

2017

The Dwight Lee Reader: Collected Columns from the Freeman

Dwight Lee
Southern Methodist University

Joshua Hall
West Virginia University, joshua.hall@mail.wvu.edu

Zachary Rodriguez
West Virginia University, zr0009@mix.wvu.edu

Follow this and additional works at: https://researchrepository.wvu.edu/free_ent

 Part of the [Economics Commons](#)

Digital Commons Citation

Lee, Dwight; Hall, Joshua; and Rodriguez, Zachary, "The Dwight Lee Reader: Collected Columns from the Freeman" (2017). *Center for Free Enterprise*. 1.
https://researchrepository.wvu.edu/free_ent/1

This Book is brought to you for free and open access by the Centers at The Research Repository @ WVU. It has been accepted for inclusion in Center for Free Enterprise by an authorized administrator of The Research Repository @ WVU. For more information, please contact ian.harmon@mail.wvu.edu.



The Dwight Lee Reader

COLLECTED COLUMNS FROM THE FREEMAN

1976-2013

JOSHUA C. HALL AND
ZACHARY RODRIGUEZ,
EDITORS

Published by the Center for Free Enterprise
College of Business and Economics
West Virginia University
Morgantown, WV 26506-6025
Cover design by Thomas Durante

Columns in this documents were made available by The Foundation for Economic Education (FEE), and in particular, *The Freeman* magazine.

This work is licensed under the Creative Commons Attribution 4.0 International License. To view a copy of this license, visit <http://creativecommons.org/licenses/by/4.0/> or send a letter to Creative Commons, PO Box 1866, Mountain View, CA 94042, USA.

Contents

Foreword	1
Basic Economics	2
Social Cooperation, Good Intentions, and Incentives	3
Specialization and Wealth	6
Demand and Supply	9
Price Ceilings Cause Shortages and Higher Costs	12
Price Floors, Surpluses, and the Minimum Wage	15
Opportunities and Costs	18
In the Absence of Private Property Rights	21
Comparative Advantage	24
Comparative Advantage Continued	27
The Hidden Cost of Taxation	30
Freedom of the Price	33
It's the Margin That Counts	36
Running Out of Agricultural Land	39
Marriages, Mistresses, and Marginalism	42
Take This Job and Shove It, at the Margin	45
More on Marginalism	48
Markets and Marginalism	51
Economic Efficiency	54
Prisoners' Dilemmas and Cooperation	57
Applied Economics	59
Markets and Morality	61
The Market for Honesty	61
The Economic Advantages of a Commitment to Liberty	64
Marginalism and the Morality of Pricing Human Lives	67
The Economics of Caring and Sharing	70
Comparing the Morality of Government and Markets	75

The Market as a Process	81
Freedom and Failure	81
The Entrepreneur on the Heroic Journey	86
Constitutional Economics	92
The Political Economy of the U.S. Constitution	92
Liberty and Individual Responsibility	106
Governments and Markets	118
The Problems of Halting Economic Growth	118
Labor Unions Aggravate Inflation by Lowering Wages	124
Controlling Inflation by Controlling Government	127
Patience and Property: Corporate vs. Union Management	131
Politics, Economics, and the Destructiveness of Deficits	136
Public Interest Is Usually Special Interest	142
Greed and Gravity	144
Should Profits Be Shared with Workers?	147
Markets and Freedom	152
Distrust and Verify	155
Costs Should Be Revealed, Not Concealed	158
How Government Prevents Us from Buying Safety	161
The Market Makes Diversity Worth Celebrating	164
Public Interest or Private Interest?	167
The Bias Favoring Governments over Markets	170
The Disconnect Between Political Promises and Performance	173
Just Wait Until It's Free	179
The Tyranny of Utility: Behavioral Social Science and the Rise of Paternalism	184
Capitalism and Freedom: A 50th Anniversary Tribute to Milton Fried- man	186
International Trade	192
Free Trade to Benefit the Many—Not Fair Trade to Benefit the Few	192
Politics and Foreign Trade	194
Social Welfare	198
The Political Economy of Educational Vouchers	198
Government Redistribution Impoverishes the Poor	204
The Perversity of Doing Good at Others' Expense	207
Social Cooperation and the Marketplace	212
Creating Jobs vs. Creating Wealth	215
Spreading the Work to Create More Jobs	218
Sacrificing Lives for Profits	221

The Cure Can Be Worse than the Disease	224
Social Security Can Be Good for Your Health	227
Libertarian Paternalism: A Test	230
Making Social Security More Harmful	236
Reducing Income Inequality at the Expense of the Poor	239

Environmental Policy **243**

The Problem of Environmental Protection	243
The Efficient Amount of Pollution	246
Are People Pleased with the Efficient Amount of Pollution?	249
Reducing the Cost of Reducing Pollution	252
The Perverse Popularity of Command and Control	255
Maximum Cooperation Means Minimum Cost	258
Energy Production versus Conservation	261
Thank You, Internal-Combustion Engine, for Cleaning up the Environment	264

Foreword

This volume, which is a compilation of Professor Lee's 37 years of Freeman columns is obviously fascinating, creative, style defining, and just "Classic Dwight Lee". That is not to imply that Dwight Lee has any class, but instead that he has established a class all by himself.

Educated in the Virginia Political Economy tradition, Professor Lee views virtually all human action, in both the public and private sectors, through the lens of the economist, with individuals choosing among alternatives based upon their varying perceptions of costs and benefits. Through Dwight's lens, Adam Smith is alive, well, and ubiquitous, if not a little tortured.

Clearly rooted in its microeconomic foundations, Dwight's Reader begins with creative applications of the analytical tools that have, to a great extent, defined his entire career. Cost and choice, supply and demand, specialization, trade and exchange, comparative advantage, marginalism, prices and market interferences, and a little public choice. That's about it! But Professor Lee would argue that was quite enough. And, he would be right. If his career collection of columns gives the impression Dwight is, at best, only a "12 trick pony", his creativity and analytical ability have demonstrably spun those few tricks into a successful 37-year circus attracting and fascinating many followers and, indeed, impersonators all along the way.

Having illustrated his basic analytical toolkit in the first 19 columns, Professor Lee applies those tools in the remaining 50 to topics as far ranging as Morality and Markets, Market Processes, Constitutions, Government and Markets, International Trade, Social Welfare, and Environmental Policy. The section on Morality and Markets proved to be a relative masterstroke eventually spawning continuing research and commentary around the world with European scholars republishing and commenting widely upon this thread in multiple languages and cultures. His columns on Morality have also added significant credence to Professor Lee's frequently stated axiom that "economic analysis allows one to acquire insights into activities without having firsthand experience."

Lee's frequent creative application and, indeed, reapplication of the same

analytical tools to problems varying only the slightest in nature, especially in the environmental policy section, stand as published proof that he was in fact the “greenest” economist ever to come out of Virginia Political Economy. He was obviously an avid supporter of recycling long before recycling was cool.

Over this 37-year contribution, Professor Lee has creatively broadened the horizons of economists while elucidating their relatively complex and boring ideas to a much larger and more critical public audience. For Dwight, academically based journalism was strategically necessary, morally obligatory, and just a lot of fun. The economics profession, readers of this volume, and the public, owe him a significant debt of gratitude for these gifts.

*Dr. J.R. Clark
Probasco Distinguished Chair of Free Enterprise
The University of Tennessee at Chattanooga*

Cooperation, Good Intentions, and Incentives

May 1, 1998

Although each of my *Freeman* columns will stand alone, let me emphasize at the outset that economics is far more than a series of unrelated concepts. Economics provides a coherent and powerful framework for seeing order in the seemingly unrelated actions of hundreds of millions of individuals as they struggle to improve their lot in life.

Improving our circumstances is always a struggle because of the fundamental problem of scarcity. All economic concepts are rooted in the problem of scarcity. No matter how productive we become, there always will be limits on what we can accomplish. Each individual confronts the fact that he must choose among many different ways to use his time and talents, and he makes those choices to achieve his particular purposes. No one else can know as much about another person's purposes as that person himself. So while we may not understand the actions of others, we can be confident that they are doing the best they can to realize their objectives; from their own perspectives, they are acting rationally.

The Power of Economics

But economics is more than just a consideration of how individuals improve their well-being. The power of economics comes from the fact that the implications of scarcity and rational decision-making allow us to understand how certain social institutions make productive cooperation possible among large numbers of people, each of whom is concerned primarily with achieving a better life. This explanatory power goes back to Adam Smith, who elaborated on the connections between "the invisible hand" and the "Wealth of Nations." It was Smith who first explained systematically how the social institutions of the free market encourage the creation of wealth by motivating people concerned with their own interests to behave in ways that best serve the interests of others.

In some respects, the economics profession has made little progress since Adam Smith. Economists have been ineffective at communicating to the public

the tremendous benefits we all realize from the cooperation promoted by the free market, or the threat to that cooperation from the political influence of organized interest groups. In part, this failure can be explained by the difficulty of the task. The benefits of the market are spread so wide in the form of lower prices, improved products, and better opportunities that they tend to go unnoticed or be taken for granted. Because the benefits are primarily the indirect and unintended consequences of the actions of millions of individuals, people fail to connect those benefits to their source.

In contrast, political benefits tend to be concentrated in visible ways and are easily connected to the intentional actions of particular people, while the damage done is spread over the entire economy and difficult to trace back to its cause. But economists could have done more to promote a widespread understanding and appreciation of economic fundamentals. Even in their teaching, professional economists tend to focus on the trees of technical details while overlooking the impressive forest of market cooperation and coordination.

But in other ways, economists have made much progress since Adam Smith. While technical economic concepts can divert economists into analytical minutia, when appropriately used, these concepts improve our economic understanding in important ways. For example, the concept of comparative advantage extends Adam Smith's insight into the benefits of free trade. The concept of marginalism (which, among other things, drained the "labor theory of value" swamp in which Smith and Karl Marx became mired, Marx more so than Smith) explains a wide range of economic activity that most people find puzzling. Those, and many other economic concepts can help economists better explain the power of the market to promote a pattern of social cooperation impossible under any other arrangement. Communicating this power as widely as possible is one of the most important contributions economists can make. I shall connect the discussion in each column back to the goal of social cooperation.

The Problem of Achieving Cooperation

Despite the common belief that economists are interested only in narrow material concerns, they are primarily concerned with explaining how the spontaneous market process expands the opportunity for people to achieve their objectives, no matter what they are, through cooperation with one another. Whether your goal is accumulating personal wealth, protecting the environment, or assisting the needy, you will be more successful if you can enlist the cooperation of others.

But how do you enlist this cooperation, given the variety of conflicting goals people are intent on pursuing? Reformers usually believe that social cooperation depends on appealing to people to put aside their narrow personal ambitions (such as amassing personal wealth) and concentrate on promoting broad social goals (such as protecting the environment or helping the needy). Achieving more social cooperation requires more virtuous people. The great economist Ludwig von Mises explained in *Human Action* (page 2):

If social conditions did not fulfill the wishes of the reformers, if their utopias proved unrealizable, the fault was seen in the moral failure of man. Social problems were considered ethical problems. What was needed in order to construct the ideal society, they thought, were good princes and virtuous citizens. With righteous men any utopia might be realized.

In contrast, good economists realize that, regardless of one's idea of "virtue," cooperation through the division of labor and exchange—the kind that people engaged in long before there were economists and moral philosophers—is what creates a better society.

Good Intentions Are Not Enough

Without denying the desirability of people behaving "virtuously," economists see it as largely unrelated to social cooperation on a broad scale. Attempts to change behavior with conventional moral appeals are sometimes frustrated, and even if people were persuaded to put the "interests of the larger community" ahead of their own, the problem of knowing how best to do so would remain.

Economists recognize that people will behave consistently in ways that are simultaneously self-interested and socially cooperative only when market incentives are permitted to reward that behavior. But this means that not just any incentives will do; they have to be incentives that embody information on the best course of action. Next month I will examine the effect of incentives on human action.

Specialization and Wealth

August 1, 1998

Last month I explained how a remarkable degree of social cooperation emerges through market communication. This month, let's consider some of the advantages we realize from that cooperation. At a general level these advantages are obvious. It simply makes sense that we can produce more if our actions are in harmony than if we are working at cross-purposes. But to really understand economics, we must consider the link between cooperation and productivity in detail.

Wealth seldom comes as manna from heaven. It has to be produced by applying human effort, intelligence, and patience to natural endowments that yield their bounty reluctantly. This should be obvious. But one measure of the success of the marketplace at improving our productive powers is that it has become all too easy for people to assume that wealth is part of the natural order of things. Academics and policy wonks consider the distribution of wealth to be the primary issue, while dismissing any concern that their policy prescriptions could hamper its production. They drone on and on about the causes of poverty (or the "improper" distribution of wealth), apparently unaware that determining the causes of wealth is the serious challenge. The success of capitalism has blinded a remarkable number of otherwise intelligent people to the simple truth that distribution comes before production only in the dictionary.

Specialization's Special Role

When economics emerged as a separate academic discipline in the late eighteenth century, it was obvious what the economic problem was. Adam Smith titled his economics book *An Inquiry into the Nature and Causes of the Wealth of Nations*, and his concern with explaining wealth is apparent from the very first page.

Smith begins by observing: "The greatest improvement in the productive powers of labour...seem[s] to be the effects of the division of labour." He illus-

trates the importance of specialization, or the division of labor, by considering the advantage of having each worker in a pin factory concentrate on a particular step in production rather than producing a pin from beginning to end. Through specialization workers can become more skillful, use machinery that increases their productive powers, and avoid the loss of time from constantly changing activities. These advantages are rather obvious, but the increase in productivity is far greater than one would expect. According to Smith, ten pin-makers, by specializing in different tasks, can produce about forty-eight thousand pins a day. But if each attempted to perform every task in pin production, Smith doubted that they could each make twenty pins a day, or two hundred among them.

But it takes more than extra output to create a real increase in productivity. A specialist produces much more of a product, or part of a product, than he wishes to consume himself. Producing lots of output is not productive unless it ends up in the hands of those who value it. So the advantage of specialization can be realized only to the degree that people can cooperate, with each specializing in the production of something that others want in order to be able to acquire what he wants from the specialized production of others. The only way for this cooperation to occur, and thus the only way to realize the productivity of specialization, is through exchange.

Adam Smith recognized the crucial connection between exchange and productivity when he observed that “the extent of this division [of labor] must always be limited by...the extent of the market.” If you can exchange only with those in a small village, your ability to specialize productively is extremely limited. For example, how many could afford to pursue careers writing novels, painting landscapes, or mastering musical instruments, no matter how great their talents, with only a few people to appreciate and reward their accomplishments? In such settings, most people tend to become “a jack-of-all trades, but master of none.” The more limited the market, the more limited the productive potential of specialization.

Expanding the Market

The link between specialization and the size of the market provides another explanation of the importance of market cooperation based on private property and voluntary exchange. Cooperation is possible without markets, at least without markets as we normally think of them. Family members cooperate on the basis of intimate knowledge and shared concerns. Members of small firms can work cooperatively in response to a common objective and peer pressures. The same can be said for churches, clubs, and other relatively small social organizations. The cooperation within families, firms, and social organizations can be explained as the result of exchange relationships. (Gary Becker’s writings on the family and the depiction of the firm as a “nexus of contracts” are good examples of such explanations.) But such relationships, because they depend on personal association and common objectives, are limited to relatively small groups.

A key to the productivity of the market is that it greatly extends the range

of cooperation, and therefore greatly increases our ability to specialize productively. Obviously the expansion of markets has depended on improvements in transportation and communication networks. But without the information communicated through market prices, and the cooperation motivated by these prices, improvements in transportation and verbal and written communication would be insufficient to realize much of the advantage of specialization. Brazilians could communicate their desire for more denim clothing with a steady barrage of faxes, e-mails, and telephone calls to clothing manufacturers in every country in the world, with it being possible to ship the clothing to them overnight from anywhere on the globe. But without the information communicated by changes in relative market prices, Brazilians would be unable to motivate cotton growers, agricultural chemical producers, dye manufacturers, textile workers, truck drivers, airline pilots, merchants, and countless others to coordinate their specialized efforts to make sure that the denim clothing was made available in Brazil in the desired quantities and preferred styles.

The Impersonal Market

The market is often criticized as impersonal. It can be, but that's why it so greatly extends the range of cooperative specialization. People don't have to know, or care for, those they are cooperating with, or those whom their cooperative efforts are serving, when they respond to market prices.

The market does far more to foster multicultural cooperation and global harmony than can ever be achieved by the personal efforts of government diplomats. It is the cooperation and harmony of the marketplace, and the specialization that it allows, that explain the creation of wealth.

Demand and Supply

October 1, 1998

No series on the basic notions of economics can continue long without introducing demand and supply. These concepts, as illustrated with demand and supply curves, are fundamental to how economists understand economic behavior. In particular, with the use of demand and supply curves, I can supplement in concise and powerful ways my previous discussion of the communication, cooperation, and coordination of the marketplace.

The Basics of Demand and Supply

Although a complete discussion of demand and supply curves has to consider a number of complexities and qualifications, the essential notions behind these curves are straightforward. The demand curve is based on the observation that the lower the price of a product, the more of it people will demand. There may be occasional exceptions to this behavior (and indeed economists have developed the theoretical possibility of such an exception), but they are so few and transient that economists refer to the negative relationship between price and quantity demanded as the “law of demand.” Because of the law of demand, demand curves (such as D in the figure) are always shown as downward sloping, with the price on the vertical axis and the quantity demanded (over some period) on the horizontal axis.

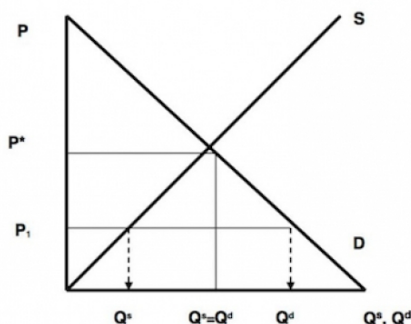
The basic notion behind the supply curve is that the higher the price of a product, the more of it producers will supply. In other words, as with the curve S in the figure, supply curves are upward sloping. A justification for this upward-sloping relationship between price and quantity supplied is that the cost of producing additional units of the product increases as more is produced. So it takes a higher price to motivate additional output. But this is not necessarily the case when there is time for new firms to enter an industry, or for existing firms to expand their plant size. Such long-run adjustments to a higher price can permit more of the product to be made available at the original cost (or even a lower cost), in which case the supply is horizontal (or negatively sloped). But

over periods of time that can extend to several months or more, it is reasonable to assume that supply curves slope upward.

