "We took her aside," one of the officers related. "She kind of just blurted out, I know who you think I am. You guys think I'm that Elizabeth Smart girl who ran away [sic]." When the officers insisted that she was Elizabeth Smart, she replied, "Thou sayest" and "showed concern only for their [Mitchell's and Barzee's] welfare, not her own."

Mitchell, a devout Mormon, was no stranger to the Smarts. In 2001 Elizabeth's father, Edward Smart, employed him as a handyman. "He was astonished," the press reported, "at Mr. Mitchell's mastery of deception. 'When I was up there on the roof with him, I never could have guessed. He was so soft-spoken; he was so quiet. I never would have guessed that such an animal would have existed behind such a person.'"

All that was more than six years ago. Mitchell and Barzee have still not been tried, and we still have no idea about what actually happened to Elizabeth Smart. While mental health professionals prevented the defendants from defending themselves in court, the Smarts convicted Mitchell and Barzee in the media as "sexual predators."

Defenseless Defendants

Actually, there was no hard evidence that Elizabeth had been kidnapped, much less raped. Eccentric and poor, the defendants inspired no one to protect their constitutional right to trial. That would have required Elizabeth to be cross-examined and testify under oath about why she made no attempt to escape her alleged captors and why she lied to the police about who she was and referred to herself as "the girl who ran away"—not "was kidnapped."

Elizabeth's parents, Edward and Lois Smart, rushed into print with a book, titled "Bringing Elizabeth Home: A Journey of Faith and Hope," a boring protes-

Thomas Szasz (tszasz@aol.com) is professor of psychiatry emeritus at SUNY Upstate Medical University in Syracuse. His latest book is Antipsychiatry: Quackery Squared.

tation of their Mormon faith and belief in "miracles." "If you want just the straight story, as I did," comments a reader on Amazon.com, "you've come to the wrong place. . . . The excruciating details of the family's faith were belabored and preached and whined about until I wanted to scream and I couldn't finish the book." The Smarts' book was used as the basis of the television movie *The Elizabeth Smart Story*, aired on CBS on November 9, 2003.

On March 9, 2006, Elizabeth Smart went to Congress to support sexual predator legislation. In 2008 she contributed to a pamphlet sponsored by the U.S. Department of Justice, titled "You're Not Alone: The Journey from Abduction to Empowerment": "Like you, I am also a survivor. . . . Do not feel obligated to tell people your experience. . . . [J]ust because they ask, or do something nice for you, does not give them the right to know what you went through. What happened is your story, which you can choose to share or to keep private." Should a person allegedly kidnapped and raped be able to choose to keep silent while her silence is used to indefinitely incarcerate the persons accused of the crime?

Early in 2004 Mitchell was declared competent to stand trial and answered "not guilty" to six different charges related to the kidnapping of Elizabeth Smart. After he began singing the Christmas hymn "Oh come, oh come, Emmanuel" at the hearing, he was ordered to submit to a new competency evaluation. (Emmanuel is the name Mitchell used as a street preacher.)

In January 2005 attorneys for Mitchell requested Elizabeth's school and medical records. Attorneys for the Smart family refused on the ground that "efforts to obtain the records are merely a ploy to get the family to agree to a lenient plea agreement." Edward Smart declared that he would rather see prosecutors make a plea bargain with Mitchell "than having his family go through the trauma of a trial."

In July 2006, TV pundit and victims' rights advocate Nancy Grace interviewed Elizabeth Smart and repeatedly asked her for information about her experience. Elizabeth asked Grace to stop and stated, "I really am here to support the bill and not to go into what—you know, what happened to me." Grace persisted, asking Elizabeth what it was like to see out of the burqa she was wearing. Elizabeth replied, "I'm really not going to talk about this at this time."

Mitchell continued to play the part of a Mormon prophet, interrupting one of his 2005 competency hearings "by singing religious songs, the third time he has done so." A defense expert testified that Mitchell is incompetent to stand trial "because he is consumed by 'messianic delusions' and wants to be crucified."

The psychiatrists "treating" Mitchell, confined in a Utah state mental hospital, sought to drug him to restore his competence. He refused and the courts were unwilling to authorize forced drugging. This prompted U.S. Attorney Brett Tolman, in October 2008, to announce his intention to prosecute Mitchell in federal court. A competency hearing for Mitchell was scheduled to begin in November. As a prelude to it, Elizabeth Smart testified in court for the first time—in a hearing ostensibly about Mitchell's mental competence to stand trial—about being raped by Mitchell "three or four times a day." According to the press, "Smart testified early because she is going on a religious mission for the Mormon church in Paris." She was not cross-examined and Mitchell—whose physical appearance belies the sexual prowess attributed to him by Smart—was excluded from the proceedings.

My brief remarks in this column are intended to call attention to still another case of the psychiatric denial of the right to trial of socially embarrassing defendants. Despite their publicity, such stories make no dent in dispelling the widely held belief that no American accused of a crime is deprived of liberty indefinitely without trial. The canard that psychiatry is a "helping profession" is even more impregnable.

Such stories make no dent in dispelling the widely held belief that no American accused of a crime is deprived of liberty indefinitely without trial.

How to End Mexico's Deadly Drug War

BY PAUL ARMENTANO

Albert Einstein declared, "The definition of insanity is doing the same thing over and over again and expecting different results." He wasn't describing the federal government's nearly century-long war on drugs but he might as well have been.

Despite ample lip-service for "hope" and "change," the Obama administration's cynical response to the escalating drug prohibition-related violence around the Mexican border epitomizes Einstein's oft-quoted observation.

Since 2008 more than 7,000 people—over 1,000 last January alone, including Mexican civilians, journalists, police, and public officials—have been killed in clashes with warring drug traffickers. Wire-service reports estimate that Mexico's drug lords employ over 100,000 soldiers—approximately as many as the Mexican army—and that the cartels' wealth, intimidation, and influence extend to the highest echelons of law enforcement and government. Where do the cartels get their unprecedented wealth and power? By trafficking in illicit drugs—primarily marijuana—over the border into the United States.

The U.S. Office of Drug Control Policy (more commonly known as the drug czar's office) says more than 60 percent of the profits reaped by Mexican drug lords are derived from the exportation and sale of cannabis to the American market. To anyone who has studied the marijuana issue, this figure should come as no surprise. An estimated 100 million Americans age 12 or older—or about 43 percent of the country—admit to having tried pot, a higher percentage, according to the World Health Organization, than any other country on the planet. Twenty-five million Americans admit (on government surveys, no less) to smoking marijuana during the past year, and 15 million say that they indulge regularly. This high demand, combined with the drug's artificially inflated black-market value (pot possession has been illegal under federal law since 1937), now makes cannabis America's top cash crop. In fact, according to a 2007 analysis by George Mason University professor Jon Gettman, the annual retail value of the U.S. marijuana market is some $113 billion.

How much of this goes directly to Mexican cartels is difficult to quantify, but no doubt the percentage is significant. Government officials estimate that approximately half the marijuana consumed in the United States originates from outside its borders, and they have identified Mexico as far and away America's largest pot provider. Because Mexican-grown marijuana tends to fetch lower prices on the black market than domestically grown weed (a result attributed largely to lower production costs—the Mexican variety tends to be grown outdoors, while an increasing percentage of American-grown pot is produced hydroponically indoors), it remains consistently popular among U.S. consumers, particularly in a down economy. As a result, U.S. law officials now report that some Mexican cartels are

> The annual retail value of the U.S. marijuana market is some $113 billion.