Obviously, a lot of things affect the amount of a product that will be demanded and supplied besides its price. But for any set of demand and supply curves, all of these other influences are held constant, since the purpose of the analysis is to allow us to concentrate on the effects of the product's price on the amount demanded and supplied.

Communicating through the Market

The simple diagram here allows us to consider the most important insight from demand and supply analysis, which is how people coordinate their decisions by communicating through market prices.



Assume that we start off with a price for denim jeans given by P_1 in the figure. The most important thing about that price from an economist's perspective is that it fails to coordinate the decisions of suppliers and consumers. At price P_1 suppliers are willing to supply only Q^s pairs of jeans, but consumers want to buy Q^d pairs. Consumers will be frustrated because they are unable to obtain all the jeans they want at the prevailing price, and in response to this frustration they will start bidding up the price of jeans relative to the price of other products. By doing so, they communicate to suppliers that they want more resources devoted to the production of additional jeans because they are worth more than what those resources are currently producing elsewhere. Suppliers respond appropriately to this information by moving up the supply curve, increasing the availability of jeans.

But the increase in price does more than communicate information from consumers to suppliers. It also is the means by which consumers communicate valuable information to one another. As consumers bid up the price of denim jeans, they are telling each other that these jeans are in short supply and that everyone should economize on their use, take better care of the ones they have, use substitute clothing, and so on. And consumers respond appropriately to this information by backing up the demand curve as they reduce the number of jeans they demand. This process continues to increase the price of denim jeans until it reaches P^* in the figure, the price determined by the intersection

of the demand and supply curves. This price is often called the equilibrium price, because at P^* there is no pressure for the price either to increase or decrease. (Our discussion could have started at a price greater than P^* and the communication would have taken the form of price decreases.) At P^* we can clearly observe the miracle of market communication and cooperation. Millions of people pursuing their private advantages as consumers and producers, with almost no direct knowledge of, or interest in, the concerns and circumstances of others, are led to a completely coordinated pattern of decisions by responding to the information contained in market prices. Each consumer decides to consume an amount perfectly compatible with the amounts that all other consumers are deciding to consume and all producers are deciding to supply.

It's the Process

The equilibrium price, along with the equilibrium quantity Q^* in the figure, is typically presented as the most important feature of demand and supply analysis. But seldom do real-world markets ever get to equilibrium. The world is constantly changing, and demand and supply curves constantly shift. Equilibrium is a moving target. The most important insight from demand and supply analysis is that the market process is constantly directing people to accommodate one another in ways that move them toward the coordination represented by equilibrium, and not just for one product, such as denim jeans, but for thousands of products. Things may not stay still long enough for equilibrium to be reached in any market. But freedom and market communication accomplish a pattern of cooperation that can never be duplicated by the coercion of central planning.

One of the best ways to appreciate the coordination and cooperation of market communication is by considering the problems that arise when political authorities censor it with price controls. In my next three columns, I'll use the demand-and-supply framework to examine those problems in detail.

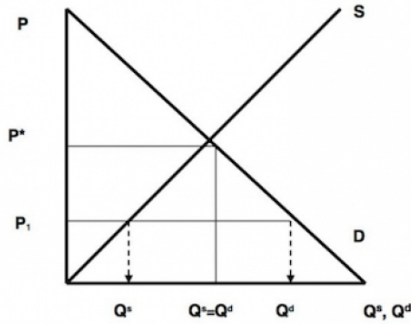
Price Ceilings Cause Shortages and Higher Costs

November 1, 1998

The coordination of demand and supply, which we discussed last month, does not occur automatically. It is an example of Adam Smith's invisible hand, which leads people interested only in pursuing their own interests to make choices that promote the interests of others as well. But the invisible hand, as amazing as it is, works only under certain conditions. Without property rights, a defense against the violation of those rights from both external and internal threats, a predictable judiciary, a stable monetary system, and a limited government, the voluntary exchange on which social coordination depends quickly breaks down.

Government has important roles in protecting private property, preventing capricious judicial decisions, and protecting the monetary unit against debasement. But these functions can be performed effectively only by a limited government. Once government goes beyond protecting voluntary exchange as an impartial referee and attempts to determine particular outcomes, it disrupts the social cooperation that is the surest means to generally desirable outcomes. Examples of disruptive government incursions into market activity are unfortunately frequent. A particularly harmful form of government meddling is the attempt to outlaw market prices.

When most people think of market prices they don't think of the communication and cooperation those prices allow. Consumers typically see prices as too high and therefore an impediment to their desire for more things. Suppliers see the same prices as too low. What happens when the government responds to consumer pressures by imposing a maximum legal price on a product below the price the market would set? The unfortunate, and ironic, result of a price ceiling is to increase the cost of products to consumers.



In the accompanying figure the demand curve, D , and supply curve, S , determine a price P^* , which the market tends toward. As I discussed in last month's column, P^* motivates suppliers to make available exactly that amount, Q^* , that consumers want at that price. This ability of millions of people to coordinate their decisions with one another is the result of the information they communicate through market prices. Now consider what happens when the government imposes a price ceiling below P^* , say at P_C .

At that price suppliers are willing to make available only Q^S units of the product, while consumers are anxious to buy Q^D units. The result is a shortage, as consumers cannot get as much of the product as they want. Shortage—the inability to buy a product although one has the money in hand—is different from scarcity, which we can define as the inability of people to have as much as they would like at a zero price. Scarcity is an unavoidable feature of the real world; shortages are not. Any shortage would be eliminated by the price generated by market communication, so shortages are always created by government restrictions on market prices.

Advocates of price ceilings claim that they lower the cost of the product for consumers. This claim seems plausible since the price consumers pay is P_C after the ceiling is imposed instead of P^* . But you can't lower the cost to consumers by restricting the price communication that allows them to secure the maximum cooperation from suppliers. Indeed, price ceilings increase the consumers' cost. Since the height of the demand curve tells us how much consumers are willing to pay for another unit of the product, we can see from the figure that when only Q^S units of the product are available, consumers are willing to pay P_m rather than do without. And just because they can't legally pay that amount in dollars doesn't mean they won't pay it in other ways.

For example, one way consumers compete during shortages is on the basis of first-come, first-served. According to Hedrick Smith's book *The Russians*, the average housewife in the former Soviet Union spent 14 hours a week queuing up for products because of the shortages created by pervasive price ceilings. How long will people queue up for an additional unit of a price-controlled product? Until the cost of doing so is equal to the difference between what they are willing to pay, P_m , and the price ceiling, P_C . So the total monetary and time cost will tend toward P_m , which is more than consumers would pay without

the price ceiling. The consumers pay more, but notice, the suppliers don't receive more. The higher amount consumers pay does nothing to communicate to suppliers that more should be made available.

Another common cost-increasing response to price ceilings is reduced quality. While suppliers cannot legally benefit from the excess demand ($QD - QS$) by raising the price above PC , they can reduce the quality of the product, which reduces their costs. The reduction in quality can take many forms, and is often tied in with the queuing just discussed.

Rent controls cause a deterioration in the quality of apartments. When landlords have more demand than they can satisfy, and are unable legally to charge higher rents, they reduce costs by doing less to maintain their apartments. New York City once tried to solve this problem with its rent-control law by exempting tenants from paying the rent if their apartments were damaged. Not surprisingly, tenants began breaking windows and ripping up carpets to avoid paying the rent.

Of course, some consumers come out ahead under price ceilings. With lots of people anxious to buy at the controlled price, it doesn't cost suppliers much to discriminate against certain people. Those whom suppliers favor often get products at lower prices without long waits. For example, celebrities and the politically well-connected have no trouble obtaining rent-controlled apartments in New York City, while others end up doing without.

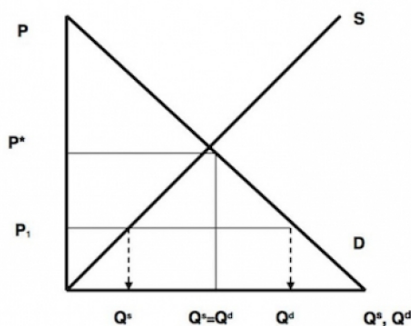
But most consumers are harmed by price ceilings. This is hardly surprising since price ceilings prevent consumers from communicating with suppliers in ways that motivate the best possible response to their demands.

Price Floors, Surpluses, and the Minimum Wage

December 1, 1998

Last month I discussed the distorting effects of government-imposed price ceilings. Not content to limit the disruptive impact on economic decisions to price ceilings, governments are also quite willing to impose floors under which prices cannot legally fall. Like price ceilings, price floors disrupt market cooperation and have consequences quite different from those advertised by their advocates. Before considering an example of price floors—minimum wages—let's examine the problem in general terms.

Creating Surpluses



The standard downward-sloping demand curve, D , and upward-sloping supply curve, S , are shown in the nearby figure. As discussed in my column on demand and supply two months ago, these two curves determine an equilibrium price, P^* , that coordinates the decisions of all consumers and suppliers. At P^* consumers want to purchase exactly the amount that suppliers want to sell.

Despite the amazing coordination that results from the equilibrium price, politicians are often convinced by organized interests that some suppliers should

receive higher prices. Interestingly, as we shall see, those who lobby for higher prices are not always the ones who will receive them. But regardless of the source of the pressure, the political response is often to impose a price floor, such as PF in the figure.

With PF being the lowest price that can be legally charged, suppliers are anxious to sell QS units of the product. But at PF, consumers are willing to buy only QD units. The result is a surplus given by the difference between QS and QD. The appropriate response to a surplus is some combination of reduced supply and increased consumption. In a free market, suppliers communicate their frustration at not being able to sell all they would like by lowering the price they charge. As the price declines below PF, consumers increase their consumption and suppliers reduce their production. This mutual adjustment continues until the price reaches P^* , where producer and consumer decisions are perfectly coordinated. But the price floor, PF, blocks that communication between suppliers and consumers, preventing them from responding to the surplus in a mutually appropriate way.

Suppliers Can Be Worse Off

Consumers are clearly made worse off by price floors. They are forced to pay higher prices and consume smaller quantities than they would with free-market prices. But price floors can also make suppliers worse off. Some suppliers can benefit from a price floor if they can sell all, or most, of the quantity they would like at that price, but then other suppliers will be even less able to sell as much as they desire.

Only if all suppliers of a product can sell as much as they want at the price floor is it possible for them to be better off as a group, and then only temporarily. Farmers favored price supports for crops because the federal government stood ready to purchase the supply that farmers couldn't sell at the above-market price. But even in this case, the benefit to suppliers was only temporary since competition among farmers increased the cost of doing business. For example, the lure of above-market prices prompted farmers to bid up the price of land. That is, the price of land incorporated the benefits of the price supports. Those who owned good farmland before the programs started won windfall benefits, but those who entered farming afterward and paid inflated land prices did not.

The Minimum Wage

A good example of how price floors can harm the very people who are supposed to be helped by undermining economic cooperation is the minimum wage. Legislating a minimum wage is commonly seen as an effective way of giving raises to low-wage workers. Unfortunately, it, like any price floor, creates a surplus. In this case, it is a surplus of workers (suppliers of labor), more of whom are willing to work in minimum-wage jobs than there are employers (demanders) willing to hire at that wage. We call a surplus caused by the minimum wage "unemployment."

A wage floor hits workers with limited skills, primarily young people. According to *The Economist*, in 1997 the average unemployment rate among workers under 25 was three times greater than the average unemployment rate among those 25 or older (June 27, 1998). Young people are best able to improve their economic prospects by developing skills that increase their productivity. For those with the fewest advantages, the best hope is work experience and on-the-job training. The minimum wage reduces the number of people employers will hire for what is essentially training.

Consider also that the minimum wage reduces the cost of discriminating on non-economic grounds in hiring. With more young people applying for jobs than employers want to hire, and with no legal way of paying a lower wage, it costs nothing to exclude some applicants from consideration. If an employer has a choice between hiring the mayor's son or a poor kid from the other side of the tracks who would be willing to work for less, the mayor's son is almost sure to get the job.

The young person from an affluent family can expect to have connections that make it possible for him to get a minimum-wage job before heading off to college, or a part-time minimum-wage job while in college. The poor kid whose education in an inner-city public school makes going to college unlikely, and whose best hope for gaining skills is job experience, is less likely to get a job because of the minimum wage. This kid would have a far better chance if he could communicate his willingness to work by accepting the lower wage that is now outlawed. It should surprise no one that the unemployment rate for nonwhite teenagers is several times the rate for white teenagers.

The political demand for the minimum wage does not come from low-wage workers. Today labor unions are the most active supporters of increasing the minimum wage. Unskilled nonunion workers can compete with skilled union workers only by offering their services for less. Increasing the minimum wage limits this competition, allowing union workers to demand higher wages than would otherwise be possible.

Opportunities and Costs

March 1, 1999

My previous columns have been devoted to an overview of how markets work by facilitating social cooperation: providing people with the information and motivation to pursue their own advantages in ways that best create opportunities for others. My emphasis has been on the forest rather than the individual trees of economic understanding. Now I shall begin looking at some of the key concepts essential to applying economic reasoning to all human activity. I begin with opportunity cost.

Limits and Opportunities

Economics has been called the Dismal Science because it studies the most fundamental of all problems—scarcity. Because of scarcity we all face the dismal reality that there are limits to what we can do. No matter how productive we become, we can never accomplish and enjoy as much as we would like. The only thing we can do without limit is desire more. Because of scarcity, every time we do one thing, we necessarily have to forgo doing something else desirable. So there is an opportunity cost to everything we do, and that cost is expressed in terms of the most valuable alternative that is sacrificed.

Eliminate the opportunity to choose among alternatives and there are no costs. But the pervasiveness of costs suggests that the dismal reality of limits is only one side of a coin with a brighter side. The limits of scarcity create costs only when there are opportunities. Eliminate the opportunity to choose among alternatives and there are no costs. If, for example, I am forced to live in a particular house, take a particular job, marry a particular woman, and consume a set bundle of goods, I incur no costs when I do those things. So the bright side of costs is the opportunities that create them. Expand our opportunities, and the costs of everything we do increase.

Although we commonly see cost as something to avoid, in fact we are better off living in an economy where we are forced to confront the cost of everything we do. I personally might be better off if I could consume products without

having to consider their costs because I could shift them to others. But any advantage I could realize would be more than offset if others could ignore the costs of their activities and shift them to me. As a result, we would all lack the information and motivation to choose wisely. Only when the costs of choices are imposed on those who make those choices can we best use the opportunities available.

This is one way of explaining the advantage of market prices. The prices people pay in the marketplace reflect the opportunity costs of their choices. You cannot generally purchase a good or service in a free market for less than others are willing to pay for it, or for less than the amount spent to make it available, which is an important part of the social cooperation that emerges out of market transactions.

Special Interests Don't Want Costs Considered

Unfortunately, many economic decisions are made, not in a market setting in response to market prices, but by government in response to political considerations. This creates opportunities for the politically influential to acquire benefits paid for by the general public. Invariably, those seeking political benefits downplay the costs in the hope of justifying larger expenditures; they commonly argue that some things are so important that costs shouldn't even be considered.

Educators argue that education is too important to be considered in terms of costs; environmentalists argue that saving the earth is so imperative that environmental programs should be implemented regardless of the costs; recipients of medical research grants argue that human health trumps any crass consideration of costs; and people supported by the National Endowment for the Arts claim that the value of "art goes to the very soul of what it means to be human" and is "contaminated when compared with dollars and cents." (That's a close paraphrase of a statement on arts funding that I heard on National Public Radio.)

All these statements are best understood as attempts by organized groups to capture more public money. To consider costs has nothing to do with exaggerating the importance of money. Money provides a convenient way of expressing costs, but money is not the cost of anything. When I put down a ten-dollar bill to pay for a meal, the money may appear to be the cost, but the real cost is the opportunity cost—the subjective value I forgo by spending the money on the meal rather than spending it on the most valuable alternative.

Silly Claims

To claim that we shouldn't consider the cost of doing some things is equivalent to claiming that we should do those things without considering the alternatives. That such a transparently silly claim continues to be used in special-interest pleading illustrates the power of deception over logic in political debate. Not considering the alternatives to doing something would make sense only if it were always more valuable than anything else. But this means that we should devote

all of our resources to this one thing. If it were really true that fine orchestral music, for example, was so valuable that costs shouldn't be considered, then everyone should go homeless and hungry and spend all of their time listening to orchestras in the nude. This is obviously silly, but not one bit sillier than claiming that something is so important that it is inappropriate to consider its cost.

To claim that we shouldn't consider the cost of doing some things is equivalent to claiming that we should do those things without considering the alternative. As soon as two or more groups claim that their program should be funded without considering costs, the relevance of costs should be obvious. Educating our youth and curing our sick cannot both be too important to consider cost, not in a world of scarcity. The cost of doing more to educate our youth is doing less to cure our sick, and vice versa. To ignore the cost of one is to treat the other as unworthy in comparison.

Of course, the reality of scarcity, and the opportunity costs that result, intrudes into the political process despite the special-interest rhetoric disparaging considerations of cost. Comparisons have to be made among competing alternatives, so opportunity costs are considered in the political process. Unfortunately, imperfections and biases in the political process prevent the opportunity cost of government action from being adequately considered. The result is what one should expect when alternatives are poorly considered. Waste occurs as decisions direct resources out of more valuable and into less valuable activities, and often into activities counterproductive to the stated objectives.

Market prices do not perfectly reflect opportunity costs, but one can appreciate how close they get by considering the perversities that arise because political decisions often ignore most of the costs of a policy. I shall consider this problem next month as a way of further illustrating the importance of opportunity costs in understanding economics.

In the Absence of Private Property Rights

July 1, 1999

We commonly benefit from things we neither understand nor appreciate. Obviously there are advantages in benefiting from a wide range of things without having to give them much thought. But the danger is that such neglect can often cause us great harm. Good health is an example. For most people, good health is easy to take for granted, and this often results in harmful patterns of behavior. In the case of health, however, most people know something about the risks of unhealthy behavior, and recognize the advantage of healthy habits even if they don't practice them.

Unfortunately, this is not true for maintaining a healthy economy. The productivity and cooperation essential to economic progress depend on things that are not only easily neglected, but also commonly denounced. Private property is a good example. Instead of recognizing private property as the foundation of economic cooperation and progress, people commonly see it as the source of economic problems actually caused by the lack of well-defined and enforced private-property rights.

Pollution and Private Property

Pollution is widely blamed on capitalism, with its emphasis on profits and private property. According to this view, private property rights should be restricted to prevent firms and individuals from putting their private gain ahead of the public's interest in a clean environment. But pollution is actually a problem caused by too little reliance on property rights, not too much. Pollution problems should teach us how much we benefit from private property by illustrating the inevitable breakdown in social cooperation in its absence.

Pollution problems would not exist if we could divide up the atmosphere, rivers, and oceans into separate units owned and controlled as private property. There would still be pollution, but not excessive pollution. If I wanted to discharge pollutants into the air that belonged to others, they would prevent me from doing so unless I paid them a price that covered the cost my pollution

imposed on them. So I would pollute only as long as the value I realized from discharging an additional unit of pollutant was at least as great as the cost to others. Private property and the market prices that result would motivate people to take into consideration the environmental concerns of others.

Pollution problems exist because without private property in air sheds and waterways there are no market prices to make polluters mindful of the cost of their polluting activities. The result is that people pollute excessively; pollution continues even though the benefits from additional pollution are less than the costs.

Although we cannot easily imagine treating the atmosphere and waterways as private property, the lack of cooperation that underlies pollution problems would extend to all aspects of human action if private property were absent. Instead of seeing pollution problems as an indictment of private property, these problems should give us an appreciation of the wonderful advantages we realize from private property. And once the power of private property to promote cooperation is realized, one can see how pollution policy can be improved through the creative establishment of private property.

Instead of having political authorities dictate how, and how much, polluters have to reduce their discharges (as they do now), it would be far better to create a form of private property in the use of the environment for waste disposal. This private property would take the form of transferable pollution permits specifying how much their owners could legally pollute. These permits would establish the total allowable pollution, but not how much each polluter reduces his discharges or how he does so. With transferable permits, market prices would emerge that force polluters to consider much of the cost of their discharges. Those who could reduce discharges cheaply would reduce a lot, releasing permits to be used by those facing higher cleanup costs. The result would be a pattern of pollution reduction that yields any given level of environmental quality at far less cost than the command-and-control approach that dominates current policy. (A more detailed discussion of the advantages of such a market-based approach to pollution control has to await a future column.)

Private Property and Patience

Another common misconception is that the profits from private property motivate people to ignore the long-run consequences of their actions. Actually, the lack of private property is the biggest threat to future concerns. Consider the captain of a whaling ship who has a whale in the cross hairs of his harpoon. The captain is about to pull the trigger when his first officer points out that the whale is pregnant and if they let it live there will be two whales within a few months. Will the captain save the whale on hearing this information? Not likely. He will correctly conclude that since he has no property right in the whale, if he doesn't kill it today someone else soon will. Being patient and allowing the whale to give birth requires an immediate sacrifice, without permitting him to benefit from that sacrifice in the future. If somehow whales were privately owned, it would then pay the captain to take the future value of the whale and her offspring into consideration, since that future value would

be his opportunity cost of killing the whale today.

It is no wonder that many species of wild animals are overexploited, and in some cases threatened with extinction. The situation is very different with domestic animals that are privately owned. There is no worry that chickens, pigs, cows, or goats will be driven to extinction. The future value of these animals is fully considered by owners who can profit from maintaining them. Indeed, the more of these animals we kill, the more of them we have. In the United States alone, approximately 25 million chickens are killed and eaten every day. It has been said that the difference between chicken hawks and people is that when chicken hawks eat more chickens there are fewer chickens, but when people eat more chickens there are more chickens. The more fundamental difference is that people establish private property rights and, as a result, take the future into consideration; chicken hawks don't.

Unfortunately, legislation such as the Endangered Species Act attempts to protect species by undermining private property rights, thereby reducing the motivation of land owners to provide suitable habitat for wildlife, endangered or not.

Private property allows us to solve problems by taking into consideration the present and future concerns of others. Unfortunately, people with good intentions but little economic understanding often call for solving problems stemming from inadequate private property by subverting rights to private property with political restrictions and mandates.

Comparative Advantage

October 1, 1999

One of the most powerful and straightforward economic concepts is “comparative advantage.” As important and simple as this concept is, however, it seldom seems to inform public discussions of international trade. Almost everyone “knows” that we can’t compete with countries that have cheap labor—if we have free trade with such countries either wages will be driven down or many workers will lose their jobs. As Will Rogers once observed, “It’s not what people don’t know that is the problem, it is what they do know that’s not true.”

Understanding comparative advantage has the same effect on concerns about free trade as water had on the Wicked Witch of the West. Free trade with other countries (regardless of how much or little their workers are paid) doesn’t increase unemployment or lower wages. Indeed, one of the best ways of increasing the wages of U.S. workers is by allowing them to compete with workers (even very low paid workers) in other countries through free trade.

Absolute Versus Comparative Advantage

The most straightforward case for free trade is that countries have different absolute advantages in producing goods. For example, because of differences in soil and climate, the United States is better at producing wheat than Brazil, and Brazil is better at producing coffee than the United States. Obviously both countries are better off when Americans produce wheat and exchange a portion of it for some of the coffee that Brazilians produce.

But does this mean that a country with an absolute advantage in the production of a good should always produce that good rather than import it? No, as the English economist David Ricardo first explained in the early 1800s. A country can have an absolute advantage in the production of a good without having a comparative advantage. Comparative advantage is what determines whether it pays to produce a good or import it.

Assume that there are only two goods, cars and computers, and one productive resource which is some composite of land, labor, and capital. Assume

also that producing 100 cars requires two units of the productive resource (PR) in the United States and four units in Brazil, and producing 1,000 computers requires three units of PR in the United States and four in Brazil. Thus:

	U.S.	Brazil
100 cars	2	4
1,000 computers	3	4

Americans have an absolute advantage in producing both cars and computers.

It may seem that Americans can realize no gain by trading with Brazilians. Why not produce both cars and computers here? Because it costs more to produce computers in the United States than in Brazil. All costs are opportunity costs. The cost of producing computers is the cars that could have been produced. Using the three units of PR required to produce 1,000 computers in the United States requires sacrificing the production of 150 cars. Using the four units of PR required to produce 1,000 computers in Brazil requires sacrificing only 100 cars.

So even though Americans have an absolute advantage in producing computers, Brazilians have a comparative advantage. Compared to what has to be sacrificed, Brazil produces computers for only two-thirds as much as it costs in the United States. The United States, of course, has a comparative advantage over Brazil in the production of cars. Producing 100 cars here costs 666 computers, while producing 100 cars in Brazil costs 1,000 computers.

Clearly the United States benefits from specializing in cars, which it produces more cheaply than Brazil, and trading with Brazil for some of the computers it produces more cheaply. If, for example, the United States produced both cars and computers it might devote 70 units of PR to car production and 30 units to computer production, yielding 3,500 cars and 10,000 computers. If Brazil produced both products, it might devote 56 units of PR to car production and 24 to computer production, yielding 1,400 cars and 6,000 computers. On the other hand, by specializing in their comparative advantages, the United States can produce 5,000 cars and Brazil can produce 20,000 computers, or a total of 100 additional cars and 4,000 additional computers. The United States could trade 1,450 cars to Brazil for 12,500 computers and have 50 additional cars (3,550) and 2,500 more computers (12,500), while Brazil would have 50 more cars (1,450) and 1,500 more computers (7,500). Trade is productive since it generates more output of both products.

Low Wages Don't Mean Low Cost

Notice that in determining that it is less costly to produce cars in the United States and computers in Brazil, we never mentioned how much U.S. or Brazilian workers are paid. Workers in the United States will be paid more than those in Brazil because they are more productive in our example. So in terms of output,

lower wages don't mean lower costs. Indeed, asking whether U.S. or Brazilian workers are less costly ignores the relevant question: less costly doing what? U.S. workers are less costly at producing cars, but Brazilian workers are less costly at producing computers. This is true no matter what U.S. and Brazilian workers are paid.

Moreover, free trade does not cause unemployment in either the United States or Brazil. True, free trade eliminates U.S. jobs in the computer industry and Brazilian jobs in the car industry, but it increases U.S. jobs in the car industry and Brazilian jobs in the computer industry.

Furthermore, the jobs that free trade eliminates are lower-paying jobs than the ones it creates. Without free trade, the United States and Brazil would each employ workers who produce both cars and computers. This means that many workers in each country would be doing jobs in which they do not have a comparative advantage, and therefore in which they are less productive than they could be. With free trade these workers would be directed into more jobs where they are more productive and receive higher pay, since the compensation workers receive ultimately depends on how productive they are.

The concept of comparative advantage is deceptively simple. Tiger Woods surely has the potential of being one of the best caddies in the world. How many people could give you better advice on lining up a putt or selecting a club? He has an absolute advantage. But everyone knows that the opportunity cost to Tiger Woods of becoming a caddie is too high to make that a sensible option. He would be sacrificing the return from being a professional golfer, the activity in which he has a strong comparative advantage. Understanding why Tiger Woods doesn't become a caddie is enough to understand why high-paid U.S. workers benefit when free trade puts them in competition with lower-paid foreign workers.

Comparative Advantage Continued

November 1, 1999

The concept of comparative advantage, which I began discussing last month, is a straightforward application of opportunity cost and is almost embarrassingly simple. Certainly people have no trouble understanding and recognizing the importance of this concept in their own personal lives. For example, if you were the best brain surgeon in town and also the best at shining shoes, you would not try to be both a brain surgeon and a shoe shiner. Compared to other shoe shiners, you would be at a tremendous disadvantage shining shoes because of the value of your time performing brain surgery.

People are very good at finding and pursuing their comparative advantages. This doesn't mean that people are always good at what they do. We have all seen people working at jobs they can't do well. It could be, of course, that they have made a mistake and will quickly move on to something they do better. But that clumsy waiter who keeps spilling hot soup on his customers may have a comparative advantage at being a waiter. He could be even worse at everything else. So just as you can be really good at something without having a comparative advantage in it, you can have a comparative advantage at something you don't do very well.

While people seem to understand comparative advantage when making personal choices, they often put this understanding on hold when accepting arguments against international trade. For example, last month I explained why the widely accepted argument that countries with low-paid workers will be able to outcompete us in all goods is wrong. I shall now consider a related, and widely accepted, argument against free trade, and explain the fallacy it contains by modifying the example in last month's column.

Being the Best May Not Be Good Enough

A common complaint by domestic producers is that foreign firms that suddenly begin outcompeting them must be selling below cost. They can often support their case by pointing out that the foreign firms were previously uncompetitive

and have not improved their efficiency one bit. So how can these firms possibly be competitive now? It may seem strange that firms unable to compete earlier are suddenly able to without becoming more productive. But it is not strange at all. Foreign firms don't have to become more productive to acquire a comparative advantage over domestic firms.

Consider the table on the next page, which contains last month's example (ignore the number in parentheses for now). Americans have a comparative advantage only in car production even though they are absolutely more productive than Brazilians at producing both cars and computers. The opportunity cost of producing 100 cars is 666 computers in the United States and 1,000 computers in Brazil. But the other side of this coin is that Americans have a comparative disadvantage in producing computers, which means Brazilians have a comparative advantage in computer production. While it costs 150 cars to produce 1,000 computers in the United States, it costs only 100 cars in Brazil.

So, as explained last month, both countries are better off when Americans specialize in cars, Brazilians specialize in computers, and they trade with each other. Free trade moves resources into each country's comparative advantage, thereby increasing total output.

But assume that an entrepreneur develops a better way of manufacturing computers in the United States: it now requires only 1.5 units of productive resources to produce 1,000 computers. U.S. car manufacturers are just as productive absolutely as before, and no productivity improvements are made in Brazil. But now, the comparative advantage in the United States has shifted to computers, with the absolute advantage in cars becoming a comparative disadvantage. It now costs 1,333 computers to produce 100 cars in the United States as opposed to only 1,000 in Brazil. Under free trade U.S. computer manufacturers are able to outcompete car manufacturers for resources as consumers in both countries find it cheaper to buy computers from the United States and cars from Brazil. Both countries are now better off than before, since trade allows the benefit from more efficient computer production to be fully realized.

	U.S.	Brazil
100 cars	2 units of resources	4
1,000 computers	3 (1.5)	4

True, U.S. unemployment may increase temporarily, as workers in the declining car industry move to jobs in the expanding computer industry. And U.S. car manufacturing will lose money, an unmistakable incentive to move resources to more productive uses. So expect U.S. car manufacturers and their labor unions to complain that the competition putting them out of business cannot possibly be fair because they are still two times more productive than Brazilian car manufacturers. Obviously the Brazilians must be selling below cost—dumping cars in America. But Brazil does not have to sell cars below cost to outcompete U.S. car producers. Americans may be twice as productive

manufacturing cars than Brazilians, but it is now 2.66 times more productive manufacturing computers. So the opportunity cost of producing cars in Brazil has become lower than in the United States. There is no legitimate complaint about Brazilian competition. In fact, the real competition is not coming from Brazil at all, but from other Americans. Brazil has done nothing new in our example. The competition facing U.S. car producers is coming from the more productive opportunity the U.S. computer industry is offering workers and resource owners. Car producers simply cannot afford to pay workers (and resource owners) enough to cover their increased opportunity cost given their comparative advantage in producing computers.

Self-Serving Claims

We can now see the self-serving silliness in the claim by industries having to lay off workers because of foreign imports that free trade will cause massive unemployment. If this were true, the opportunity cost of workers would be reduced by trade and they could be profitably re-employed at low cost by the declining industry. The problem declining industries have with free trade is that trade increases employment opportunities, not that it diminishes them.

Our discussion of international trade has ignored many real-world complexities. For example, we observe countries producing and importing the same product, as opposed to our example where countries import only what they don't produce. To explain how both producing and importing the same product is consistent with pursuing one's comparative advantage we will have to examine the concept of marginalism, which will be done in a subsequent column. But our discussion goes a long way to dispel common myths about the dangers of free trade.

The Hidden Cost of Taxation

March 1, 2000

In my last column I pointed to the harm government typically does when it attempts to promote prosperity by creating jobs. Such attempts always distort the market cooperation that directs people into those jobs in which they create the greatest value. But government does have legitimate, though limited, functions, and performing them requires hiring people. If government confines itself to its legitimate role and performs efficiently, government employees will produce more value than they can in alternative jobs. Unfortunately, government neither limits itself to its legitimate functions, nor performs efficiently. I shall consider one reason for this government failure, a reason based on a distortion in the political process. Because the costs of taxation are never fully considered in political decisions, those decisions are biased in favor of excessive taxing and spending.

The costs of taxation are dispersed widely. Everyone pays taxes, so when a general tax is increased it is spread over so many people that no one individual will find the increase very burdensome. Conversely, if the tax is decreased, no one may perceive a significant benefit. And even if some people do notice the costs of a tax increase, or the benefits of a decrease, an effort to organize other taxpayers (given their large numbers, geographic dispersion, and diverse interests) to take effective political action would be difficult. This helps explain why the costs of taxation are largely ignored politically. Politicians can nudge certain taxes up without hearing from taxpayers, except for some brief grumbling.

Of course, not everyone is politically passive about tax burdens. Relatively small groups with an intense interest in the burden of particular taxes are well positioned to influence policy on those taxes. The federal tax code is full of highly specific loopholes for particular industries, and often for particular companies. Also, some general tax breaks, like interest deductions on mortgages, are seen as promoting a desirable objective (home ownership), are easily noticed as significant by taxpayers, and also benefit an organized interest (homebuilders). Thus they are politically popular.

But the tax loopholes permeating almost all tax systems add to insidious “dead weight” costs of taxation, which result from distorted economic decisions caused by all taxes, but aggravated by tax loopholes. These costs are insidious because besides being widely dispersed, they go undetected even by those who suffer from them. The result is an even greater bias toward excessive taxing and spending.

The Tax Wedge

All taxes drive a wedge between what buyers pay and sellers receive. Consumers pay more than producers receive because of sales taxes, and employers pay more than employees receive because of income taxes. Thus some production and effort worth more than it costs is not provided, and the value sacrificed is the dead-weight cost of taxation. This deadweight cost is greater when the tax system contains loopholes. When some products or activities are taxed more heavily than others, people will favor those taxed less even when they are less valuable than those more heavily taxed. For example, when much of the cost of a house is deducted from taxable income but not the cost of clothing, people will sacrifice clothing to buy a larger house, even though they value the clothing more than the additional housing space. When the profits in one industry are taxed less than the profits in other industries, people will continue adding to investments in the low-tax industry even though the additional investment would create more value in other industries.

Dead-weight costs of taxation go unnoticed, even by those who pay them, because instead of taking from people what they already have, they take from people what they would have had, but never get. No one sees the extra value that would have been created by economic decisions that would have been made without taxes. The problem here is similar to the one that governments create, and take advantage of, with tax withholding. When taxes are deducted directly from our paychecks, few of us pay much attention to just how much we are paying. Indeed, people often get excited when they overpay their taxes through withholding and get a refund at the end of the year. The tax withdrawals were hardly noticed (and neither is the interest lost because the government had the money), but the refund is obvious and seems to be a gift from the government.

Even though unnoticed, the dead-weight costs of taxation are real and significant. It has been estimated that the dead-weight costs of the federal government’s raising an additional dollar equal 39 cents.¹ So for the federal government to obtain an additional dollar, taxpayers have to sacrifice \$1.39—\$1.00 taken from them directly, plus another 39 cents in value they could have had but never will. But because people are unaware of these dead-weight costs, the political process ignores them, and government decisions that appear efficient actually destroy wealth.