Paul Armentano (paul@norml.org) is the deputy director of NORML (National Organization for the Reform of Marijuana Laws) and the NORML Foundation (www.norml.org). He is the coauthor of Marijuana Is Safer: So Why Are We Driving People to Drink?

moving to the United States to set up shop permanently. A Congressional Research Service report says low-level cartel members are now establishing clandestine growing operations inside the United States (thus eliminating the need to cross the border), as well as partnering with domestic gangs and other criminal enterprises. A March 23 *New York Times* story speculated that Mexican drug gangs or their affiliates are now active in some 230 U.S. cities, extending from Tucson, Arizona, to Anchorage, Alaska.

In short, America's multibillion-dollar demand for pot is fueling the Mexican drug trade and much of the turf battles and carnage associated with it.

Same Old "Solutions"

So what are the administration's plans to quell the cartels' growing influence and surging violence? Troublingly, the White House appears intent on recycling the very strategies that gave rise to Mexico's infamous drug lords in the first place.

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In March the administration requested $700 million from Congress to "bolster existing efforts by Washington and Mexican President Felipe Calderón's administration to fight violent trafficking in drugs . . . into the United States." These efforts, as described by the *Los Angeles Times*, include: "vowing to send U.S. money, manpower, and technology to the southwestern border" and "reducing illegal flows (of drugs) in both directions across the border." The administration also announced that it intends to clamp down on the U.S. demand for illicit drugs by increasing funding for drug treatment and drug courts.

There are three primary problems with this strategy.

First, marijuana production is a lucrative business that attracts criminal entrepreneurs precisely because it is a black-market (and highly sought after) commodity. As long as pot remains federally prohibited its retail price to the consumer will remain artificially high, and its production and distribution will attract criminal enterprises willing to turn to violence (rather than the judicial system) to maintain their slice of the multibillion-dollar pie.

Second, the United States is *already* spending more money on illicit-drug law enforcement, drug treatment, and drug courts than at any time in our history. FBI data show that domestic marijuana arrests have increased from under 300,000 annually in 1991 to over 800,000 today. Police seizures of marijuana have also risen dramatically in recent years, as has the amount of taxpayer dollars federal officials have spent on so-called "educational efforts" to discourage the drug's use. (For example, since the late 1990s Congress has appropriated well over a billion dollars in anti-pot public service announcements alone.) Yet despite these combined efforts to discourage demand, Americans use more pot than anyone else in the world.

Third, law enforcement's recent attempts to crack down on the cartels' marijuana distribution rings, particularly new efforts launched by the Calderón administration in Mexico, are driving the unprecedented wave in Mexican violence—not abating it. The *New York Times* states: "A crackdown begun more than two years ago by President Felipe Calderón, coupled with feuds over turf and control of the organizations, has set off an unprecedented wave of killings in Mexico. . . . Many of the victims were tortured. Beheadings have become common." Because of this escalating violence, Mexico now ranks behind only Pakistan and Iran as the administration's top international security concern.

Despite the rising death toll, drug war hawks at the U.S. Drug Enforcement Administration (DEA) remain adamant that the United States' and Mexico's "supply side" strategies are in fact successful. "Our view is that the violence we have been seeing is a signpost of the success our very courageous Mexican counterparts are having," acting DEA administrator Michele Lionhart said recently. "The cartels are acting out like caged animals, because they are caged animals." President Obama also appears to share this view. After visiting with the Calderón government in April, he told CNN he intended to "beef up" security on the border. When asked whether the administration would consider alternative strategies, such as potentially liberalizing pot's criminal classification, Homeland Security Secretary Janet Napolitano replied that such an option "is not on the table."

A New Remedy

By contrast the Calderón administration appears open to the idea of legalizing marijuana—or at least reducing criminal sanctions on the possession of small quantities of drugs—as a way to stem the tide of violence. Last spring Mexican lawmakers made the possession of personal-use quantities of cannabis and other illicit substances a noncriminal offense. And in April Mexico's ambassador to the United States, Arturo Sarukhan, told CBS's *Face the Nation* that legalizing the marijuana trade was a legitimate option for both the Mexican and U.S. governments. "[T]hose who would suggest that some of these measures [legalization] be looked at understand the dynamics of the drug trade," Sarukhan said.

The Calderón administration appears open to the idea of legalizing marijuana.

Former Mexican President Vicente Fox recently echoed Sarukhan's remarks, as did a commission of former Latin American presidents. "I believe it's time to open the debate over legalizing drugs," Fox told CNN in May. "It can't be that the only way [to try to control illicit drug use] is for the state to use force."

Writing recently on CNN.com, Harvard economist and *Freeman* contributor Jeffrey Miron said that ending drug prohibition—on both sides of the border—is the only realistic and viable way to put a permanent stop to the rising power and violence associated with Mexico's drug traffickers. "Prohibition creates violence because it drives the drug market underground," he wrote. "This means buyers and sellers cannot resolve their disputes with lawsuits, arbitration or advertising, so they resort to violence instead. . . . The only way to reduce violence, therefore, is to legalize drugs."

Growing Support

Americans' support for legalizing the regulated production and sale of cannabis—an option that would not likely rid the world of cartels, but would arguably reduce their primary source of income—is at all an all-time high. In May a national Zogby telephone poll of 3,937 voters by the Republican-leaning O'Leary Report discovered, for the first time ever, that a slight majority (52 percent) of Americans "favor the legalization of marijuana." A separate Zogby poll reported even stronger support (58 percent) among west-coast voters.

Predictably, critics of marijuana legalization claim that such a strategy would do little to undermine drug traffickers' profit margins because cartels would simply supplement their revenues by selling greater quantities of other illicit drugs. Although this scenario sounds plausible in theory, it appears to be far less likely in practice.

As noted, Mexican drug lords derive an estimated 60 to 70 percent of their illicit income from pot sales. (By comparison, only about 28 percent of their profits are derived from the distribution of cocaine, and less than 1 percent comes from trafficking methamphetamine.) It is unrealistic to think that cartels could feasibly replace this void by stepping up their sales of cocaine, methamphetamine or heroin—all of which remain far less popular among U.S. drug consumers anyway. Just how much less? U.S. Department of Health and Human Services survey data show that roughly two million Americans use cocaine, compared to 15 million for pot. Fewer than 600,000 use methamphetamine, and fewer than 155,000 use heroin. In short, this is hardly the sort of demand that would keep Mexico's drug barons in the lucrative lifestyle to which they've become accustomed.

Of course, it's unrealistic to think that pot legalization would wipe out prohibition-inspired violence altogether. After all, ending alcohol prohibition in America didn't single-handedly put the Mafia out of business (though it greatly reduced its power and influence). And it's always possible that Mexico's drug cartels would continue to engage in violent acts toward one another as competing factions fought over the crumbs of America's drastically shrunken illicit-drug market.

That said, it's equally unrealistic, if not more so, to think that continuing our same failed drug war policies will do anything but exponentially increase the catastrophe they've spawned, both in Mexico and at home. It's time to engage in a different strategy. It's time to seriously consider legalizing marijuana and other drugs. FEE

Ten Reasons Why Slavery Should Not Be Abolished

BY ROBERT HIGGS

Slavery existed for thousands of years, in all sorts of societies and all parts of the world. To imagine human social life without it required an extraordinary effort. Yet, from time to time, eccentrics emerged to oppose it, most of them arguing that slavery is a moral monstrosity and therefore people should get rid of it. Such advocates generally elicited reactions ranging from gentle amusement to harsh scorn and even violent assault.

When people bothered to give reasons for opposing the proposed abolition, they advanced various ideas. Here are ten such ideas I have encountered in my reading.

The same arguments used in the past to justify slavery are used to justify the existence of government as we know it.
Graphic courtesy sonofthesouth.net

1. *Slavery is natural*. People differ, and we must expect that those who are superior in a certain way—for example, in intelligence, morality, knowledge, technological prowess, or capacity for fighting—will make themselves the masters of those who are inferior in this regard. Abraham Lincoln expressed this idea in one of his famous 1858 debates with Senator Stephen Douglas: "[T]here is a physical difference between the white and black races which I believe will forever forbid the two races living together on terms of social and political equality. And inasmuch as they cannot so live, while they do remain together there must be the position of superior and inferior, and I as much as any other man am in favor of having the superior position assigned to the white race."

2. *Slavery has always existed*. This reason exemplifies the logical fallacy *argumentum ad antiquitatem* (the argument to antiquity or tradition). Nevertheless, it often persuaded people, especially those of conservative bent. Even nonconservatives might give it weight on the quasi-Hayekian ground that although we do not understand why a social institution persists, its persistence may nonetheless be well grounded in a logic we have yet to understand.

3. *Every society on earth has slavery*. The unspoken corollary is that every society *must have* slavery. The pervasiveness of an institution seems to many people to constitute compelling proof of its necessity. Perhaps, as one variant maintains, every society has slavery because certain kinds of work are so difficult or degrading that no free person will do them, and therefore unless we have slaves to do these jobs, they will not get done. Someone, as the saying went in the Old South, has to be the mud sill, and free people will not tolerate serving in this capacity.

4. *The slaves are not capable of taking care of themselves*. This idea was popular in the United States in the late eighteenth and early nineteenth centuries among people, such as George Washington and Thomas Jefferson, who regarded slavery as morally reprehensible yet continued to hold slaves and to obtain personal services from them and

Robert Higgs (rhiggs@independent.org) is a senior fellow at the Independent Institute (www.independent.org), editor of The Independent Review, *and author of* Neither Liberty nor Safety: Fear, Ideology, and the Growth of Government *(Independent Institute).*

income from the products these "servants" (as they preferred to call them) were compelled to produce. It would be cruel to set free people who would then, at best, fall into destitution and suffering.

5. *Without masters, the slaves will die off.* This idea is the preceding one pushed to its extreme. Even after slavery was abolished in the United States in 1865, many people continued to voice this idea. Northern journalists traveling in the South immediately after the war reported that, indeed, the blacks were in the process of becoming extinct because of their high death rate, low birth rate, and miserable economic condition. Sad but true, some observers declared, the freed people really were too incompetent, lazy, or immoral to behave in ways consistent with their own group survival. (See my 1977 book *Competition and Coercion: Blacks in the American Economy, 1865–1914*.)

6. *Where the common people are free, they are even worse off than slaves.* This argument became popular in the South in the decades before the War Between the States. Its leading exponent was the proslavery writer George Fitzhugh, whose book titles speak for themselves: *Sociology for the South, or, the Failure of Free Society* (1854) and *Cannibals All!, or, Slaves Without Masters* (1857). Fitzhugh seems to have taken many of his ideas from the reactionary, racist, Scottish writer Thomas Carlyle. The expression "wage slave" still echoes this antebellum outlook. True to his sociological theories, Fitzhugh wanted to extend slavery in the United States to working-class white people, for their own good!

7. *Getting rid of slavery would occasion great bloodshed and other evils.* In the United States many people assumed that the slaveholders would never permit the termination of the slave system without an all-out fight to preserve it. Sure enough, when the Confederacy and the Union went to war—set aside that the immediate issue was not the abolition of slavery, but the secession of eleven Southern states—great bloodshed and other evils did ensue. These tragic events seemed, in many people's minds, to validate the reason they had given for opposing abolition. (They evidently overlooked that, except in Haiti, slavery was abolished everywhere else in the Western Hemisphere without large-scale violence.)

> Today, opponents of a different form of abolitionism—of government as we know it—use these or very similar arguments.

8. *Without slavery the former slaves would run amuck, stealing, raping, killing, and generally causing mayhem.* Preservation of social order therefore rules out the abolition of slavery. Southerners lived in dread of slave uprisings. Northerners in the mid-nineteenth century found the situation in their own region already sufficiently intolerable, owing to the massive influx of drunken, brawling Irishmen into the country in the 1840s and 1850s. Throwing free blacks, whom the Irish generally disliked, into the mix would well-nigh guarantee social chaos.

9. *Trying to get rid of slavery is foolishly utopian and impractical; only a fuzzy-headed dreamer would advance such a cockamamie proposal.* Serious people cannot afford to waste their time considering such farfetched ideas.

10. *Forget abolition. A far better plan is to keep the slaves sufficiently well fed, clothed, housed, and occasionally entertained and to take their minds off their exploitation by encouraging them to focus on the better life that awaits them in the hereafter.* We cannot expect fairness or justice in this life, but all of us, including the slaves, can aspire to a life of ease and joy in Paradise.

At one time, countless people found one or more of the foregoing reasons adequate grounds on which to oppose the abolition of slavery. Yet in retrospect, these reasons seem shabby—more rationalizations than reasons.

Today these reasons or very similar ones are used by opponents of a different form of abolitionism: the proposal that government as we know it—monopolistic, individually nonconsensual rule by an armed group that demands obedience and payment of taxes—be abolished. I leave it as an exercise for the reader to decide whether the foregoing reasons are more compelling in this regard than they were in regard to the proposed abolition of slavery.

Climate Change in the Great American Desert

BY TYLER WATTS

President Obama's science adviser, Dr. John Holdren, a Harvard physicist and persistent global-warming alarmist, made the news recently with a stunning and bold idea on how to halt the imminent danger posed by global warming—sorry, global climate change. Holdren has discussed the feasibility of geo-engineering, a deliberate attempt at manmade climate change to counteract dreaded global warming. He says that although geoengineering may be farfetched, it might become necessary as a last-ditch attempt to save the planet, especially if greenhouse-gas emissions are not cut soon enough or deeply enough.

> The idea of manmade climate change has been around in the United States since the middle of the nineteenth century.

Global-warming skeptics like to point out the vanity of the idea that human activity can actually change the climate of the planet. If there is a significant change in average temperatures, skeptics argue, it comes from massive and unstoppable natural forces, not human activity. Skeptics also like to point out the inconsistency of climate-change fear-mongers, particularly the widespread fear of global cooling as recently as the late 1970s.

Green activists and global-warming skeptics alike might be surprised to learn that the idea of manmade climate change has been around in the United States since the middle of the nineteenth century. Much like today, this early wave of climate-change fever was vouched for by many prominent scientists and publications, and had many adherents among the general public. Instead of alarm and distress about the danger of climate change, though, in the later 1800s there was excitement and anticipation about what it portended for American agriculture. Although the two episodes differ in this important aspect—whether climate change was to be viewed as a bane or a boon—there is undoubtedly much to learn by examining the nature of nineteenth-century climate-change thinking and its impact on the U.S. economy.