Consider a government program to create jobs that pay \$10 million a year in salaries. Assume that the government workers who receive these salaries will create a service worth \$12 million a year. This program will be heralded as an economic success, yielding \$2 million above its costs (I assume that the only input into the program is labor). But the program is a loser, as is obvious once

the dead-weight costs of taxation are recognized. Based on the above dead-weight costs estimate, it will cost approximately \$13.9 million dollars to raise \$10 million in tax revenue-\$10 million in direct tax payments, plus another \$3.9 million in value sacrificed because of the economic distortions caused by those tax payments. So instead of being an economic success, the program destroys \$1.9 million dollars' worth of value a year.

The Seen and Unseen

All public policies have both seen and unseen effects. Frederic Bastiat, the nineteenth-century French economist, pointed to many of the economic errors people make by focusing on the seen and ignoring the unseen.² Although Bastiat did not discuss the unseen dead-weight costs of taxation (he did point out that politicians tend to ignore even the direct costs of taxation), there are few better examples of his general point than taxing and spending. The benefits of government spending are easily seen, and often concentrated on organized-interest groups that exaggerate them to politicians. But the costs of funding the spending, especially the dead-weight costs, are largely unseen. The result is that the political process overemphasizes the benefits of spending, under-emphasizes the costs, and consistently expands spending to economically destructive levels.

Freedom of the Price

May 1, 2000

Last month I explained why our liberties will be steadily eroded without a genuine commitment to liberty in general.

Fortunately some liberties are widely recognized as crucial and have influential interests protecting them from political violation. An interesting example is freedom of speech—freedom against government censorship. Recent examples of the censorship of politically incorrect speech have occurred on, of all places, state college campuses, and too much of this censorship remains, even if unofficially, despite court decisions outlawing it. But the freedom to communicate in speech and writing is for the most part protected. If the government attempts to censor the news media (even in the name of national security) there is an immediate and powerful outcry from journalists. (Remember the Pentagon Papers.) We can be proud of our long tradition of freedom of the press and appreciative of the journalism profession for helping protect that freedom. At best, however, journalists deserve only two cheers for resisting censorship, since they not only condone, but often report sympathetically on, a very pernicious type of censorship.

As valuable as the communication of the news media is, it is less valuable than communication through market prices. As I have explained in earlier columns, the global cooperation that provides our wealth and protects our freedoms would be impossible without the information and motivation communicated through market prices. Yet governments routinely distort this communication with policies that force prices above or below what they would be in a free market. This price censorship violates our right of free expression as much as government's dictating the content of daily newspapers and TV news.

Minimum-wage laws censor unskilled youth who would like to communicate with potential employers: "I have few skills and college is not feasible, so I am willing to work for little now while I have few financial responsibilities to acquire the on-the-job training that will allow me to be more productive later." Agricultural price supports victimize all families by censoring the ability of

farmers to communicate with them. Without that censorship dairy farmers, for example, would communicate that they are willing to make more milk available to children (and adults) by lowering milk prices. This censorship is particularly harmful to poor families because they devote a larger percentage of their budgets to basic foods than do wealthy families.

The censorship of rent control prevents people from communicating their desire for housing space through higher prices. The result is that people who would be willing to provide additional housing don't have adequate information on how valuable the housing is and little motivation to provide the right amount even if they did. Rather than helping the poor, who are supposedly the beneficiaries of rent control, the available housing space generally goes to well-connected nonpoor families; the poor end up with less housing than they would have been willing to pay for in an open market and are often relegated to the squalor of public housing. If journalists were as informed as they want us to believe, and as socially concerned as they claim, they would help the poor by attacking price censorship with the same fervor as they do press censorship.

Journalists can fill newspapers and news broadcasts with stories of jobless teenagers, write compellingly of the need to increase the availability of food to the nation's poor, and urge landlords to make more low-income housing available. But the effectiveness of this free expression is nil compared to the free expression that would allow lower wages, lower food prices, and higher housing prices.

I am not arguing that we should be complacent about low wages and farm incomes, or high rents. But we should recognize that low wages and incomes and high rents are only the symptoms of the problems that should concern us. Low wages inform us that productive skills are lacking; low farm incomes send a message that some farmers would create more value elsewhere in the economy; and high rents tell us that housing space should be expanded. We may not like the news communicated through market prices, but that is no reason for censoring it. No one would suggest that we censor news of natural disasters, political scandals, or outbreaks of disease. We may not like to hear such news, but suppressing it would reduce our ability to respond in ways that reduce the costs of such unfortunate events. Similarly, censoring price communication reduces the information and incentive needed to respond appropriately to the problems created when our efforts and resources are not being directed to their most urgent employments.

Harming the Poor

Some will object that the freedom of price communication puts those with few financial resources at a disadvantage. If this argument were correct, it would also be true that the traditional freedom of expression discriminates against those lacking education and the ability to express themselves. But no one is put at an absolute disadvantage by the freedom to communicate either through prices or words. Obviously those who are knowledgeable and articulate benefit from free speech, but can anyone believe that censoring verbal and written communication would help the ignorant and inarticulate? The best

hope for acquiring knowledge and developing intellectual skills is through the free flow of spoken and written information. Similarly, the best hope for the poor is through the free flow of market communication, which informs them of their best opportunities, motivates them to increase their productivity by taking advantage of those opportunities, and keeps others responsive to their preferences and concerns.

No one would argue that price communication is always completely honest and accurate. But who is prepared to argue that distortions and misrepresentations are not easily found in newspapers, magazines, books, and TV and radio programs? Such imperfections can never be eliminated, but the most effective way of moderating them is not through censorship but through the competition of free expression, as any self-respecting journalist will quickly inform you. But any journalist informed enough to warrant self-respect should also recognize that the most effective way of moderating the imperfections in price communication is by allowing more competition in price communication, not by stifling that competition with price censorship.

Journalists should understand the importance of freedom in communication. And certainly no group is as quick to defend that freedom, or more articulate at making the case for it, than journalists. But if journalists were fully committed to freedom of communication, they would find price censorship just as abhorrent as press censorship.

It's the Margin That Counts

June 1, 2000

Economists, like everyone, have opinions about how the world should be. And it would be disingenuous to claim that economists never let their opinions influence their conclusions and recommendations. But the power of economics is in fundamental concepts that prevent economists from letting their imaginations obscure reality. They may wish that scarcity didn't exist, that agonizing tradeoffs could be avoided, that people would subordinate their private interests to the public interest, or that world peace and global cooperation could be achieved by all joining hands and singing "We Are the World." But economists don't let such fantasies pollute their analysis because they take seriously scarcity, opportunity cost, self-interest, imperfect knowledge, market prices as necessary for social cooperation, and economic failure as necessary for economic success.

This attachment to reality strikes some as defeatist, as too hasty to dismiss proposals for making the world a better place. There is no denying that economists dismiss many proposals to improve the world. But economists see their realism as essential for genuine improvements. As Nobel-Prize winning economist F. A. Hayek observed, "For it has always been the recognition of the limits of the possible which has enabled man to make full use of his powers."¹ Perpetual-motion machines would be wonderful things, and it's too bad everyone doesn't have one. But the "defeatist" attitudes of physicists discourage work on them."

One of the most useful economic concepts is marginalism—the effect of incremental, or small, changes. Marginalism shows how economic reasoning allows us to accomplish more by accepting limits on what can be accomplished—by focusing on marginal (some will say mundane) adjustments to make things better, rather than on more heroic attempts to solve problems totally and completely. It also shows that what many people see as objection-

¹F.A. Hayek, *Law, Legislation and Liberty, Vol. 3: Rules and Order* (Chicago: University of Chicago Press, 1973), p. 8.

able outcomes and actions are actually reasonable accommodations to scarcity and that attempts to “correct” them are harmful. I illustrate marginalism with two examples. In following months I shall discuss how failure to understand marginalism reduces the good we can do, and often ends up being deadly.

Diamonds and Water, Wrestlers and Nurses

We have all heard arguments like these: Something is wrong with the economy when professional wrestlers are paid a lot more than nurses. Food is far more important than golf, so we are making a big mistake by converting so much prime agricultural land to golf courses. If you are going to do a job, do it as well as you possibly can. Most people enjoy their work and don’t have to be bribed with bonuses and merit pay to get them to perform well. Some things, such as human life, are simply too valuable to put a price on.

Each of these sounds plausible. But all of them are flawed because they ignore the importance of marginal considerations, and if we acted on them we would end up reducing the good that can be accomplished.

For years economists and others were perplexed that the price of diamonds is far greater than the price of water, even though water is far more valuable than diamonds. This diamond-water paradox wasn’t resolved until the 1870s when the Austrian economist Carl Menger and the British economist William Jevons independently recognized the difference between marginal value and total value. Price reflects the value people place on one more unit of something (its marginal value), not the value of all of it (its total value). The total value of water is obviously much greater than the total value of diamonds—we would pay orders of magnitude more to avoid living in a world without water than we would to avoid living in a world without diamonds. But because water is so plentiful (except in unusual circumstances), the amount people are willing to pay for one more gallon is close to zero—the marginal value of water is low. On the other hand, diamonds are so rare that people are willing to pay thousands of dollars for one more.

This brings us to wrestlers and nurses. Because so few have the physical attributes to satisfy the demand for wrestling performances, people are willing to pay a lot to attract one more person with those attributes into the ring. Many more have the attributes to satisfy our demand for nurses, and so people are willing to pay a lot less to attract one more person into nursing. Although the total value of nurses is far greater than the total value of wrestlers, the marginal value of nurses is far less. And it is the marginal value of people in an occupation, not total value, that is important in determining salaries in that occupation.

So there is nothing remarkable about professional wrestlers’ earning a lot more than nurses, although some consider it objectionable. But what some really see as objectionable in the large ratio of wrestlers’ to nurses’ earnings is that people with “disagreeable” preferences have the freedom to communicate those preferences through market prices. There is nothing wrong with trying to reduce the earnings gap between different occupations by trying to change peoples’ preferences. But if people try, as some do, to reduce earning gaps

with government controls over wages and salaries, they are trying to distort the price communication that benefits us all.

Unintended Consequences

Government could mandate higher salaries for nurses, for example. This would send a signal that the marginal value people receive from nurses has increased, and more people should train to become nurses. Few professional wrestlers will want to shift into nursing, but many other people will. Unfortunately, the higher salary communicates the wrong information. While telling more people to become nurses, the higher salaries are telling consumers that the marginal cost of nurses is greater than their marginal value, and so fewer should be employed. The result would be that few newly trained nurses will find jobs, some practicing nurses will lose their jobs, and consumers will have fewer nurses than they want at market salaries, that is, salaries that reflect their marginal value.

Because people fail to distinguish between marginal value and total value, they believe nurses (and those in many other occupations) are suffering an injustice and recommend solutions that harm everyone, particularly nurses.

Several more columns will be required to adequately explain the concept of marginalism and to provide examples of the mistakes people make when they confuse marginal value and total value. In the next column I shall use marginalism to provide comfort to those who worry that we are running out of agricultural land.

Running Out of Agricultural Land

July 1, 2000

Fear that we are running out of important resources is perpetual. Oil is a favorite thing to worry about; landfill space is another, and trees yet another. I could continue listing things (coal, copper, iron ore, even tin) that people have worried would soon be exhausted, and I plan to discuss the persistent fear of resource exhaustion in future columns. In most cases the fear is baseless—fueled by organized interests hoping to capture advantages by scaring the public, by sloppy journalism, and by a general lack of basic economic understanding. Where concern is appropriate, the problem is invariably the lack of private property rights in the threatened resource.

To see the role of property rights in preventing the depletion of resources, consider the following question: have we ever run out of a nonrenewable resource? I have asked dozens of audiences this question and have never found anyone who can name one. But aren't nonrenewable resources the ones we are most likely to run out of? After all, they are nonrenewable. More puzzling, we have run out of—driven to extinction—a number of animals, which are renewable. Aren't these the resources we should be least likely to run out of?. The puzzle is resolved by recognizing that nonrenewable resources just sit there; they don't run around, so it is easy to establish private property rights over them. As I discussed in earlier columns, people conserve resources they own by taking their future value into account. Many animals, because of their fugitive nature, are difficult to own as private property, and so people have little motivation to consider their future value. So despite their renewability, some of these animals have been extinguished.

Creating scares that we are running out of nonrenewable resources would be far more difficult if people understood the power of private property to motivate the proper consideration of our resources' future value. But in this column I consider another reason people mistakenly fear we are running out of, or dangerously depleting, resources—failure to distinguish marginal value from total value, a distinction I introduced last month.

Disappearing Farmland

I had just begun my first teaching job at the University of Colorado in 1972 when I was asked to participate in a debate on the “problem” of disappearing farmland. Despite my compelling arguments (several in attendance who agreed with me before the debate still agreed with me afterward) that decreasing farmland was the result of market forces working properly, concern over lost farmland has continued. For example, Lester Brown of Worldwatch Institute puts out an annual report predicting that food supplies will fall behind population growth, a problem he sees caused partly by the loss of farmland to development. In my local newspaper, columnist Tom Teepen recently warned, “Development is taking up farmland, forest and other open space in this decade at twice the rate of the 1980s...Between 1992 and ‘97 some 16 million acres went to development.”¹

It is true that in the United States fewer acres are used for agriculture today than in the past, although the loss is far less than what Worldwatch and United States Department of Agriculture report.² But this “loss” of farmland is not a crisis or even a cause for concern. Instead, it is good news. First, with less land being used for farming, more land has reverted to open space and forest. You won’t hear this from the crisis crowd, but there is more forestland in the United States now than 80 years ago³. Second, farmland has been paved over for shopping centers and highways, converted into suburban housing tracts, covered with amusement parks, developed into golf courses, and otherwise converted because consumers have communicated through market prices that development is more valuable than the food that could have been grown on the land.

Food or Golf

Why would consumers willingly sacrifice food for golf courses, shopping centers, and parking lots? Isn’t food more valuable than golfing or parking? Of course—in total value. If the choice is between eating and no golf or playing golf but no eating, even the most avid golfer would choose eating. But economic choices are not all-or-none choices. Instead, we make decisions at the margin, deciding if a little more of one option is worth sacrificing a little bit of another. And at the margin it isn’t clear that food is more valuable than golf or many other things we can live without. Golfers are communicating through greens fees that another golf course is at least as valuable as the additional food sacrificed.

At the margin, golf is certainly more valuable than food would be if millions of acres of farmland had not been “lost” to development. In 1900 most of the horsepower used on the farm was really horse power, or mule power, and tens

¹Tom Teepen, “Facts Justify Criticism of Suburban Sprawl,” *Atlanta Journal and Constitution*, December 26, 1999, p. D4.

²In chapter 2 of *Hoodwinking the Nation* (New Brunswick, N.J.: Transaction Publishers, 1999), the late Julian Simon gives examples of exaggerated claims by organizations, including the USDA, that benefit from the perception that farmland “loss” is a serious problem.

³Gregg Easterbrook, *A Moment on the Earth* (New York: Viking, 1995), pp. 10-13.

of millions of acres were needed to grow the food for these animals. Trucks, tractors, harvesters, and other gasoline-powered farm machinery have efficiently substituted for these animals and the acres needed to feed them. Also, much less land is needed now to feed the same number of people because improvements in fertilizers, pesticides, irrigation, seeds, and weather forecasting allow more food to be grown per acre, and improvements in harvesting, packaging, storage, and transportation allow more of what is grown to get to the dinner table. If we still devoted as much land to farming as we did in 1900, with today's technology we would be knee-deep in cantaloupe. In this situation, how valuable would another few acres of cantaloupe be compared to another golf course that could be constructed on those acres?

We don't have nearly as much farmland as we did in 1900 because as food production increases, its marginal value decreases relative to that of houses, shopping centers, golf courses, and more. Consumers communicate this change in relative value with purchases that cause food prices to decline relative to the prices for other uses of farmland. This motivates a decrease in farmland that continues as long as the marginal value of land is greater in nonfarm uses than in agricultural production.

But don't expect the farmland "crisis" to disappear. Public agencies hoping for bigger budgets, and private organizations hoping for more research funding or larger subsidies, are always anxious to identify crises to scare the public. Crisis creation wouldn't be so easy if more people understood the difference between total value and marginal value.

Marriages, Mistresses, and Marginalism

August 1, 2000

Distinguishing between marginal and total values is crucial to understanding many human activities and decisions. Almost all the decisions we make are made at the margin, but there are exceptions. We are sometimes faced with decisions that force us to compare the total value of one option to the marginal value of another. These decisions can be far more agonizing than decisions made entirely at the margin, which require sacrificing a little bit of one thing to have a little bit more of another.

Consider love and marriage, a topic not commonly thought to be one that economics has much to say about. But decisions that lead to love, marriage, and sometimes divorce always involve choices between competing alternatives, and therefore involve costs and benefits. These costs and benefits are personal and subjective, but so are all costs and benefits. And if people consider the relevant costs and benefits when making relatively trivial decisions, say on whether to acquire or discard a pair of socks, then surely we should expect them to consider the costs and benefits of vital decisions such as getting married or divorced.

Wives and Mistresses

My wife reads these columns, so I want to emphasize that economic analysis allows one to acquire insights into activities without having firsthand experience. Also, nothing important would be altered if I reversed the sexes' roles.

After a few years of marriage a husband has had lots of experience with his wife. He has seen her almost every day, most of their time together being spent in rather routine activities. He knows her habits, so most of her behavior is predictable and not very exciting or even particularly interesting. He spends hours with her and never says a word to her or notices her presence, even if the football game is less interesting than the beer commercials. And she experiences him in much the same way, so her responses to him typically lack enthusiasm, which reinforces his own lack of enthusiasm. In other words, before long the husband doesn't find his wife very valuable at the margin.

In contrast, the woman he meets at work or on a business trip seems far more interesting. He has not known her long, and likely doesn't see her often, so she is less predictable and more exciting than his wife. Also, he likely sees her in more interesting situations than in a messy kitchen with screaming kids. And if his interest in her is reciprocated, it will probably be with far more eagerness than he has experienced at home in a long time. If she becomes his mistress, with occasional liaisons in romantic settings, he can find himself exhilarated at the thought of the next encounter. His mistress is far more valuable to him than his wife at the margin.