The theories back then held that the high-plains region of the western United States was undergoing a secular increase in rainfall, changing from a semiarid to a humid climate. These theories turned out to be dead wrong and several prominent scientists dismissed them from the beginning. But that did not stop hundreds of thousands of people from making life-altering decisions and undertaking big investments based largely on the mistaken belief that human activity was changing the climate for the better.

The westward drive of American settlers during the 1800s was stunning in its scale, scope, and speed. Within a hundred years adventurous entrepreneurs and hardy pioneers, with some help from the U.S. military, had wrested control of the western frontier and turned it into a well-organized extension of the United States. Settlement proceeded apace, despite the fact that vast swaths of this land had, early in the century, been deemed barren and unfit for agricul-

Tyler Watts (twatts3@gmu.edu) is a Ph.D. candidate in economics at George Mason University.

ture. Major Stephen H. Long, commissioned to explore and map the far western frontier, famously labeled the high plains—extending from roughly the 100th meridian (marking the eastern third of Kansas today) to the base of the Rocky Mountains—the "Great American Desert" in 1823.

Yet the agricultural frontier was approaching the high plains by the 1860s. The 1862 enactment of the Homestead Act, which offered 160 acres to anyone who would farm the land for five years and build a house, encouraged further settlement. Homesteading drew hundreds of thousands of settlers to this "free" land after the Civil War. Although Frederick Jackson Turner declared the frontier closed in 1890, homesteading continued up to the 1920s. Eventually 270 million acres of public domain were claimed.

Homesteading and Climate Change

As many astute commentators of the day noticed, and as thousands of ill-fated "sodbusters" would find out the hard way, 160 acres was far too small a plot of land for a farm to be sustainable and economically viable over the long-term on the high plains. The climate there is officially labeled semiarid, receiving far less rainfall on average than the midwestern states that most of the homesteaders came from. The rain that does come is highly variable. Some years are so wet that corn and wheat crops exceed midwestern yields, but randomly interspersed with these good years are droughts so severe that nothing at all can be grown. Despite this climatic challenge, and observations and reports detailing the difficulty of traditional agricultural methods and crop selections, homesteaders poured onto the high plains confident in the prospects of dryland farming.

The first wave of homesteaders to hit the high plains of western Nebraska and Kansas in the 1870s had lucked out, arriving during an extremely wet phase in the natural climate cycle. The farms did well initially, which prompted further waves of migration. But rather than discount the good years as extraordinary based on the long-term climate experience (going back at least 50 years to Major Long's expedition and the accumulated knowledge of Plains Indians), settlers were beguiled by the idea of climate change, represented by the common nostrum that "rain follows the plow." This doctrine held that human activity—in this case, cultivation of large tracts—would lead to a positive climate change in the form of increased rainfall. Economists Gary Libecap and Zeynep Hansen have noted:

> [O]n the Kansas frontier, homesteaders relied upon predictions of climate change and increased rainfall due to cultivation. Webb [a Great Plains historian] labeled the notion that precipitation would rise with settlement as a "false hypothesis" that grew out of the intense desire of farmers for more rain. But rainfall initially was high as agriculture moved into the region, and observers lacked any compelling reason to deny its possible link to settlement.

> The first wave of homesteaders to hit the high plains of western Nebraska and Kansas were beguiled by the idea of climate change, represented by the common nostrum that "rain follows the plow."

In 1938 Frederic Clements, writing in *Scientific Monthly*, likewise reported the allure of climate-change theories:

> With memories of grasshopper years in mind, pioneer and newcomer alike felt that drought and hard times had passed for good and that the future held nothing but timely rains and bountiful crops. This feeling was capitalized by those with lands to sell or commonwealths to build, and in good faith even men of science gave their support to the myth that the climate had permanently changed for the better as a result of settlement and cultivation.

Theories of increased rainfall attributed its possible causes to all sorts of human activity, from plowing of the soil, to irrigating it, to the planting of trees. Henry Nash Smith, founder of American Studies as an academic discipline, discussed one such theory as advocated by Ferdinand Hayden, a well-known geologist and western explorer:

[I]n 1867 [Hayden] triumphantly advanced a proposal which he believed would increase precipitation on the Plains permanently. Hayden's scheme was simple: the planting of trees along the eastern edge of the treeless Plains. He believed he had seen experimental proof that trees would thrive there without artificial watering, and that in this fashion "forests may be restored to these almost treeless prairies in a comparatively short period of time." Forests would bring rain: "The settlement of the country and the increase of the timber," asserted Hayden, "has already changed for the better the climate of that portion of Nebraska lying along the Missouri, so that within the last twelve or fourteen years the rain has gradually increased in quantity and is more equally distributed through the year. I am confident this change will continue to extend across the dry belt to the foot of the Rocky Mountains as the settlements extend and the forest-trees are planted in proper quantities."

Climate-Change Theories Published

Lending to their credibility, official government reports and major scientific journals published climate-change theories like Hayden's. As Smith further pointed out,

[D]uring the decade 1865–1875 the idea of a permanent increase in rainfall gained much wider currency and was treated with respect by scientists of unquestioned professional standing. A communication setting forth theories of this type was, for example, accepted by Joseph Henry for publication in the Reports of the Smithsonian Institution; and similar ideas were discussed favorably at a meeting of the American Association for the Advancement of Science.

All the "rain follows the plow" believers were eventually disappointed by the cycles of severe drought normal for semiarid zones. But the early climate-change optimism, combined with terribly inadequate government land policies, set the stage for tremendous malinvestment, economic waste, and often a tragic and painful dislocation of population. In the journal *Agricultural History* (1977) Gilbert Fite gave details of the dislocations prompted by an 1890s drought:

> Thousands of broke and starving settlers fled the region. Between 1890 and 1900 the population of western Kansas and Nebraska dropped sharply. There were 15,284 less people in the counties west of the 100th meridian in Nebraska in 1900 than a decade earlier and 6,018 fewer farms. Sixteen of South Dakota's counties, mostly between the James and Missouri Rivers, lost population in that discouraging decade. Depopulation in the countryside also brought decline in the towns and villages and punctured the speculative plans of promoters and town-site boosters.

> The early climate-change optimism, combined with terribly inadequate government land policies, set the stage for tremendous malinvestment, economic waste, and a dislocation of population.

Clements likewise noted the massive depopulation brought on by the drought and the shaking of climate-change views: "Such beliefs ['rain follows the plow'] were disturbed by the drought of 1889 and shattered for a generation by that of 1893–95, when the exodus from the parched regions sent a half million settlers across the Missouri River and back to their homes in the East."

Similar waves of farm failure and farmer flight recurred after a region-wide drought in the early 1920s. Libecap and Hansen have noted that in eastern Montana, for instance, one-fifth of the homestead farms failed in the early 1920s, with 60,000 farmers packing up and leaving. Henry Smith reported contemporary observations of the economic hardship:

The seasoned plainsman, General William B. Hazen, asserted in 1875 that "dreadful suffering and almost starvation" had resulted from agricultural occupation of inadequately watered areas in Kansas under the influence of "the very popular theory" that the rainfall was undergoing a permanent increase. Fifteen years later the distinguished British geologist John W. Gregory, who had been conducting a study of artesian wells in the

Dakotas for the United States Department of Agriculture, wrote in the *Century* magazine that large portions of the Plains had been thrice occupied by overconfident settlers and then abandoned because of drought. And as late as 1901 Willard D. Johnson of the United States Geological Survey pointed to the "vexing problem" created by "fruitless and demoralizing movements of population" into subhumid portions of the Plains under the mistaken belief that "a radical change of climate" was taking place.

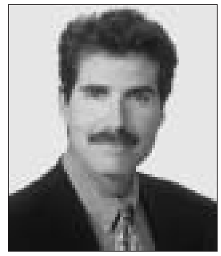
The net result of a well-intentioned though terribly misguided government land policy, combined with a pseudo-scientific popular belief in climate change, was wasteful malinvestment in high plains farming on a grand scale. The 160-acre plots allowed by the original Homestead Act turned out to be far too small to support a dryland farm family over the long haul. Although the homestead size was doubled in 1909, 320-acre plots still proved inadequate; by the early 1980s, when most of the failed and marginal farmers had long since fled, average farm sizes had reached into the 1,200–2,500 acre range, according to Libecap and Hansen. Widely held and supposedly "scientific" ideas of climate change magnified the eventual problems. Indeed, the idea of a permanent increase in rainfall in the Great American Desert, though patently absurd from our vantage point, was nothing but a confirmation-biased rationalization of existing government policy and popular ideas about American development.

Today, we are again facing a string of weird weather coupled with highly dubious science proclaiming that man has it in his power to change the climate of the planet.

I don't have the scientific knowledge or training to cast an authoritative judgment on the possibility of manmade global warming nor the efficacy of geoengineering. What I do know, however, is that most grandiose schemes to drastically remake the world, whether based on science or morality, have been tried before in some form or another and found wanting, sometimes with utterly disastrous consequences. More than a century ago, people were fooled by an unlucky coincidence of bad science and good weather into thinking that man could change earth's climate. Today, we are again facing a string of weird weather coupled with highly dubious science proclaiming that man has it in his power to change—in our case, to wreck—the climate of the planet. Will we learn a lesson in patient skepticism in the face of "scientific" alarmists, or let them in their hubris lead us down a path of improvident and ultimately wasteful investments? I'm skeptical, not just about the very idea of manmade climate change, but also that we'll be able to take the alarmist-crusaders' calls for action with the grain of salt they deserve. FEE

Give Me a Break!

Big Business Goes Big for Healthcare Reform



BY JOHN STOSSEL

"What disturbs Americans of all ideological persuasions is the fear that almost everything, not just government, is fixed or manipulated by some powerful hidden hand," Frank Rich wrote in the *New York Times* a few months ago.

That manipulation should disturb us. But contrary to Rich, it is not the work of "corporatists" who have sprung up to attack Progressive reforms proposed by Obama and the Democratic majority. Manipulation is what we got many years ago when we traded a more or less free market for the "Progressive" interventionist state. When government is big, the well-connected always have an advantage over the rest of us in influencing public policy.

When government is big, the well-connected always have an advantage over the rest of us in influencing public policy.

Observe: Although President Obama and big-government activists demonize health-insurance companies, the companies "are still mostly on board with the president's effort to overhaul the U.S. health-care system," the *Wall Street Journal* reports.

And even though the activists criticize Big Pharma, "The drug industry has already contributed millions of dollars to advertising campaigns for the healthcare overhaul through advocacy groups like Healthy Economies Now and Families USA. It has spent about $1 million on similar advertisements under its own name," the *Times* reports.

Big Business, Big Pharma, and Big Insurance

Big Pharma and Big Insurance want Obama-style healthcare reform?

It's not so hard to understand. "The drug makers stand to gain millions of new customers," the *Times* said. And from the *Journal*: "If health legislation succeeds, the [insurance] industry would likely get a fresh batch of new customers. In particular, many young and healthy people who currently forgo coverage would be forced to sign up." No wonder insurers are willing to stop "discriminating" against sick people. (Forget that the essence of insurance is discrimination according to risk.)

Not that Big Pharma and Big Insurance like every detail of the Democratic plan. Drug companies don't want Medicare negotiating drug prices—for good reason. If it forces drug prices down, research and development will be discouraged. (Depending on whom you believe, Obama may or may not have agreed with the drug companies on this point.)

As for the insurance companies, they worry—legitimately—that a government insurance company—the so-called public option—would drive them out of business. This isn't alarmism. It's economics. The public option would have no bottom line to worry about and therefore could engage in "predatory pricing" against the private insurers.

But despite these differences, the biggest companies in these two industries are on board with "reform."

Horwitz's First Law In Action

It illustrates economist Steven Horwitz's First Law of Political Economy: "No one hates capitalism more than capitalists." In this case, big business wants to shape—and profit from—what inevitably will be an interventionist healthcare "reform." Can you think of the last time a major business supported a truly free market in anything?

John Stossel hosts Stossel *on Fox Business Network and is the author of* Myths, Lies, and Downright Stupidity: Get Out the Shovel—Why Everything You Know is Wrong. *Copyright 2009 by JFS Productions, Inc. Distributed by Creators Syndicate, Inc.*

In light of all this, it was funny to watch Democrats and their activist allies panic over the protests at the August congressional town meetings around the country. Tools of the corporate interests! they cry. But anyone opposing "socialized medicine" can't be a mouthpiece for big business because, as we've seen, big business supports government control. Conservative groups may be encouraging people to vent their anger at congressmen who pass burdensome legislation without even bothering to read it, but that's no reason to insult the protestors as pawns. What's wrong with organizations helping like-minded people to voice their opinions? Why do Democrats, such as Speaker Nancy Pelosi, dismiss citizen participation as "AstroTurf"—not real grassroots—only when citizens oppose the kind of big government they favor?

> Anyone opposing "socialized medicine" can't be a mouthpiece for big business because big business supports government control.

They weren't so dismissive when George W. Bush was president and people protested—appropriately—his accumulation of executive powers.

"When handfuls of Code Pink ladies disrupted congressional hearings or speeches by Bush administration officials," Glenn Reynolds wrote, "it was taken as evidence that the administration's policies were unpopular, and that the thinking parts of the populace were rising up in true democratic fashion. . . . But when it happens to Democrats, it's something different: A threat to democracy, a sign of incipient fascism. . . . House Speaker Nancy Pelosi calls the 'Tea Party' protesters Nazis. . . . So when lefties do it, it's called "community organizing."

When conservatives and libertarians do it, it's "AstroTurf."

Give me a break. FEE

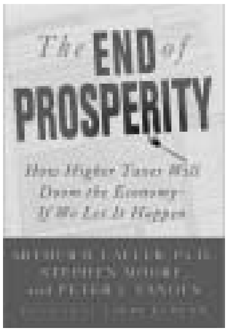
Book Reviews

The End of Prosperity: How Higher Taxes Will Doom the Economy—If We Let It Happen

by Arthur B. Laffer, Stephen Moore, and Peter J. Tanous

Threshold Editions • 2008 • 304 pages • $27.00 hardcover; $16.00 paperback

Reviewed by George C. Leef



If you were to believe spokesmen for the Obama regime and its allied pseudo-economists, there is no tradeoff between the size of government and our standard of living. On the contrary, they would like people to believe that the bigger the government gets, the more it can "stimulate" the economy and solve all sorts of alleged social problems, like the need for "affordable" health care. In their Alice-in-Wonderland world, government is the *source* of prosperity.