The passion of the love affair causes the husband to think about leaving his wife for his mistress. But leaving his wife involves a different calculus from comparing the value of a little more time with his wife with that of a little more time with his mistress. A divorce is not a decision made at the margin but one that forces the husband to confront competing total values. Here the advantage can easily shift to the wife. Her marginal value may be small, but her total value can be very large. The husband's relationship with his children, his parents, and many of his friends; his standing in the community; his sense of permanence and place; and his financial prospects are all inextricably connected with his wife and marriage. Plus there is the genuine fondness he likely has for his wife and their shared memories and experiences.

The wife is like water and the mistress like diamonds. Given a marginal choice between the two, the husband readily sacrifices a little time with the wife for a little more with the mistress. But when the choice is between the total value of the wife and the total value of the mistress, the wife wins.

Obviously the analogy of the wife as water and the mistress as diamonds is not perfect. Men do leave their wives. A marriage can fail because the wife (remember, the sexes can be reversed) ceases to provide value both at the margin and in total. But the important distinction between total value and marginal value explains why so many men who are genuinely enthralled by their mistresses give them up rather than sacrifice unexciting marriages.

Hurting Those We Love the Most

As this discussion indicates, there can be a lot of pain in a marriage, even a strong marriage. Obviously in many strong marriages there is little pain, and certainly this is what most of us would consider the ideal. But there is an old saying that "we hurt the ones we love the most," and marriages (especially strong marriages) are often good examples of this.

We often do things to aggravate and hurt those we love that we would never consider doing to casual acquaintances. The distinction between total and marginal value is important here. Those we love (who provide us with a lot of total value) are generally those who love us (we provide them a lot of total value), so we can impose some marginal costs on them with hurtful comments and behavior without eliminating all the total value they receive from us. If we did the same thing to casual acquaintances at work, for example, our total value to them would quickly become negative and we would find ourselves isolated or worse. Of course, even with loved ones, there are limits to how much pain they

will take from you, but the stronger the marriage the more latitude there is. In a weak marriage there will not be much pain, at least for long, since there is little total benefit sacrificed by divorce.

To reinforce the point, consider how much aggravating behavior parents will endure from their children. There is probably no love stronger than that which parents have for their children. And children often take advantage of this love by behaving in ways that inflict tremendous pain on their parents.

I am not recommending that you take advantage of the love people have for you by behaving badly. Far from it. Neither am I arguing that economics gives a complete explanation of the behavior observed in marriages and families. That behavior is influenced by many factors best considered by those trained in other fields. But unless you distinguish between total and marginal effects of behavior, you will leave unopened an important window of understanding on marriage and families.

Take This Job and Shove It, at the Margin

September 1, 2000

Many believe that pay is overemphasized and much too unequal in market economies. Supposedly, most people enjoy working, and so while they have to be paid to survive comfortably, they don't have to be bribed with bonuses tied to performance to do a good job. Indeed, psychological experiments indicate that the intrinsic interest people have in doing a task declines when they are paid for doing it.

And why the large differences in the amounts different people are paid? Since people enjoy working, big pay differences aren't needed to overcome the unpleasantness of working, at least not in most jobs. Anyway, how can you explain that people who have the most enjoyable jobs (such as professional athletes, successful entertainers, and corporate executives) typically receive far larger incomes than those who have the least enjoyable jobs (such as custodians, trash collectors, and coal miners)? Also, the argument continues, pay differentials reduce productivity by shifting the emphasis in the workplace from cooperation to competition.

Those arguments can be persuasive at first glance, as they are in a very readable book by Alfie Kohn.¹ But the case is seen to be seriously flawed when examined with an understanding of basic economic concepts, such as marginalism.

Economists are often criticized for assuming that workers have to be paid because people like leisure and dislike work. For example, Kohn (p. 131) claims, "Economists have it wrong if they think of work as a 'disutility'... something unpleasant that we must do in order to be able to buy what we need, merely as a means to an end." In fact, economists have no problem admitting that most people enjoy their work. But they also recognize some other important considerations regarding work.²

¹ Alfie Kohn, *Punished by Rewards* (Boston: Houghton Mifflin Company, 1993).

² See Richard B. McKenzie and Dwight R. Lee, *Managing Through Incentives* (New York: Oxford University Press, 1998), chapter 20, for a more detailed discussion of the argument in this column.

If a person enjoys one job, he will also enjoy others. So what job should he take? Clearly his preferences for the type of work he most enjoys should be considered. But so should the preferences of consumers who will value the contribution of a worker more in some jobs than in others. Fortunately, consumers can communicate their preferences effectively through their purchases, which translate into greater demand and higher incomes for workers who produce the most valued products. This communication would be censored by government policies that arbitrarily reduced the pay differentials generated in labor markets. Such censorship would reduce not only the value of what workers produce, but their freedom. Workers can be allowed to choose a job that is less productive, but more enjoyable, only when they are held accountable through lower pay for the reduction in value created for consumers.

In the psychological experiments cited by Kohn that show interest in performing a task declining when people are paid, it makes little difference what tasks are being performed. In the economy, attracting workers into the right jobs is crucial and requires pay differentials that critics like Kohn find objectionable. Even if the pay differentials generated by the market do reduce the performance of workers (a doubtful proposition, as we are about to see), it is better having people working at less than full capacity at valuable tasks than at full capacity at useless tasks.

Economists also recognize that while people generally enjoy their work in total, most jobs are a pain at the margin. Even if you get tremendous satisfaction from your job, the marginal satisfaction can be very low, in fact negative. Well before the work day is over, most of us are tired of the grind and would love to leave work early and do something else. We would like to tell the boss, "Take this job and shove it, at the margin." People put in eight hours of diligent effort because there is a financial inducement to do so.

In fact, the ability of consumers to communicate their preferences to workers through differential pay acts to guarantee that workers receive marginal "disutility" from their jobs. The value a worker is contributing to consumers by remaining on the job is positive even though the marginal value he receives from working longer has declined to zero and is about to become negative. Since consumers can communicate through additional pay that the value to them is greater than his cost of staying on the job, he continues working. The additional pay compensates him for the marginal "disutility" of working as long as that disutility is less than the marginal value he is creating.

Even popular entertainers and athletes, who receive enormous total satisfaction from their jobs, perform in late-night shows, take road trips, and put in extra hours rehearsing and practicing when they would rather be doing something else. But because their performance is valued so highly by consumers who communicate that value with extremely lucrative compensation, they put in the extra hours.

I am not claiming that compensation is always tied directly to worker output. That is not always practical. But even when employees are being paid about the same, even though some are better workers than others, long-term considerations can still connect pay to performance. Those who miss too much

work are dismissed; less productive workers are more likely to be laid off in business downturns; and more productive workers are more likely to be given better work schedules and promoted. Responding to consumers effectively requires that firms have compensation arrangements that, over time, connect pay to contribution.

Importance of Cooperation

Obviously cooperation is important in the workplace. But few things can reduce cooperation more than the perception that compensation isn't tied to contribution. There is a strong temptation for workers to shirk, at the margin (and it can be a wide margin), even when they enjoy their jobs, if they don't see a financial reward for diligent effort. Even assuming that most workers were willing to put in a full day of responsible work without the incentive of pay, a few will always take advantage of the opportunity to shirk if there is no penalty. This will be noticed by the dependable workers, who find their effort harder and less productive because of the shirking of the few, and who will begin to feel like suckers since they are receiving no more than the slackers. So a few more will decide it is better to be a shirker than a sucker, increasing the temptation of the rest to slack off. The result is a destructive cycle of shirking that undermines productive cooperation among workers.

I am not arguing that money is the only thing that motivates workers. Also important are such things as respect from supervisors, an uplifting sense of mission, and a feeling of comradeship. But the effectiveness of these considerations will soon crumble without a reasonable connection between pay and performance.

More on Marginalism

January 1, 2001

There are so many economic issues that cannot be understood properly without recognizing the importance of marginal considerations that I could continue writing columns on marginalism indefinitely. Indeed, marginal analysis will reappear both explicitly and implicitly in my future columns. But this month I will wrap up my emphasis on marginalism with some additional observations on this crucial economic concept.

We have all heard the advice, “If a job is worth doing, it’s worth doing right.” There is wisdom in this advice if we are careful about what is meant by “doing a job right.” People sometimes suggest that if a job is worth doing, it’s worth doing perfectly. But this advice, by ignoring the importance of marginal considerations, is a prescription for waste and inefficiency, as anyone who attempted to put it into practice would soon discover. No matter how much time is spent doing a job, it can almost always be done a little better by spending more time on it. But at some point the value of doing the job a bit better is less than the value of diverting a little more time to another activity. So even if perfection were possible, it would not be sensible. Instead of doing any one thing as well as possible, you are far better off doing several things not so well.

In general, you will accomplish the most by doing what economists call “equating at the margin.” This means allocating your time over several activities so that the marginal value created from more time on each is the same for all. If your time isn’t being allocated this way, then the marginal time spent on some things creates more value than on others. In this case, you can create more value in the same amount of time by shifting time into the higher-marginal-value activities and out of the lower-marginal-value activities. As this shift takes place, the marginal value of time in the former activities declines and the marginal value of time in the latter activities increases. Only when the marginal value of time in all activities is the same are you taking advantage of all opportunities to create more value for the time spent.

So “if a job is worth doing, it’s worth doing right” is good advice as long as we keep in mind that doing a job right doesn’t mean doing it as well as you can. “Don’t do your best at anything, equate at the margin instead” may not be very inspiring, but it’s good advice. Fortunately, it is advice that few need, since it is what we tend to do anyway. It should be emphasized that since all value is ultimately based on our subjective evaluations, the patterns of activities that equate at the margin vary enormously over different individuals. But all people’s behavior reflects the advantages of doing less than their best at everything they do as they constantly adjust the margins toward equality.

Doing Well in School

Consider the objective of doing well in school. I often hear my colleagues complaining that their students are not taking their course work seriously. I often join in these complaints. We are convinced that many of our students would get more out of our courses if they attended lectures and read the texts more diligently. We are surely right in this, but as economists we shouldn’t be surprised at, or critical of, our students’ behavior. Being a good student can be important in achieving one’s objectives, but so are lots of other things, such as working part-time, making friends, developing social skills, or just hanging out and having fun. Spending more time on class assignments adds value, but it necessarily means less time for other valuable activities. And long before a student has done the best job possible in his or her course work, the marginal value of time spent studying will have fallen below the marginal opportunity cost—the marginal value sacrificed in other pursuits.

So the student who did his absolute best in class is getting less value from the additional minute spent studying than he would if he spent that minute doing something else. He increases the value realized from his time by “equating at the margin”—reducing the time spent studying until study time has the same marginal value as time spent doing other things. Even if the student is a complete nerd, he will still tend toward equating at the margin over his different courses since he will learn the most by learning less than possible in each course taken.

Don’t Try to Do Too Much

I need to emphasize that “equating at the margin” only applies when the marginal value of time in every activity eventually begins declining relative to the marginal value of time spent in other activities. This is a plausible assumption, as is seen by considering what people would do if it were not true. If the marginal value of time a person spent, say, bowling increased indefinitely relative to other things, then we would expect to see him spending all his time bowling, since the more time spent bowling the more valuable another minute spent bowling would be compared to another minute doing anything else. This obviously doesn’t describe how people behave. Even the most dedicated bowler (or bird watcher, golfer, etc.) eventually takes time out for a beer, a burger,

and bed. In other words, the marginal value of bowling declines relative to the marginal value of alternatives, and the bowler equates at the margin.

But it is important to realize that we get better at doing many things as we spend more time on them, which means that the marginal value of time in these activities does increase up to some point. This suggests that we don't want to try to do too many things, never becoming very good at any of them. There is real advantage in choosing a relatively few things that we have talent for, or which we really enjoy (talent and enjoyment generally go together), and developing skill in them, which increases our enjoyment even more. But no matter how much we enjoy an activity, or how good we are at it, eventually the marginal value of doing it begins to decline relative to other things, and so we will want to equate at the margin over a number of activities. And although this means that we will end up doing nothing as well as we possibly could, we can still be extremely good at what we do.

Let me conclude by emphasizing that equating at the margin is not an excuse for shoddy and careless work. Not doing your absolute best at any one thing is quite consistent with doing everything you do very well. Furthermore, not doing your absolute best at anything is not the same as not doing your absolute best overall. The point is that being as successful as possible in general requires being somewhat less successful than possible in everything we do.

Markets and Marginalism

February 1, 2001

To do your best in your personal activities, you have to “equate at the margin,” which, as I explained last month, means allocating your time over different activities so that the marginal value of time in every activity is the same. The importance of equating at the margin extends beyond individuals doing as well as possible personally; it is also crucial to the success of the general economy. And because of the information and incentives transmitted through market prices, people and businesses, responding to their private concerns, are led to cooperate in ways that are constantly moving margins toward equality throughout the economy. A discussion of this process provides additional insight into the advantages we all realize from the communication and cooperation motivated by market prices.

There are a large number of firms in the economy, each concerned primarily with increasing profits. But the decisions these firms make affect all the others. For example, the more that one firm produces, the more scarce resources it has to use and the less other firms can produce. Ideally, each firm will produce whatever amount it chooses in a way that minimizes the sacrificed value elsewhere in the economy. Achieving this ideal requires an enormous amount of information on such things as weather conditions, resource discoveries, hostilities between countries, productive technologies, and the particular circumstances and subjective preferences of millions of workers, resource owners, and consumers.

No government agency could ever acquire and constantly update all this information and use it properly. Fortunately, this information is communicated through market prices, with the input prices that firms pay reflecting the marginal value of those inputs in their best alternative uses. So with each firm motivated to choose the input combination that minimizes its cost of producing a given amount of output (which requires equating the marginal productivity per dollar cost of all inputs)¹, it also chooses the input combination that pro-

¹For example, if the marginal productivity for \$1 of input X is 2 while the marginal

duces that output at a minimum sacrifice of value elsewhere in the economy. This equating at the margin reflects an impressive amount of coordination, with each firm responsive to the value of inputs to others.

Outputs and Marginal Adjustments

But it is not enough that each firm minimize the value lost (the cost) from producing its output to make the best use of our limited resources. Each firm could be producing its output at the lowest cost, with the combination of all firms' outputs being too costly. For example, we could produce dozens of disposable diapers daily for every American with the least-cost combination of inputs. This is obviously too many disposable diapers because the marginal costs (even though as low as possible) of diapers would be far greater than their marginal value—the value sacrificed to produce one more diaper is greater than the diaper is worth. Producing the combination of all goods that creates the greatest value for the resources used requires not only that each good be produced at least cost, but that each good be produced only up to the point where its marginal value equals its marginal cost.

Again, equating at the margin generates the most valuable combination of products over all firms. And by simply responding to market prices, each firm has access to all the necessary information. The price of a firm's product reflects its marginal value, and input prices determine the firm's marginal production costs. This information, when used by firms trying to make as much profit as possible, results in that combination of outputs that creates the most value. Each firm increases its profits by expanding output as long as the price it receives for its product is greater than its marginal cost (the value sacrificed by reducing the amount produced by other firms).¹ So when all firms produce the amount where price equals marginal cost, each firm is maximizing its own profit and the value of the combination of goods produced is maximized. Because market prices coordinate production decisions, these decisions are equated at the margin over all firms, and it is impossible to increase the value of the combination of goods produced by expanding the output of some firms and reducing the output of others.

The Big Advantage Is Liberty

I have discussed a level of “perfection” never reached in the real world. The relevant margins never reach complete equality because the countless number of preferences, circumstances, and technologies affecting the value of inputs and outputs constantly changes. But market prices constantly change to provide

productivity for \$1 of input Y is only 1, then the firm could expand its use of input X by \$1 (increasing output by 2 units), reduce its use of input Y by \$2 (reducing output by 2 units), therefore maintaining the same output at a cost of \$1 less.

¹This statement has to be qualified if the firm is a monopolist because price and marginal revenue diverge, as explained in every microeconomics text. But unless perpetuated by government, this monopoly “distortion” is rather benign when considered over time. Indeed, dynamic economy efficiency is increased when firms can strive for, and temporarily achieve, “monopoly” power.

information on new conditions and to reward behavior that pushes the margins toward equality. That reduces the cost and increases the value of what is being produced. These market adjustments do a far better job maximizing the value of economic decisions by keeping all decision-makers responsive to others than any group of government planners could ever do.

But the greatest advantage of the market is the liberty it allows. People can pursue their individual values and concerns instead of being herded into broad categories by remote authorities and told how to behave to promote some vision of the general good. For example, a business may not maximize profits because the owner wishes to employ disadvantaged youth or take time off for volunteer work. Or a worker may choose not to take the highest-paying job because he doesn't want to move away from a sick parent. People make these types of decisions every day, and the values they reflect can never be communicated through the political process and properly responded to by political authorities. But people can communicate their values and concerns through the effect their decisions have on market prices. And when people do so, they can be confident that others will consider those concerns in their own decisions. The result is a pattern of mutual adjustment and coordination that creates far more wealth and opportunity than could ever be achieved by central direction.

Economic Efficiency

March 1, 2001

Economic efficiency is the standard that economists use to evaluate a wide range of things. Economists who favor markets argue that they generate outcomes more efficient than do socialism or government regulation. As we shall see in the next few months, economists don't like pollution because it is inefficient. This emphasis on efficiency seems strange, if not reprehensible, to many people. They are convinced that economists are so narrowly focused on efficiency that they ignore the truly important things in life. Who but someone lacking completely in a sense of what makes life meaningful doesn't recognize that pollution is bad because it harms the environment? We should get rid of it whether or not it is efficient.

This criticism is unwarranted, though understandable. Efficiency is a tricky concept. Once it is understood what economists mean when they refer to efficiency, it becomes clear that it is a much broader, and more desirable, goal than many people realize.

Technical versus Economic Efficiency

People often think of efficiency as an objective ratio of inputs to outputs. For example, they sometimes argue that the internal-combustion engine is inefficient because only a small percentage of the energy in the gasoline is converted into motion. Furthermore, the argument continues, it is possible to build engines that convert a larger percentage of gasoline energy into motion. But such objective measures of technical efficiency are meaningless by themselves because they leave out the relative values people place on things, values that are necessarily subjective. Even the argument that the internal-combustion engine is inefficient depends on valuing motion, which people do. But motion is not the only thing they value. For example, much of the energy in gasoline is converted into heat, some of which can be channeled inside the car. So even if all the energy in gasoline could be converted into automotive motion (which

it can't), people in cold climates would be willing to sacrifice some of this technical efficiency to heat their cars. This reduction in technical efficiency would increase economic efficiency, which involves making marginal sacrifices of one thing (motion) to obtain marginal increases in something people value more (heat).

One might argue that we should make engines as technologically efficient as possible since, even if we did, there would still be enough heat generated to warm a car. But this ignores the subjective value people place on lots of things that must be sacrificed to increase technical efficiency. Sure, new engines might convert more of the energy in gasoline into motion, but doing so would require diverting resources away from producing other things of value. Long before technical efficiency was maximized, the marginal cost of improving that efficiency would exceed the marginal value. This would reduce economic efficiency because it requires sacrificing more value (marginal cost) than is realized (marginal value).

Fortunately, market prices provide the information and motivation required to achieve economic efficiency. For example, engine producers increase profits by improving the technical efficiency of engines until the marginal revenue from the improvement declines to the marginal cost. Since marginal revenue tends to reflect how much consumers value additional improvement, and the marginal cost reflects the value of the goods and services sacrificed to make additional improvement (since input prices reflect their value in alternative uses), engine producers increase their profits by improving engines only as long as they add more value than is sacrificed. That's not technically efficient, but it is economically efficient because it increases the total value realized from scarce resources.

Our discussion of economic efficiency should provide comfort to those who worry that we are wasting resources by using more than we need. We do use more of some resources than we need, but that is not wasteful if it allows us to create more value. In the engine example, using additional gas in technically inefficient engines frees resources to create more value than the gas is worth. This is not fundamentally different from leaving a light on in the bathroom because I am watching an exciting golf match on TV, something many would say is wasteful. But it's not! Sure, I'm using more electricity than I need, but by doing so I'm using my time for something I value more than the electricity I could save. (If not I would have left the program and turned off the light.)

Electricity provides another good example of increasing economic efficiency by doing something easily seen as wasteful. Almost 20 percent of the hydroelectricity used in the United States is produced by pump-storage, the use of electricity to pump water uphill into a reservoir so the water can be released to generate electricity. It takes significantly more electricity to pump the water uphill than is generated when the water runs back downhill, so pump-storage is clearly not technically efficient. But pump-storage is widely used because it increases economic efficiency and avoids waste. The value of a kilowatt of electricity depends on when it is available. Late at night, additional electricity is worth much less than it is during the day and into the early evening. So

electricity can be used to pump water uphill from midnight until early morning with little value sacrificed. That lost value is more than made up by the value of the electricity produced by releasing the water during the day when electricity is very valuable. Pump-storage reduces the amount of electricity available to consumers, but it increases economic efficiency and reduces waste by shifting availability from periods when it is worth less to periods when it is worth more.

Freedom and Efficiency

People often argue that wide-ranging government restrictions on our freedom are necessary to promote efficiency. But economic efficiency is impossible without freedom because it is not the narrow concept many accuse it of being. It is about increasing value as determined by the diverse and subjective preferences of hundreds of millions of individuals. The only way people can effectively communicate information about their values to those best able to respond is through the freedom to engage in market transactions for whatever and with whomever they choose. This freedom, for example, allows a person to take what seems to be a less-productive (and lower-paying) job than he could have because he enjoys the work, or prefers the location, or feels a duty to care for elderly parents, or numerous other reasons that can be fully known only to those faced with the particular tradeoffs involved. The freedom to take the lower-paying job, and to make any other choice in a free market, is essential for economic efficiency because value is determined by far more than just money and narrow material considerations.

Prisoners' Dilemmas and Cooperation

February 1, 2002

Economics is largely about how people cooperate so each can best pursue his or her objectives, whatever they may be. Decentralized market-based economies are wealthier than those based on central direction because markets facilitate the communication of the information and motivation necessary for people to cooperate, while central direction always censors that communication. Even market-based economies sometimes lack markets for important resources and the result is waste and inefficiency due to the absence of cooperation. For example, the pollution problems I discussed in previous columns are caused by the lack of markets in the use of the environment for disposing waste. Without those markets people don't consider the concerns of others when deciding how much to pollute. Creating artificial markets is the best way of facilitating the cooperation needed to reduce pollution to acceptable levels as cheaply as possible.

But no matter how well markets work, and how extensively they are operating, we remain in a world of scarcity, with people wanting more than they have and often seeing ways to acquire more by behaving in noncooperative ways—ways that create more losses for others than gains for themselves. There is almost always a tension between cooperative and noncooperative behavior, and this column examines that tension in the context of a simple model widely known as the prisoners' dilemma. By looking at this dilemma we can understand the interaction between politics and economics and the tendency for government action to encroach on market action even though the result is destructive of wealth and, more important, liberty.

To Confess or Not to Confess

The problem I am about to illustrate is very general, but it takes its name from an example involving two prisoners known to have committed a serious crime but who can be convicted only of a relatively minor crime without a confession from at least one of them. The prisoners are separated and each told the same

thing: “If you confess to the serious crime, you will receive a sentence of ten years if your accomplice also confesses, but only two years if he doesn’t. But if you refuse to confess to the serious crime you will receive a sentence of 15 years if your accomplice does confess and three years (for the minor crime) if he also refuses.”

The possibilities the prisoners face are shown in the nearby payoff matrix, where the first number in each cell is the sentence Prisoner A receives and the second number the sentence Prisoner B receives. As easily seen, the collective interest of both prisoners is best served when neither confesses, in which case they will serve a total of only 6 years. The worst thing for their collective interest is for both to confess, since this results in their serving a total of 20 years. Yet no matter what each thinks his accomplice will do, the best thing for him to do is confess. For example, if A thinks B is not going to confess, then if he doesn’t confess he gets 3 years, but only 2 years if he does confess. Or if A thinks B is going to confess, then if he doesn’t confess he gets 15 years, but only 10 years if he does confess. And the same situation faces B. So from the perspective of each, the best thing to do is confess even though this leads to the worst outcome from the perspective of both. The action that is individually rational is collectively irrational.

		Player B	
		<i>Don'tConfess</i>	<i>Confess</i>
Player A	<i>Don'tConfess</i>	<i>3years/3years</i>	<i>15years/2years</i>
	<i>Confess</i>	<i>2years/15years</i>	<i>10years/10years</i>

The prisoners’ dilemma is an example of the tension between cooperation and noncooperation that is unavoidable. For example, pollution problems are prisoners’ dilemmas. We would all be better off if everyone cooperated by polluting less. But for each of us it makes more sense not to do so. Regardless of what others do, it doesn’t pay me to reduce my pollution, since the benefit will go primarily to countless others, while I incur all the cost and inconvenience. The reader is encouraged to construct a payoff matrix like the one above showing the payoffs to two individuals from the four different pollution-reduction possibilities (with a higher number representing a higher payoff rather than a longer sentence).* The point of pollution policy is to change the payoffs to eliminate the prisoners’ dilemma by making it pay for each individual to reduce pollution no matter what others do. Creating markets in pollution permits does exactly this, which is not surprising since markets excel at promoting cooperation by eliminating prisoners’ dilemmas.

Consider how eliminating markets destroys cooperation by putting everyone in a huge prisoners’ dilemma. Marxist ideology claimed to substitute the rule “From each according to his ability, to each according to his need” for the “exploitation” of the market. Forgetting that without markets we cannot determine what people’s abilities and needs are, such a rule can be

implemented only with brutal force, because without force the rule creates a prisoners' dilemma: having lots of needs and no ability is the only sensible choice for each person. Whether each person thinks that others will produce to the best of their ability or live off the efforts of others, the rational action is the latter. But obviously this leads to a situation that is collectively irrational, with few abilities being used and few needs being satisfied.

But surely not everyone will shirk since many, probably most, of us want to do our part by being a productive member of society. True, at least initially. But even if only a few people exploit the prisoners' dilemma initially, soon others will see that they are being treated as suckers by the shirkers. As the number of shirkers increases, it becomes increasingly obvious that cooperation is for suckers, and the productive process unravels. Without markets to eliminate this prisoners' dilemma by rewarding cooperation, only government force can prevent a breakdown in productivity. But while government can force people to work, it cannot provide either the information or motivation people need to work in their most productive activities and to do so with the creative zeal and cooperative attitude that is characteristic of market activity.

A destructive prisoners' dilemma is eliminated by the information and motivation provided by markets. But the prisoners' dilemma comes in many forms and, as a practical matter, markets do not eliminate them all. Because of this, the prisoners' dilemma is commonly used to justify government and the coercive power it exercises. I will discuss this justification next month.

Markets and Morality

The Market for Honesty

February 1, 1999

The recurring theme of all my columns has been that economics is a study of how people cooperate with each other and that market economies succeed because of the incredible amount of cooperation they promote. Market cooperation, like all cooperation, depends on a high level of honesty. People who cannot trust each other cannot cooperate with each other, certainly not for long. And with the market, it's not just a matter of trusting a few people whom we know and care about. Market cooperation depends on our being able to trust large numbers of people, most of whom we will never know.

Consider the behavior of business people. If the proverbial man from Mars observed our business activity, he would surely conclude that business people are extraordinarily honest. For example, they sell precious gems that really are precious to customers who cannot tell the difference between diamonds and cut glass. They promise not to raise the price of a product once customers commit themselves and make switching to another product costly—and they keep the promise. They make good-faith promises that the business they own, but are about to sell, will continue to give their customers good service. The examples could be continued indefinitely since honesty and trust are essential for all but the simplest business transactions.

I am not naïve enough to argue that business people are never dishonest. Just like people in all walks of life, some will cheat, lie, and steal to snatch short-run advantage. But they are not nearly the scoundrels as presented in the media and popular entertainment. According to one study, almost 90 percent of all business characters on television are portrayed as corrupt.¹ In fact, business people can be depended on to act more honestly than most. This is not because business people are inherently more virtuous than others (though there is no reason to believe they are less virtuous), but because the free market penalizes those who do not provide consumers with things they value—and consumers value honesty.

The reason the market penalizes dishonesty is obvious at one level. Those who fail to provide the quality they promise, and charge for, may profit in the

short run, but not in the long run. But even in the short run there are gains from honest dealing, and those who can credibly promise to deal honestly can capture some of those gains. So business people are strongly motivated to put themselves in situations in which dishonest behavior is quickly penalized. By doing so they are better able to entice customers with assurance of everyday honest dealing.

Committing to Continuity

Consider the fear of dishonesty that can arise when it is believed that a business is about to shut down, say, because the proprietor is getting old. Even if such a proprietor has no intention of cheating customers, they will have reason to worry without some credible assurance of the proprietor's long-run interest in the business. An owner can often provide this assurance by bringing his offspring into the business ("Samson and Sons" or "Delilah and Daughters"). Not surprisingly, research shows that children of single proprietors are three times more likely to follow in their parents' lines of work than the children of others. Even large corporations, with lives that extend far beyond those of any of their managers, often depend on single proprietorships to represent and sell their products. This explains why Caterpillar, for example, has a school on running Caterpillar dealerships for the sons and daughters of the owners of those dealerships.

To consider another example of the importance of business continuity in promoting honesty, ask yourself where you would rather shop for an expensive piece of jewelry, a jewelry store with a well-advertised brand name and ornate fixtures, or a sidewalk vendor operating out of a Volkswagen van parked at the curb? What could the store do with its brand name and fixtures if it went out of business? Not much, and this tells customers that the store has a lot to lose by misrepresenting its merchandise to capture short-run profits. It has made a commitment to staying in business by being honest.

Embracing Competition

Intel, having received a patent on its 286 microprocessor in the early 1980s, immediately gave up its monopoly by licensing a competitive firm to also sell the microprocessor. Why would any company give up a legal monopoly? Because of the importance of honesty. Intel was willing to sell its new microprocessor to computer manufacturers at a reasonable price, and promised to do so. But the manufacturers were afraid that once they committed to using the new microprocessor (making expensive changes in their production process that would be difficult to reverse), Intel could exploit its long-term patent monopoly by raising the price. Intel could make a credible promise that it would maintain competitive prices by giving up its monopoly. Committing itself to honest dealing was more important to Intel, and more profitable in the long run, than exploiting a monopoly position in the short run.²

Selling and Repairing

It is difficult for consumers to determine the quality of automobile repair. They can generally tell if the work eliminated the problem: the car starts, the rattle is gone, the oil light is off, and so on. But few people know if the repair shop charged them for only the repairs necessary, or if it charged them for lots of parts and hours of labor when all the mechanic did was tighten a screw. One way repair shops can reduce the payoff from dishonest repair charges is through joint ownership with the dealership selling the cars being repaired. In this way the dealer makes future car sales largely dependent on honest repair work. Dealerships depend on repeat sales from satisfied customers, and an important factor in how satisfied people are with their car is the cost of upkeep and repairs. The gains a dealership could realize from overcharging for repair work would be quickly offset by reductions in car sales.

Automobiles are not the only product for which it is common to find repairs and sales tied together in ways that provide incentives for honest dealing. Many products come with guarantees and warranties entitling the buyer to repairs and replacement of defective parts for a specified period. These guarantees provide confidence in the seller's honesty when advertising the quality of his product.

Some will always go for the short-run gain through deceit and dishonesty. But the greater the freedom of others to compete with credible commitments to honesty, the less dishonesty pays even in the short run. The cooperation that characterizes the free market would never be possible without the high level of honesty and trust motivated by market competition.

The Economic Advantages of a Commitment to Liberty

April 1, 2000

In my last column I discussed the bias toward excessive government caused by the dead-weight costs of taxation. Because these costs go unseen, while the benefits from government spending are readily apparent, government expands beyond reasonable limits.

Unfortunately, the unseen cost of taxation is only one factor pushing for too much government. Much of the cost of government is in lost liberty—decisions on how we live our lives are increasingly made by government authorities. And just as with the dead-weight costs of taxation, the costs of gradually losing our liberties go largely unseen. On the other hand, benefits (typically temporary and small) from restricting liberty are easily seen. The result is a political bias that steadily erodes our liberty. Pragmatic politics, free of ideological considerations, with each issue decided solely on its perceived costs and benefits, gives free rein to this bias against liberty. Only with a genuine ideological commitment to liberty, one that creates serious obstacles to all proposals for sacrificing it to some public objective, can we halt, and hopefully reverse, the erosion.

The Hidden Cost of Restricting Liberty

All government actions, whether taxing income, restricting imports, controlling prices, regulating businesses, or subsidizing agricultural production, reduce our liberty to some degree. Of course, some restrictions are necessary for maintaining the social order on which other liberties depend. Traffic laws, sanctions against criminal activity, and the requirement to pay enough taxes to defend our borders come to mind. However, beyond some minimum level the loss of liberty begins imposing costs without offsetting social benefits.

But even when a government restriction on liberty imposes large net costs on society, it still creates benefits commonly captured by a relative few. An example is an import restriction, which concentrates benefits on those in the protected industry by restricting consumers from buying from those who offer

them the best deal. As discussed in earlier columns, consumers lose far more than those in the protected industry gain. But because the reduction in liberty spreads cost over all consumers, the political process easily overlooks it. Likewise, government regulations that restrict people from going into certain occupations are advertised as necessary to protect consumers from the unqualified. Yet these restrictions reduce the competition faced by existing members of the protected occupation (who lobby for the restrictions), with the benefits they receive more than offset by the costs to those whose freedoms are restricted. But again, the costs are widely spread and largely unnoticed.

The costs of restricting our liberties are easily ignored not only because they are spread widely over the general public, but also because they are indirect and delayed. Often the greatest advantage we realize from freedom is its availability to others. For example, only a relatively few people will choose to become entrepreneurs. But most of the benefits from entrepreneurial freedom take the form of better products and lower prices for untold millions of consumers who will never start companies themselves. As F. A. Hayek observed, “The benefits I derive from freedom are thus largely the uses of freedom by others, and mostly of the uses of freedom that I could never avail myself of.”¹ So most of those harmed by the erosion of a freedom will notice no additional restriction on their own freedom and remain unaware of the harm they are suffering.

Also, freedom is vitally important because we have no idea how it will be used. No one can confidently predict the advances that will be made in the future if people are free to try things most would never consider trying. Quoting Hayek again, “If we knew how freedom would be used, the case for it would largely disappear.”² So most of the cost of restricting freedom today will be doing without things we otherwise would have had tomorrow. The cost is not only delayed, but almost impossible to recognize when it does arrive because it comes as the absence of things we never knew we could have had.

Finally, our liberty is seldom lost all at once. Instead, it is nibbled away a little at a time. Supposedly, if you place a frog in a pan of water and heat it up gradually, the frog will remain in the water completely unaware of the increased temperature until it boils to death. Similarly, as our liberties are eroded slowly, one by one, we hardly notice the loss.

Commitment to Liberty

Because we overlook the costs of eroding liberties, the bias in favor of excessive government is more pronounced and harmful than indicated in previous discussions. Even if all the financial costs of expanding government were fully considered, there would still be too much government if the personal costs of restricting our liberties were ignored. Unfortunately, when government proposals are considered, many of the financial costs and almost all the costs of reduced liberty are politically ignored. The minor benefits to a few trump the

¹F. A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960), p. 32.

²*Ibid.*, p. 31.

far greater loss of the liberty by the many in case after case. Seldom does anyone oppose a particular program because it will erode our liberty; and when someone does, he is typically dismissed as an ideological crackpot. But unless we restore a broad and deeply felt ideological commitment to liberty in general, the value of the particular liberties lost to each government expansion will do nothing to retard that expansion, and our liberty will be surely and steadily sacrificed to the special-interest influence of ordinary politics.