Opposing that view are numerous writers who understand the simplest of economic concepts—that scarcity imposes tradeoffs. The more government grows, the more it consumes and directs resources that would otherwise have been put to use by individuals, firms, and other voluntary organizations. Government has no wealth and creates no wealth. All it can do is redirect wealth, employing it in ways chosen by politicians rather than the ways consumers would have chosen. Once you understand that political choices are dominated by short-run, vote-buying concerns that impede productivity, you see that the bigger government gets, the less prosperous the people will be.

Among the writers who understand this are the authors of *The End of Prosperity*, three advocates of the supply-side theory, which says that when taxes are too high, the government strangles the incentives for investment and productivity. Their book, published before the 2008 election but clearly anticipating the victory of Barack Obama and the dominance of demand-side economic thinking (the notion that the more the government spends, the stronger the economy will be), explains why the high-tax, big-government approach always puts the economy on downers. Laffer, Moore, and Tanous provide a good survey of our last several economic decades for Americans either too young or too forgetful to know that there is an inverse relationship between government and prosperity.

It's a useful history going back to the 1960s that connects our economic ups and downs to what they call "The Four Killers of Prosperity": trade protectionism, tax increases and profligate spending, regulations that increase government intervention in the economy, and mistakes in monetary policy. We had big doses of all of them in the late 1960s and throughout the '70s, when the nation was socked with the Nixon-Ford stagflation and later the low-productivity, high-interest-rate economic malaise under Carter. Then we experienced somewhat less of the Four Killers in the Reagan years and the economy improved considerably.

The authors might have done more to explain how the current economic debacle (especially the housing bubble) was caused by policy blunders, but at least they debunk political insiders' arguments that the economic crisis was due to laissez-faire. "As if we ever had that," they write. The Obama economic policy agenda, they show, is a disastrous concoction of those prosperity killers, and if it goes through we will face the end of prosperity.

That's all good, but the book has a serious weakness. Like most writings by people in the supply-side camp, it overemphasizes tax policy and underemphasizes the need to reduce government spending. Worse, it repeatedly says that one of the reasons to favor tax cuts is that they can increase government revenues. But increasing government revenues just means more spending on military adventures, failed social policies, and special-interest group handouts.

As Milton Friedman used to point out, government's true burden on the economy is measured by its spending not its taxing. It has to get the money one way or another: taxation, borrowing, or printing money.

The problem we face is how to keep Leviathan from destroying what is left of liberty and property rights. That being the case, the authors missed an opportunity to drive home the point that the federal budget must be put on a crash diet.

Our real problem isn't so much getting tax policy right; it's persuading people we should radically downsize government. If we can do that, how it collects tax revenue isn't very important. FEE

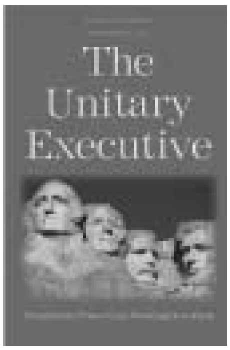
George Leef (georgeleef@aol.com) is book review editor of The Freeman.

The Unitary Executive: Presidential Power from Washington to Bush

by Steven G. Calabresi and Christopher S. Yoo

Yale University Press • 2008 • 431 pages • $60.00

Reviewed by Joseph R. Stromberg



Steven G. Calabresi and Christopher S. Yoo count as founding fathers of the much-debated unitary executive theory (UET), which they named in 1992. In this large book they argue that every American president has subscribed to the theory, and that along with constitutional text and structure, this continuous presidential practice makes the law.

Briefly, UET asserts that a great thing or shapeless blob is granted in Article II: "the executive power." (We naïve folk thought it just named a job.) Presidential power to remove subordinates (at will) follows directly. "Departmentalism" is another implication. This finds the executive to be a coequal interpreter of the Constitution along with Congress and the Supreme Court. (The states need not apply.)

The authors, both law professors, undertake a Maoist Long March through 43 presidencies, turning up many uses (and abuses) illustrating presidential power. It all amounts to a revealing, power-centric history of the United States. The authors purport to adduce "solid antecedents" for their view, such as James Wilson's ruminations during the Pennsylvania ratifying convention.

Calabresi and Yoo's key evaluative tool is how much a given president improved and empowered the mighty office. First up, George Washington supervised, removed, controlled all prosecutions (just like George III), called out militia, and granted pardons. Thomas Jefferson executed an embargo and bought Louisiana. Andrew Jackson was a Bonapartist (my term), who somehow embodied The People. Lincoln deployed, suspended, censored, "repelled" attacks, and invented presidential war powers by wedding the commander-in-chief clause to the "Take Care" clause. In fact, say the authors: "The Civil War was fought over the issue of the president's authority to take care that the laws be executed in the South." This is a peculiar focus indeed.

Much later, President McKinley's foreign policy and war strengthened the office. Teddy Roosevelt had no war but nevertheless issued numerous executive orders to expand the reach of the presidency. Woodrow Wilson, war in hand, did much more. Under Franklin Roosevelt, "power exploded," as he controlled, executed, and issued innumerable orders. Harry Truman got us into Korea with unitary fervor. When he unitarily seized certain steel mills, the Supreme Court declared that while the president has much unspecified power, it wasn't *quite as much* as Truman asserted.

Leading largely by stealth, President Eisenhower removed officials, delegated authority, ordered federal troops into Arkansas, and expanded claims of executive privilege to thwart Senator McCarthy. The ill-starred John Kennedy issued numerous orders and had federal troops invade Mississippi. Lyndon Johnson pushed presidential power well beyond Kennedy, and Nixon stalwartly asserted yet more executive powers. The upward trajectory continued on through Reagan, Clinton, and the Bushes.

Other presidents weigh less in the unitary scale. James Buchanan, the authors' "worst president," failed to bring on war and grab power. Andrew Johnson at least defended the office against congressional Radicals. Hoover was only so-so but did much executing of Prohibition and issued the Stimson Doctrine. Even Jimmy Carter, called the "nadir" of executive power, at least ordered the freezing of Iranian assets. They also serve who only keep presidential powers intact. Naturally, this reduces the normal ("historically correct") charges against them.

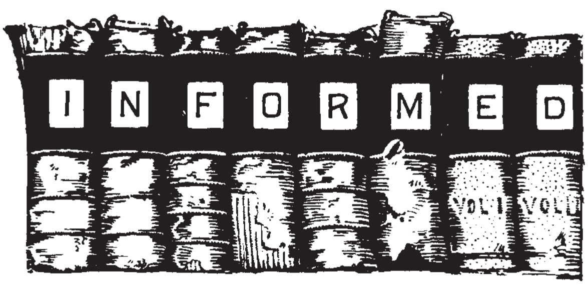
War meets with awkward treatment in this book. Popular wars or those too ancient to stir controversy may be mentioned, mostly as an arena for presidential heroics. The Mexican War squeaks by and the "Civil War" and World Wars I and II are noticed. The Spanish-American War gets an allusion. Oddly, the word "Vietnam" hardly intrudes on the discussion of Kennedy, LBJ, and Nixon. Neither would we ever learn here that anything warlike happened under George H. W. Bush or Bill Clinton. After all, an office best suited for getting us into wars might seem less lustrous if all the wars were reckoned in.