Quite apart from the value of liberty as an end in itself, genuine commitment to liberty is essential for sound, long-run economic policy. The importance of freedom to the innovations and technological improvements on which all economic progress depends cannot be overemphasized. Consider that the national income of the U.S. economy is now a little over \$8.5 trillion annually. If average economic growth is reduced from 2.5 to 2 percent per year because of liberties eliminated by government action, in 25 years the national income will be \$1.81 trillion less per year than it would have been. That amounts to a loss of approximately \$6,830 for every American, a loss that almost no one will notice and which would be difficult to connect to the erosion of liberty even if it is noticed. What will be noticed, and appreciated, are the benefits of particular government activities, even though the entire country is far worse off because of many of them.

The advantage of a commitment to liberty, with respect rather than ridicule accorded those who champion it, is that it would replace the political pragmatism of case-by-case considerations with an ideological rule of restraint that would better promote the long-term interests of all. The problem with political pragmatism is that it doesn't work, not if the objective is to serve the general interest.

Marginalism and the Morality of Pricing Human Lives

October 1, 2000

When I ask students in my large economics classes if some things are just too important to put a price on, someone always answers, “human life.” This seems like a reasonable answer. After all, how many people would sacrifice their lives for cash, no matter how much was offered? What is the point of being a rich corpse? But economists reject the notion that human life is priceless. They put a price on human life, not because they are uncaring, callous, and completely lacking in moral sensitivity, but because they have a professional interest in understanding human action and because they understand that there is nothing morally lacking about pricing human life.

All of us put a price on our own lives every day with the choices we make and the actions we take. And pricing human life provides information that can save large numbers of lives, certainly not an immoral activity. Unfortunately, the moral superiority that so many people feel when expressing outrage at pricing human life helps keep in place government policies that cause many people to die needlessly.

Recognizing that prices reflect the marginal value of things is the key to understanding why economists put prices on human life. The price of asparagus gives us information on the value of one more pound of asparagus, not the value of the entire crop. Similarly, when economists talk about the price of human life, they are referring to the marginal value of life—the value of a slightly longer life expectancy—not the total value. The total value we put on our lives is extremely high (in most cases infinite), so we would not agree to be killed for any amount of money. Yet we put a very low marginal value on our lives. We routinely do things that reduce our life expectancy by marginal amounts in return for rather minor conveniences and pleasures. We often stay up too late, eat and drink too much, fail to get enough exercise, and drive too fast. When we do so, we are putting a price on our lives, and a pretty low price. Just how much is it worth to eat that extra cream puff or drink that extra beer? You would probably forgo the cream puff for \$10, but not to avoid reducing

your life expectancy by a marginal amount. If so, the implication is clear—the marginal value, or price, you place on your life is no more than \$10.

The Risks of Government Policies to Reduce Risks

There is nothing wrong or irrational about putting a low marginal value on our lives. We face tradeoffs in everything we do, and living a meaningful and satisfying life requires doing things that reduce how long we can expect to live. It is sensible to avoid paying very much to avoid very small risks and the corresponding reductions in life expectancy.

In many situations we can choose how much to pay to avoid risks. We can choose to sacrifice time by slowing down a little, taking a somewhat less dangerous job that pays a little less, or buying a slip-resistant rubber mat for the bathtub (bathtubs are dangerous places). Government policy attempts to reduce many risks we face, but we have little choice in how much we pay for the risk reduction we receive. The justification for government action is that the risks are general, like the risks from pollution, and it would be difficult, if not impossible, for individuals to protect themselves acting alone. This is a reasonable justification for some risks, although it cannot be used for many government regulations, such as those requiring seat-belt use or outlawing smoking in all bars. But even when government action is justified, it doesn't make sense to enact regulations that make people pay more to reduce risks than the reduction is worth. Unfortunately, this is common practice.

According to many studies of how much people pay for safety devices and how much income they sacrifice to take safer jobs, they are willing to spend from \$3 million to \$7 million to save a life. Yet many government regulations impose a far greater cost per life saved. For example, Environmental Protection Agency (EPA) regulations on benzene storage are estimated to cost \$260 million per life saved; EPA regulations on contaminated land disposal over \$4.5 billion per life saved; and Occupational Safety and Health Administration (OSHA) regulations on formaldehyde over \$92.7 billion per life saved.* The problem with the high regulatory cost of saving a life is not only that these costs are far higher than the amount individuals would pay, but that these regulations increase the number of lives lost.

* The figures in this and subsequent paragraphs come from W. Kip Viscusi, "The Dangers of Unbounded Commitments to Regulate Risks," in Robert W. Hahn, ed., *Risks, Costs, and Lives Saved* (New York: Oxford University Press, 1996), pp. 135-66.

Such costly policies may reduce some risks, but they also reduce wealth, and there is plenty of evidence of a positive relationship between wealth and life expectancy. Obviously healthy people are more productive and therefore wealthier. But cause and effect also goes the other way; studies show that costly policies, by reducing our wealth, also reduce life expectancy, with an estimated one life lost for every \$10 million to \$50 million in regulation costs. Using the \$50 million estimate, this implies that saving one life with the formaldehyde regulation would cause the loss of over 1,854 lives due to reduced wealth.

Another problem with extremely costly regulations to reduce risk brings us

back to the importance of marginal considerations. When the marginal cost of saving life is higher with one regulation than with another, it is possible to save more lives at the same cost by reducing the high-marginal-cost regulation and expanding the low-marginal-cost regulation. For example, if the EPA land-disposal regulation (which saves fewer than three lives) were scrapped, and just a small portion of the \$4.5 billion in saving were used to expand low-marginal-cost-per-life-saved regulation, thousands of additional lives could be saved and there would be a net reduction in government regulation. In addition, by reducing costly regulations, more resources would be available for the creation of wealth and this would save even more lives.

By refusing to put a price on human life government regulators can justify regulations with extremely high costs for a life saved. Despite the superficial morality suggested by this “save-a-life-at-any-cost” approach to regulation, the result is more lives lost than if the marginal cost of saving lives were considered—if a price were put on human life—when we legislate and implement regulations.

The Economics of Caring and Sharing

June 11, 2011

If we were to apply the unmodified, uncurbed rules of the micro-cosmos (i.e., of the small band or troop, or say our families) to the macro-cosmos (our wider civilization), as our instincts and sentimental yearnings often make us wish to do, we would destroy it. Yet if we were always to apply rules of the extended order to our more intimate groupings, we would crush them.

F. A. Hayek, *The Fatal Conceit: The Errors of Socialism*

The widespread belief that markets are immoral is a major reason they are so poorly understood and so rarely appreciated. This belief is not easily overcome. The fundamental problem is that our instinctive sense of morality, which I shall call magnanimous morality (the morality of caring and sharing), makes it easy to see markets as morally flawed. Furthermore, the explanation economists give for what they see as the major advantage of markets reinforces the instinctive tendency to see them as immoral. Unless economists recognize the source of this hostility and acknowledge it is based on a praiseworthy morality—but one not fundamental to the success of markets—there can be little progress overcoming the view that markets are immoral. This would be a shame since there is a strong moral case to be made for markets.

Markets are based on a morality, which I shall call market morality, that helps to direct our actions into a global pattern of mutual assistance which appears to result from magnanimous morality but in fact could never be achieved by that morality. Because market morality lacks instinctive appeal, there is widespread support for attempts to create a more moral economic order by substituting magnanimous morality for market morality. Such attempts unavoidably erode the benefits from both moralities and lower the overall morality of the economy.

I wish to emphasize the difference between magnanimous and market moralities, showing that each supplements the other in contributing to a moral social order—but only if they are confined to their proper spheres of human action.

The Magnanimous Morality of Caring and Sharing

We instinctively think of morality as personally caring for and sharing with others. It can be defined briefly as satisfying three conditions: 1) helping others intentionally; 2) doing so at a personal sacrifice; and 3) providing the help to identifiable individuals or groups. Behavior of this sort is clearly beneficial to the well-being of small groups in which the members are in close personal contact and knowledgeable of the circumstances and concerns of one another. We spent most of our evolutionary history in small hunter/gatherer tribes fitting this description, so a strong affinity for magnanimous morality has been hardwired into our emotional makeup. Its presence or absence has predictable effects on how we view behavior and social arrangements.

The enduring popularity of Charles Dickens's *A Christmas Carol*, published in 1843, illustrates the emotional appeal of intentionally caring for and sharing with identifiable people at personal sacrifice. Ebenezer Scrooge is introduced as “a squeezing, wrenching, grasping, scraping, clutching, covetous, old sinner” with no regard for the welfare of this employee, Bob Cratchit, his own family, or anyone else. But after Scrooge's encounter with the ghost of his former partner and the three ghosts of Christmas he experiences a moral transformation. He finds true happiness in paying for the medical care needed by Tiny Tim, the Cratchits' crippled son, raising Bob's salary, and more generally using his wealth for the benefit of others.

The appeal of magnanimous morality is fully warranted and understandable. The relationships we have with family and friends are rooted in it, providing us with our greatest happiness and most satisfying and meaningful moments. It should be emphasized that magnanimous morality is not inconsistent with the proper functioning of a market economy. Success in market transactions depends on being sensitive to the concerns of others. And this sensitivity seems to extend beyond strictly market transactions. Based on experimental evidence from a number of countries with wide differences in the degree of integration into global markets, Herb Gintis concludes, “[S]ocieties that use markets extensively develop a culture of cooperation, fairness and respect for the individual” (quoted in Matt Ridley's *The Rational Optimist*).

It should also be admitted, however, that the proper functioning of a market economy does not depend primarily on magnanimous morality. Indeed, the morality on which markets primarily depend is easily seen as rejecting magnanimous morality, and the way most economists make the case for markets encourages this view and the instinctive hostility that so many have for markets.

The Morality of the Market

Market morality is rather modest, with little if any emotional appeal; in fact, it scarcely seems to deserve the name “morality,” instead being commonly seen as a justification for behavior widely held to be immoral. This morality can be defined as following the general rules and norms of market exchanges, such as respecting property rights, honoring contractual obligations, and not harming others by violating their legitimate rights and expectations through force or fraud. Market morality can be achieved, according to Adam Smith in *The Theory of Moral Sentiments*, “by sitting still and doing nothing.” And while markets reward kindness and caring for those with whom we have personal exchanges, the vast majority of the exchanges we benefit from are impersonal; we neither know nor meaningfully care for those on the other side of the exchange.

Since these impersonal exchanges create enormous benefits from outcomes that emerge without conscious direction, people seldom give much thought to those benefits or the market morality on which they depend. Of course people do think about markets occasionally, but when they do it is seldom with appreciation for the benefits they are receiving. More often than not people think about markets when they are being inconvenienced by the market discipline—the requirements “imposed” on us, for example, in return for income—that makes their benefits possible. Few of us connect such discipline to the far greater benefits we receive as a consequence, particularly when we see others who appear to be reaping great rewards from the very discipline that is apparently making us so much worse off. Under these circumstances it is easy to conclude that we are imposed on unnecessarily by the greed of others. How easy it is to also believe there is something immoral with an economic system that not only tolerates greed but also rewards it.

When economists make the case for what they see as the most impressive feature of markets, they typically do so with the aid of Adam Smith in a way that reinforces the view that markets at best lack morality. Smith understood and appreciated magnanimous morality, as any reader of *The Theory of Moral Sentiments*, his first book, knows. But this would not be known to someone who knew only Smith’s “invisible hand” argument for markets in *The Wealth of Nations*. The advantage of markets, according to Smith, is that by pursuing their own interests in the marketplace, people unintentionally do more to promote the public interest (the interest of no one in particular) than if it had been their intention to do so. This argument ignores every requirement for magnanimous morality, and the way economists phrase the argument makes it easy for people to conclude erroneously that the argument for the market rules out the more personal caring and sharing in which our personal relationships are rooted.

I am not proposing that economists discard the invisible-hand explanation of the market. But to make the case for the morality of markets, economists should recognize the tendency for people to dismiss the benefits of the market for its apparent moral failing and counter that tendency by pointing out the inability of magnanimous morality to achieve the desirable economic outcomes expected of it.

Demanding More Than Magnanimous Morality Can Deliver

The belief that markets are immoral causes many either to fail to notice or to dismiss the benefits they realize from them. For example, while most people claim to value conservation and clearly benefit from the conservation that smooths the availability of goods and resources over time, the nearly unanimous criticism of speculators, whose profit-seeking behavior makes this conservation possible, suggests that most people are unaware that this is a benefit of markets.

Even those aware that they are receiving a benefit from market activity commonly feel it is contaminated by the process providing it. This was illustrated after Hurricane Fran knocked out power in Raleigh, North Carolina, in September 1996. According to Michael Munger, four men from Goldsboro, North Carolina (an hour from Raleigh), rented two freezer trucks and drove to Raleigh with a thousand bags of ice, which they bought for \$1.70 each. Customers quickly queued up to pay \$8 a bag, with each limited to five bags. Some complained about the price, but no one refused to pay. With the line still long, the local police arrived in force, arrested the four men for price gouging, and confiscated their trucks and all the remaining ice—which was not distributed to those in line. Surprisingly, at least to economists, the frustrated shoppers applauded the police for arresting those whose activities would have made them better off; would the customers have been happier had the sellers not bothered at all? The applause strongly suggests that those in the line felt that the benefit for which they had lined up was contaminated by the profit motive.

Or consider the idea of getting consumers in developed countries to pay extra for “fair trade” coffee, bananas, tea, and chocolate to reduce the poverty of poor farmers in developing countries. Assuming the premiums paid for “fair trade” products go to the intended recipients and forgetting Gene Callahan’s economic analysis suggesting these recipients may be harmed even if they do (“Is Fair Trade a Fair Deal?,” Freeman, March 2008), it is clear that “fair trade” advocates are sincere in their belief that this approach will reduce poverty and hope that it will catch on with consumers. Yet many are conflicted by what has been described as a paradox in the “fair trade” movement resulting from the widespread hostility toward markets that pervades it. As described by Sarah Lyon and Mark Moberg in *Fair Trade and Social Justice*, “In seeking social justice...fair trade...pursues a market-based solution to the very problems developing from free markets.” When large corporations such as Starbucks, Nestlé, Walmart, and McDonald’s signed on to sell “Fair Trade” products, which would clearly increase sales and supposedly the incomes of poor farmers, many in the movement objected. Representative of these objections are those voiced by Pedro Haslam and Nicholas Hoskyns (in their contribution to *The Fair Trade Revolution*), who see these corporations motivated by “marketing success rather than ideology.” “[F]air trade certified farmers who sell to them [big corporations]...” they continue, “are still locked into the traditional supply chain dominated by the largest companies. This is not the vision of sustainability and community many of us started out with, where local family-owned businesses sell the products of small farmers and personal relations are maintained throughout the supply chain.”

These statements reflect hostility for economies based on “marketing success” and impersonal exchanges between large companies and the suppliers they depend on. The statements, and numerous others from “fair trade” enthusiasts, express a yearning for economies based on personal dealings between consumers in developed countries and those in poor countries who supply them with products anonymously. In this they are like many others who are emotionally attracted to the idea of economies based more on the magnanimous morality of caring and sharing and less on the market morality of pursuing self-interest through impersonal market exchange.

While it is hard to imagine a life of meaning and joy without mutual caring and sharing, we shouldn’t demand more of magnanimous morality than it can deliver. Calls for a more moral marketplace—sometimes referred to as capitalism with a human face—are invariably motivated by the hope of substituting the instinctive morality of the small group for the morality of impersonal markets. When such a substitution goes beyond feel-good rhetoric and is actually attempted, the result is less morality and prosperity as political power replaces voluntary exchange.

Good economists see nothing wrong with caring and sharing. But they also see the opportunity to supplement that morality by extending our ability to help far more people than we can personally care about. The primary advantage of markets is that they provide each of us with the information and motivation to share with literally millions of people, without caring for them.

Of course some will say, “Yes, people are helping each other, but they are doing so for the wrong reason by considering only what’s in it for them.” Such people may never be convinced that self-interest is a legitimate motivation. But one would like to ask them if, when enjoying a good cup of coffee, reading a thrilling mystery on their e-reader, or boarding an airplane to visit a sick friend, they are troubled by the thought that all the many people who made those things possible were motivated primarily by a desire to improve their own conditions and the conditions of the families they love. I doubt they are, and for their sake I hope they aren’t.

The healthiest and certainly the most compassionate way to think about markets is by recognizing that they allow us to provide better for the few we genuinely do care about by doing more to serve and share with the multitude of those we don’t. This suggests that a strong moral case can be made for the market by explaining why the noble desires inspired by magnanimous morality are more fully realized when the urge to substitute that morality for market morality is resisted.

Comparing the Morality of Government and Markets

March 28, 2012

Beyond a very limited role in our economy and our lives, further expansions of government retard economic efficiency and reduce human liberty. The most important contribution of the Public Choice school of political economy has been to use economic analysis to realistically compare the efficiency of government and markets and to explain the tendency to substitute government activity for market activity far beyond the point where economic efficiency is reduced. Yet this substitution continues.

I shall argue that by limiting its concern almost entirely to efficiency comparisons, Public Choice has limited its influence over the prevailing political ideology, which has made the continued growth of government possible. Economic efficiency is important, but efficiency arguments are less convincing than moral arguments. As Joseph Schumpeter observed, “The stock exchange is a poor substitute for the Holy Grail.” So even if people are convinced that markets generate more efficient outcomes than government, it will still be favored over markets as long as most people believe it is more moral than markets. Unfortunately, convincing them otherwise is difficult.

Economists have argued that markets are moral, but they almost always do so by pointing to the desirable, but unintended, outcomes that result from people pursuing their private interests. Economists are rightly impressed with the ability of markets to motivate self-interested individuals to unintentionally serve the interests of a multitude of others they don't know, much less care about. The result is a truly impressive pattern of individual freedom, social cooperation, and prosperity. But people are emotionally programmed to judge morality on the motivations that produce outcomes rather than on the outcomes themselves. If people make personal sacrifices with the intention of benefiting others, their actions are seen as moral. When the effort is directed toward identifiable people, this sense of morality is intensified. The outcome of the effort carries less moral significance than the intention motivating it and the personal sacrifice involved.

For example, if a man risks his life by jumping into a rapidly flowing river to save a child from drowning, his action would be credited as moral whether he is able to save the child or not. On the other hand, he would receive little if any moral credit if he saves the life of the child by accidentally providing him something to hold on to as he steers his boat to shore.