Now it comes out that there are two flavors of UET. Our authors only claim that whatever executive powers *really exist* belong to the president alone. They are quite reasonable and do not believe in certain "inherent" powers that George W. Bush asserted. But with so many undefined and nebulous powers so moderately claimed, how can the "moderate" UE theorists spy the "excessive" ones?

Much like Hobbes's *Leviathan*, this is a good book: It shows us what is at stake. Is the case made? Should enemies of the UET concede? It might seem so, but there is a problem. It would be easy enough to write a lengthy work proving that for 200 years prominent American burglars have firmly asserted their "right" to break and enter. This would neither put our minds at rest nor establish the "right."

So it is with the American executive. This interesting book demonstrates that most American presidents have been unwilling to abide by constitutional limits on their power, but not that their power was meant to be almost limitless. FEE

Joseph R. Stromberg (strombergjr48@gmail.com) is an independent historian living in Georgia.



Biography of the Dollar: How the Mighty Buck Conquered the World and Why It's Under Siege

by Craig Karmin

Crown Business • 2008 • 272 pages • $25.95 hardcover; $13.95 paperback

Reviewed by John Tamny

Think of the various dollar-denominated bills in your pocket. They surely represent value, but with the dollar backed by nothing beyond trust in the United States and its Treasury, the greenback's success as a worldwide store of value is something of a marvel.

Wall Street Journal reporter Craig Karmin's *Biography of the Dollar* helps us to understand the dollar's role in the world economy. Karmin's book provides fascinating statistics about the dollar, not to mention lively writing that takes us everywhere from the trading floor of a currency hedge fund, to the building where dollars are printed, to countries such as Ecuador that have made the greenback their own currency.

The dollar figures in about 90 percent of all trades in the $3.2 trillion foreign exchange market, Karmin writes. Nearly two-thirds of the world's central-bank holdings are also denominated in dollars. And of the $760 billion worth of dollars in circulation at the time of publication, two-thirds of those bills were in the hands of individuals outside the United States.

That statistic alone is a reminder that the Fed cannot control the quantity of dollars within the country. If the Fed tries to prevent inflation by draining the U.S. "pond" of dollars, other dollar ponds from abroad will spill greenbacks into our own to make up for the Fed's perceived tightness.

Karmin notes that before 1971, when President Nixon stopped redeeming foreign-held dollars in gold, currency markets and trading were largely nonexistent because the dollar was defined as one thirty-fifth of an ounce of gold and the world's currencies were pegged to the dollar. Since then, currency trading has skyrocketed. From 1989 to the present, the currency markets have grown sixfold, given the globalized nature of the economy, which requires that all transactions be hedged to account for floating units of account. What Karmin misses here is the unseen: How many brilliant innovators did ours and the world's economies lose to Wall Street and other centers of finance? Nothing against Wall Street or finance, but currency trading is a form of economic facilitation, as opposed to productive economic activity.

Karmin correctly notes that "there is no such thing as a bull or bear market for foreign exchange" since currencies only "strengthen or weaken relative to one another." True, but he leaves out the important truth that currencies today are uniform in their lack of definition. As such, currency strength or weakness can be a mirage. Indeed, if the dollar and yen are stable with regard to one another, the alleged stability could mask two currencies in decline. That's why it's unrealistic to discuss currencies without an objective benchmark such as gold to measure their true value.

The gold question is where I found the greatest disagreement with Karmin. He argues that Nixon's decision to leave gold was a "crucial step toward unlocking the dollar's full potential to mobilize the global economy at the end of the twentieth century." That's a well-worded platitude, but it's impossible to see how giving the federal government a free hand to inflate did anything to help mobilize the global economy. Doesn't Karmin know that international trade expanded greatly under gold in the nineteenth century?

On the inflation front, Karmin seems torn. While he acknowledges that price inflation is the result of falling currency values, he also engages in discredited Phillips Curve thinking, which suggests that economic growth itself causes a rise in the price level. Just once I would like Phillips Curve adherents to reveal *any* evidence supporting the notion that growth is inflationary.

Despite my disagreements with Karmin over his economic analysis, *Biography of the Dollar* is informative and well worth a read. FEE

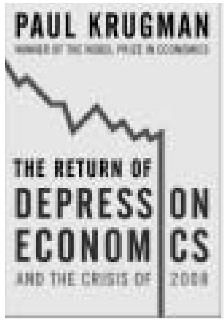
John Tamny (jtamny@realclearmarkets.com) is editor of RealClearMarkets and a senior economic adviser to Toreador Research and Trading.

The Return of Depression Economics and the Crisis of 2008

by Paul Krugman

W. W. Norton & Company • 2008 • 224 pages • $24.95 hardcover; $16.95 paperback

Reviewed by William L. Anderson



Reading *The Return of Depression Economics*, I have to admit I was surprised. Paul Krugman, 2008 Nobel Prize winner in economics and *New York Times* columnist, isn't as feisty and partisan in the book as he is in his column. Moreover, he presents some useful information about the many economic collapses that have occurred in the past 20 years.

But, alas, in the end Krugman resorts to the arguments of the great economic cranks of history, from Silvio Gesell to John Maynard Keynes. He's like the mechanic who expertly describes a problem with your fuel pump—then insists your car needs more gas. If the tank is full, he tells you to attach an auxiliary tank.

In other words, Krugman is still the one-trick pony featured in the *Times.* Whatever the problem, his solution is always the same: inflation. It shows up in the example he uses throughout the book, a 1970s babysitting co-op on Capitol Hill.

The baby-sitting "economy" is a co-op in which the couples agree to babysit one another's children for coupons (babysitting credits) instead of dollars. But Krugman says this scheme ran into problems during the winter. The couples hoarded their coupons (that is, they refused to hire babysitters) while trying to get more coupons (sell babysitting services) so they would be able to go out more often in the summer.

Unfortunately, with everyone pursuing the same strategy at once—trying to sell without buying—Krugman writes, the co-op went "into a recession." But never fear: This babysitting "liquidity trap" ended when the directors of the co-op printed and distributed more coupons and everyone lived happily ever after.

The problem with drawing general lessons from this situation should be obvious. A babysitting co-op in which a few people with similar preferences produce one good cannot be a model for a complex economy. But since Krugman—like other Keynesians—believes an economy is a crude, simple mechanism controlled by "aggregate demand," this is the best he can do.

Writing about this "fix" for the co-op, Krugman says, "Recessions, in other words, can be fought simply by printing money—and can sometimes (usually) be cured with surprising ease."

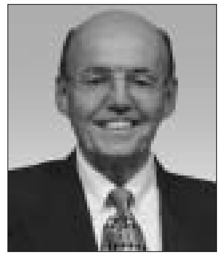
Even though I have read many of Krugman's columns and was not surprised by this answer, it is nonetheless shocking to read that a Nobel laureate actually believes that we can "cure" almost any economic downturn by cranking up the printing presses.

That's bad enough, but Krugman also likes to rewrite economic history.

He says our present economic and financial troubles are due to free markets and financial deregulation. He argues that the cartelized financial system created during the New Deal should have remained unchanged, even though it was actually in crisis back in 1980. The alleged "deregulation," however, did not create free markets but expanded moral hazard by increasing deposit insurance and empowering the Fed to "backstop" financial market losses, which invited reckless behavior on Wall Street. All this federal interference with both free markets and an authentic profit-and-loss system resulted, predictably if sadly, in the current financial meltdown.

From blaming the Great Depression in part on the gold standard to caricaturing free markets, Krugman places himself squarely in the socialist-interventionist camp. He writes: "Some people say that our economic problems are structural, with no quick cure available; but I believe that the only important structural obstacles to world prosperity are the obsolete doctrines that clutter the minds of men." Unfortunately Krugman counts freedom among them. FEE

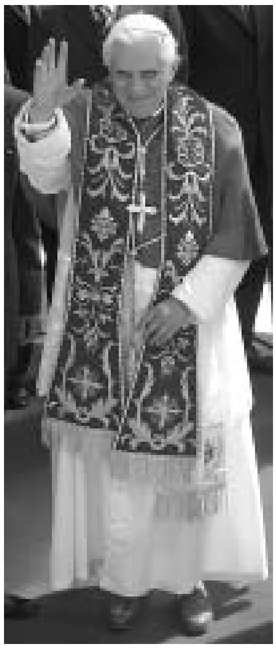
William Anderson (banderson@frostburg.edu) is associate professor of economics at Frostburg State University.



Benedict XVI on Labor Unions

BY CHARLES W. BAIRD

On June 29 Pope Benedict XVI issued an encyclical letter titled *Caritas in Veritate* (*CV*) in which he discusses several economic questions. There is much in the letter that suggests Benedict lacks a clear understanding of economics, such as his belief that market exchanges should involve things of equal value. However, notwithstanding absurd claims by union bosses, the encyclical cannot reasonably be read to endorse unionism as we know it. Some unionists have gone so far as to assert that *CV* demonstrates that Benedict supports the deceptively named Employee Free Choice Act (EFCA; www.tinyurl.com/pefn5t). The pope actually says little about unions, and there is nothing in *CV* to suggest that Benedict supports American-style coercive unionism, much less the efforts of union bosses to attain even more coercive power over workers through the EFCA.



Pope Benedict XVI does not support coercive labor union practices.
Photo: Agência Brazil

In §25 of *CV* Benedict worries that "deregulation" of labor markets can be hazardous to the interests of workers. AFL-CIO chief John Sweeney and Service Employees International Union (SEIU) president Andy Stern interpret this as Benedictine support of regulations like the National Labor Relations Act (NLRA). However, Benedict neither cites any concrete examples of the deregulation he abhors nor endorses any specific labor regulation regimes. He is concerned that the pressures of global competition can diminish the ability of "workers associations" to protect the legitimate interests of workers. He explains:

> Through the combination of social and economic change, trade union organizations experience greater difficulty in carrying out their task of representing the interests of workers, partly because Governments, for reasons of economic utility, often limit the freedom or the negotiating capacity of labour unions. . . . The repeated calls issued within the Church's social doctrine, beginning with *Rerum Novarum*, for the promotion of workers' associations that can defend their rights must therefore be honoured today even more than in the past. . . .

Of course workers should never be forbidden to join voluntary workers associations in support of worker rights. Nor should any government limit the ability of such associations to represent the interests of their members. Although Benedict did not describe workers associations as "voluntary," his reference to Leo XIII's 1891 *Rerum Novarum* (*RN*) makes clear that that is what he had in mind. In §54 of *RN* Leo warned that workers should not be forced to join labor unions that "do the utmost to get within their grasp the whole field of labor and force workingmen to join them or to starve." A more fitting description of the EFCA, which would permit union thugs to terrorize any worker who refused to sign a union card, is hard to find.

Leo revisited the question of legitimate unions in *Longinqua* (1895). Such unions have "very important duties" among which are "not to touch what belongs to another; to allow everyone to be free in the management of his own affairs; [and] not to hinder any one to dispose of his services when he pleases and where he pleases" (§16). The NLRA violates each of these duties. Union security (forced dues) allows unions to touch and take what belongs to

Charles Baird (charles.baird@csueastbay.edu) is a professor of economics emeritus at California State University at East Bay.

another; exclusive representation (forbidding individuals to decide on their own whether to be represented by a union) denies workers the right to manage their own affairs; and strike rules prohibit workers from disposing of their services when they please and where they please.

In §63 of *CV* Benedict writes that part of the definition of "decent work" is "work that permits the workers to organize themselves freely, and to make their voices heard." Yet exclusive representation prohibits free organization and overrides individual voices. Individual choice in affiliation is overridden by mandatory submission of a numerical minority to the will of a numerical majority. Individuals are forbidden to represent themselves. Individuals are forbidden to discuss terms and conditions of employment with their employers without union permission. Employers are forbidden to reward individual workers for meritorious performance without union permission. Individuals have no voice. Only unions may speak.

Again in §63 Benedict writes, "The global context in which work takes place also demands that national labour unions, which tend to limit themselves to defending the interests of their registered members, should turn their attention to those outside their membership, and in particular to workers in developing countries where social rights are often violated." Neither Sweeney nor Stern assent to this idea. They vigorously oppose even the Colombian Free Trade Agreement, which would abolish Colombian tariffs on U.S. goods in exchange for the U.S. continuing not to impose tariffs on Colombian goods. Free trade and the economic development that goes along with it are dependable means to foster the rights of workers in developing countries.

In §64 of *CV* Benedict reminds his readers, "The Church's traditional teaching makes a valid distinction between the respective roles and functions of trade unions and politics." In this he follows John Paul II in §20 of *Laborem Exercens* (1981): "[T]he role of unions is not to 'play politics' in the sense that the expression is commonly understood today. . . . [T]hey should not be subjected to the decision of political parties or have too close links with them. In fact, in such a situation they easily lose contact with their specific role, which is to secure the just rights of workers within the framework of the common good of the whole of society."

The AFL-CIO and the SEIU, along with most other unions, especially those representing government workers, are deeply immersed in American politics. Stern brags that "We spent a fortune to elect Barack Obama—$60.7 million to be exact—and we're proud of it." It pays off. For example, Obama appointed Hilda Solis, the SEIU's "top choice," secretary of labor. Solis was a four-term member of Congress thanks in part to over $900,000 of campaign contributions from unions. And it is not just money. For example, on August 6 purple-shirted enforcers from the SEIU allegedly assaulted Kenneth Gladney at a town-hall meeting in St. Louis for passing out "Don't Tread On Me" flags in opposition to ObamaCare (www.tinyurl.com/ov3z2f). Unions and the American politicians they have bought need each other to survive.

Unions and the American politicians they have bought need each other to survive.

In sum, Pope Benedict does not ally himself with the likes of Sweeney and Stern. In keeping with papal teaching on labor unions since Leo XIII, he is more in tune with Samuel Gompers, who founded the American Federation of Labor (AFL) in 1886. In the April 1916 issue of the *American Federationist*, the official AFL newsletter, Gompers wrote, "The workers of America adhere to voluntary institutions in preference to compulsory systems which are held to be not only impractical but a menace to their rights, welfare and their liberty." He carried this belief through to the end of his life. In his last address as president of the AFL at its 1924 convention, shortly before he died, he said: "Men and women of our American trade union movement . . . I want to urge devotion to the fundamentals of human liberty—the principles of voluntarism. No lasting gain has ever come from compulsion. If we seek to force, we but tear apart that which, united, is invincible."

Benedict XVI doesn't, and Samuel Gompers wouldn't, approve of the coercive features of the NLRA and the EFCA. FEE

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IDEAS ON LIBERTY
VOLUME 59
JANUARY–DECEMBER
2009

Prepared by Michael Nolan, with the assistance of Linda Newton

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