Not only are the benefits of markets the unintended byproducts of people motivated primarily by self-interest, but they are widely dispersed over the public (or no one in particular) and generated by an indirect process of market coordination that obscures the connection between the benefits created and the actions that make them possible. Such a process is unlikely to be seen as moral; many see it as immoral and are unaware of the benefits it provides. Even those who recognize the beneficial outcomes of markets commonly consider them contaminated by a morally tainted process. In other words, they don't believe the desirable ends justify the market means.

In contrast to the market process it is easy for people to see morality as an inherent feature of the political process. Political rhetoric emphasizes the intention of doing good, not for personal advantage but because it is the right thing to do. The good is directed toward deserving groups whom we should care for, such as the poor, the elderly, the sick, and operators of family farms. And the political process allows us to care for these groups in direct and easily understood ways, such as mandating a minimum wage, providing a pension program, subsidizing medical care, and creating price supports for agricultural products. Also, the means by which most people make political decisions, voting, encourages them to be responsive to moral claims for government programs and to reject evidence that those programs often do more harm than good.

It is useful to consider an important difference between "voting" in the market with dollars and voting at the polls with ballots. When you "vote" for something in the market you get what you "vote" for, and you get it and pay for it only because you "vote" for it. This is very unlikely when you vote at the polls. At the ballot box you often get, and have to pay for, what you vote against. And except in elections with only a few voters, you almost never get what you vote for because you vote for it. This feature of voting is often interpreted to mean that your vote doesn't count. Wrong. Your vote will be counted. If you vote in Chicago it might be counted several times. The important characteristic of an individual's vote, as just described, is that it is almost never decisive.

The probability that any one vote will decide the outcome in a state or national election is far too small to take seriously. Indeed, it is much smaller than the probability of winning millions of dollars in a state lottery or being killed by a shark. A few people win millions in lotteries every year, and in an average year there are 16 people attacked by sharks in the United States, with one fatality every two years. But I am not aware of any state or national election that was decided by one vote, with one exception—but it is the exception that proves the rule. I'm referring to the 2000 presidential election between George W. Bush and Al Gore. That election came down to a 5–4 U.S. Supreme Court decision to end the vote recounting in Florida, with Bush 327 votes ahead. So

in that instance one vote did decide the election, but it was a vote with only nine voters.

The minuscule probability that an election will be decided by one vote explains why people are more influenced by moral considerations when voting in an election than when making purchases in markets. Consider a voter who is convinced that an increase in government transfers would help the poor escape poverty, but because she is in a high tax bracket, she knows that if the transfer policy is enacted it will increase her lifetime tax burden by \$10,000 in present value. Furthermore, the only benefit she will receive from voting for the transfer is the moral satisfaction from intentionally making a sacrifice to provide what she believes will be direct government help to an identifiable and deserving group. Will she vote for the transfer?

The answer obviously depends on a comparison of the perceived cost and benefit of voting yes. The common response is that she has to receive at least \$10,000 worth of moral satisfaction to vote in favor of the transfer. But this response is incorrect because even though it will cost our voter \$10,000 if the transfer policy passes, it will cost her almost nothing to vote yes. The cost of voting yes is an expected cost and it equals \$10,000 times the probability that her vote will decide whether or not the policy passes. Even if we assume a one-in-a-million probability her vote will be decisive (which is very much on the high side for most state and federal elections), the expected cost of voting yes is one penny. If the moral satisfaction she receives from voting yes is worth only the price of a designer cupcake, her yes vote is a bargain. Voting provides her with the opportunity to enjoy a sense of moral virtue at virtually no cost.

Benefiting from cheap virtue in the polling booth depends on more than the low cost of voting for expensive government policies that are claimed to achieve noble objectives. First, the voter has to believe that her vote contributes to passing the policy she favors, and that it represents her willingness to make a personal sacrifice. It is difficult to feel particularly virtuous for doing something that costs and accomplishes almost nothing. The voter also has to believe the policy she votes for really will do all the wonderful things claimed. It is difficult to feel virtuous supporting a policy if you believe it will harm those you want to help. Therefore, it is not surprising that so many people are aggravated when economists point out that their vote has a meaningless effect on the outcome of most elections, and therefore casting their vote for an expensive government program represents a trivial sacrifice.

Also, expect those who get a sense of moral superiority by voting for a policy to be hostile to evidence casting doubt on the policy's ability to achieve the noble objectives claimed for it. Even when it is irrefutable that a policy causes great harm, many who voted for it will defend their vote by arguing that the policy is motivated by good intentions. The ends may be unfortunate, but because the political means are seen to be motivated by moral intentions, those ends should be overlooked, or euphemistically dismissed. For example, those who defended what they believed were the noble goals of Soviet communism initially rejected the evidence that millions of people were being killed in the name of achieving those goals. When the evidence was overwhelming, the

euphemism for killing millions of people was that “you’ve got to crack a few eggs to make an omelet.” Those who find it morally comforting to trust in the good intentions of government have been willing to condone outrageous immorality to maintain that comfort.

If those who vote to give government more power to do good things were as virtuous as they fancy themselves, they would do more than cast a vote and proudly walk out of the ballot booth wearing an “I Voted” sticker. They would realize that even if a policy is potentially desirable, voting for it (or for a politician who claims to favor it) is but the first step in realizing its potential. Good political outcomes depend on more effort and virtue than voting requires.

To make sensible decisions at the polls, voters would need to become well informed on a wide range of issues and consider alternatives to government for addressing particular problems. They would need to follow up their votes by paying attention to the type of legislation that the two branches of Congress passed and find out what came out of the reconciliation process. This follow-up would need to continue when legislation goes to government agencies to be supplemented with thousands of pages of detail and then enforced with bureaucratic discretion. Finally, voters would also write letters, make calls, and work with genuinely public-spirited groups to pressure politicians and agencies to keep the legislation consistent with the lofty goals they voted for. Obviously, few voters can be expected to incur the cost of doing much if any of these tasks. And we would not want them to, given the productive opportunities they would have to sacrifice in their occupational specialties. It can be hoped, however, that more voters would recognize that there are some who are making the political effort just described but with less elevated objectives than voters want to believe they are achieving with their votes.

Members of groups organized around particular interests and their hired lobbyists will work to influence legislation that directly affects those interests. In many cases they are actively involved in writing the legislation for congressional committees. They will follow the legislation as it goes through both the House and Senate and is turned over to the bureaucracy for fine-tuning, interpretation, and enforcement. It should surprise no one that the political efforts of special interests are invariably directed at serving their narrow objectives at the expense of the noble objectives voters had in mind when casting their ballots. Of course special interest groups and their lobbyists will use the rhetoric of moral concerns and the public interest in support of the legislation they favor. Their primary interest in high-minded objectives, however, is in determining which arguments for the legislation they favor are most likely to convince voters that supporting it at the ballot box is the moral thing to do.

Teachers’ unions calculate that expressing concern for our children is the most effective way to motivate public opposition to policies that would improve education by subjecting government schools to competition. Similarly, corn farmers and agricultural firms calculate that expressing concern for the environment is the most effective ploy for securing government tax advantages for ethanol. And industries facing competition from imports calculate that expressing their desire to save American jobs is the best way to get public sup-

port for import restrictions that will increase consumer prices and reduce job creation in other industries. Most of the benefits from farm subsidies and agricultural price supports go to wealthy owners of large farms rather than small family farmers, while (in the case of price supports) increasing the prices the poor pay for food. Numerous interest groups seize the widespread public concern for the poor to create support for government transfers that are designed and implemented to benefit those very interest groups more than the poor who were supposedly the primary beneficiaries.

Voters are being enticed by the pretense of morality to vote to give government more money and power that will be captured largely by the politically influential for their personal gain, with government doing little to achieve the noble goals voters expected, and commonly undermining the achievements being made without government. Government is a poor agent for those who hope to do good through the morality of good intentions and personal sacrifice.

The reality is that political behavior is no less motivated by self-interest than is market behavior. Voters are motivated by the desire for a low-cost sense of moral virtue to vote for noble-sounding policies while remaining oblivious to the morally appalling outcomes those policies often generate. Organized interest groups use the rhetoric of morality, supplemented by backroom deals, to manipulate the political process and capture privileges and protections at public expense. And incumbent politicians secure the support of naive voters and campaign contributions from self-serving voting blocs. Where is the morality here?

Any realistic moral comparison of markets and government obliterates the fiction that political behavior is more moral than market behavior and compares politics and markets in terms of the desirability of their outcomes. Political self-interest is not nearly as productive as the self-interest pursued in markets. People serve the interests of others more effectively when they are spending their own money, subject to the information provided and the discipline imposed by markets, than they do when casting votes to spend other peoples' money and lobbying for political favors paid for by others. Markets encourage a fundamental morality in terms of taking responsibility for the consequences of one's actions, being responsive to the concerns of others, and reciprocating value in return for value. This market morality is nowhere to be found in the political process when one looks behind the smokescreen that characterizes so much current political rhetoric.

Truly moral political behavior is voting against most proposals put forth by politicians. The most noble of all political objectives is limiting government's ability to erode our freedoms and reduce our prosperity under the pretense of noble-sounding objectives.

The Market as a Process

Freedom and Failure

October 1, 1986

During good times and bad, the economic landscape seems always littered with firms that have failed, workers who have become unemployed, farmers who have lost their land, and the residue of entire industries in the process of withering away. The natural tendency is to see these failures, and the genuine human hardships that result, as a flaw of the economic system that produces them. Even those who consider themselves supporters of the market economy call for government action to buffer society against the harsh failures of unfettered capitalism.

It is certainly the case that when viewed in isolation the consequences of economic failure appear cruel, harsh, and unfair. Because of events over which they have little or no control, many hard-working, law-abiding citizens experience serious economic hardships in a system of free market capitalism. No one can argue with credibility that all, or even a significant minority, of these victims of economic failure are getting what they deserve in any particular instance of adversity. But economic outcomes that in isolation seem unjustified may be the necessary consequence of a system that is generating an overall, long-run pattern of outcomes that is entirely justified. As Henry Hazlitt has warned repeatedly, the major source of error in economic understanding comes from the tendency “to concentrate on...short-run effects on special groups and to ignore...the long-run effects on the community as a whole.”¹

Hazlitt’s warning cannot be overemphasized when considering economic failure and the fairness of free market capitalism. Each market failure is an inseparable part of a wider web of interactions and outcomes that provides everyone the maximum opportunity for success in the world of scarcity. Scarcity is an unfortunate fact of life, and it is easy to see scarcity itself as unfair. But unless one is prepared to argue that making the best of an unfortunate situation is also unfair, there can be nothing unfair about free market capitalism. And

¹Henry Hazlitt, *Economics in One Lesson*. New York, Arlington House Publishers, 1979; p. 17.

because instances of failure are necessary companions to the general success of the free market process, it would require a sharp twist of logic to characterize as unfair the failures that arise from free market activity.

Economic failure is inevitable if we are to have economic progress. One explanation for this link between failure and progress was provided by Joseph Schumpeter when he described capitalism as a “process of creative destruction.”¹ The discovery of improved products, and better ways of producing existing products, necessarily means that many established products and technologies are valued less. Those who have committed their resources to these now obsolete products and technologies will suffer a decline in wealth as their investments turn sour and their skills become less employable. They will experience economic failure. But this destruction of wealth, or economic failure, is only part of a larger picture of wealth creation and economic success. The loss of wealth experienced by some is (1) a transfer of resources to those who will put them to more valuable use, and (2) a compelling incentive to redirect efforts into more productive employment. The process of “creative destruction” is our best hope for economic success.

Entrepreneurial Freedom and Failure

There is another vital link between economic failure and progress. Economic progress that expands opportunities for all is clearly a force for fairness. Such broad-based economic progress depends on what is best described as the entrepreneurial spirit. Without those with visions of what might be, and the dedication and courage to pursue those visions, few of the technologies and products that provide the foundation for our current wealth would be available. It is only because individual entrepreneurs have had the freedom to attempt what the more “sensible” among us would never have attempted that economic development has been possible.²

This does not mean that most entrepreneurial ventures contribute to our economic well-being. Quite the opposite is true. A relatively small percentage of the projects promoted by entrepreneurs add more to our wealth than they consume in time, talent, and resources. Most entrepreneurial ventures turn out to be exactly what most of us would have predicted in advance, impractical fantasies. But, it is impossible to know in advance which entrepreneurial gambles will be an economic step forward. There is only one way to discover these economic successes, and that is by giving entrepreneurs the freedom to snub their noses at the conventional wisdom and venture forth in pursuit of their “impossible” dreams.

This freedom to attempt success in the face of daunting odds requires an accompanying freedom to fail. And the freedom to fail has to be sufficiently painful that it cannot be ignored. The entrepreneur whose project is rejected by the consumer will remain convinced that it is the consumer who is mistaken. Unless such entrepreneurial confidence is sternly subordinated to con-

¹ Joseph A. Schumpeter, *Capitalism, Socialism and Democracy*, New York, Harper Torch Books, 1962; pp. 81-86.

² F. A. Hayek, *The Constitution of Liberty*. The University of Chicago Press. 1960; p. 32.

sumer preferences, the losses from the many entrepreneurial mistakes would persist and overwhelm the gains from the relatively few entrepreneurial successes. Without the discipline of failure forcing accountability to consumer preferences, entrepreneurial ventures would be economically destructive and entrepreneurial freedom could not be tolerated. The economic system that cannot condone failure cannot risk freedom.

Communication, Honesty, and Concern

There is only one economic system that turns failure into a force for the type of accountability that makes freedom possible. That system is free market capitalism. It is a system that allows freedom because it is a system that motivates people, both when they succeed and when they fail, to deal with each other with honesty and fairness.

Consider the characteristics of a system of human interaction that would be ideal from the perspective of economic accountability and fairness. First, this system would have each of us in constant communication with everyone else. If there is to be any hope of being accountable to the preferences of others in our use of resources, each of us will need to receive information from others on their preferences. Second, the communication that took place would be honest. Transmitting inaccurate information on the value derived from resources would make it impossible to direct resources into their highest valued uses. Third, each individual would give the preferences of others the same weight he gives his own. No matter how much an individual may desire one economic outcome, if others communicate to him that they value another outcome even more he would accommodate their preferences.

It is possible to achieve a real world approximation to this ideal system—free market capitalism. The key to understanding this approximation is in recognizing the incentives established by the private property system which forms the foundation of the market.

In the private property system, resources are transferred from one individual to another through voluntary exchanges. The market prices that arise from these exchanges are the means by which all market participants communicate their preferences to each other. There exist strong incentives for people to communicate honestly through prices. It is in the interest of all market participants to assess carefully the value realized from different resources, and to communicate their desire for more of a particular resource only if it is honestly worth more to them than the prevailing market price. The temptation sellers would otherwise have to overstate the values of their products with excessive prices is controlled by market competition.

Finally, each market participant is motivated to act as if he has the same concern for the preferences of others as he has for his own. When an individual reduces his use of a product in response to a higher price, he is in effect saying, “Others are telling me that this product is worth more to them than it is to me, so I will consume less so that they can consume more.” Similarly, economic failures such as bankruptcies and unemployment can be thought of as people saying, “Others are telling me that my resources would be more valuable in

other activities, so I will respond to their preferences.” These “failures” reflect the success of free market capitalism in getting people to cooperate with each other freely, fairly, and honestly.

Focusing on Failure

Unfortunately, few people heed Henry Hazlitt’s warning and look beyond the isolated trees of economic failure to see the overall forest of economic success. This oversight is explained in part by the fact that it is easier to concentrate on particular outcomes than to comprehend the larger pattern of which these outcomes are only a part. But this is far from a complete explanation. The fact is that there is more for people to gain as members of organized interest groups by concentrating on the isolated failures than by considering the overall success of free market capitalism.

When individuals suffer losses from the operation of free market capitalism, they are in fact making a necessary contribution to the working of an economic system that serves the long-run interest of all. From the perspective of each individual, however, the best possible situation would be to receive protection against personal economic failure while benefiting from the contributions the failures of others make to economic progress. The fundamental fairness of the free market is that it does not provide anyone a free ride on the contributions of others. In the free market everyone has to contribute to the general economic prosperity by accepting the failures as well as the successes that come his way.

It is the legitimate function of government to enforce the private property rights upon which the fair and honest cooperation of the free market depends. When property rights are enforced no one can avoid making the cooperative adjustments required by economic failure while benefiting from the cooperative adjustments economic failures force on others.

Unfortunately, government power, though justified as a means of protecting property rights, can be destructive of these rights. This abuse of government power is sure to occur when, as has been the case in recent decades, government ceases to be viewed as a necessary evil and instead is seen as the primary source of social progress. Once it becomes widely believed that the discretionary use of government power is an acceptable means of solving particular economic problems, economic failure will become a useful justification for the politically organized to receive unfair advantages at the expense of the politically unorganized.

The negative consequences of economic failure are highly visible because at any one time they tend to be concentrated on a relatively few. The positive consequences of economic failure are largely invisible because they are indirect and spread over the entire population. When the few who experience economic failure are organized they will see it to their advantage to lobby government for relief. By granting this relief, politicians receive the gratitude of the benefiting few by imposing a diffused cost on the entire population. This imparts a clear political bias in favor of substituting unfair government force for the fairness of market cooperation. This bias, however, although generated by the political muscle of organized special interests, ultimately rests on perceptions of fairness.

If protecting a particular group against the consequences of economic failure is widely considered to be an unjust use of government power, then politicians will be very reluctant to provide such protection. Special interest groups lobbying government for relief from an economic failure cannot rely solely on the organizational advantage they have over the general public. Success depends crucially on the perception that justice is served by indemnifying particular groups against failure. There is much to be gained by those that are, or would be, politically influential from portraying their economic failures as unfair. No one should be surprised that as government has grown, the focus on economic failures has increased, as has the perception that these failures are unfair. With government standing ready to transfer wealth to those whom the economy has treated “unfairly,” the private payoff is increasingly in lamenting the “unfairness” of failure rather than celebrating the fairness of the cooperation, wealth, and freedom that this failure makes possible.

Conclusion

The fact is that government cannot reduce economic failure. It can only protect some against failure by increasing the overall level of failure and imposing it on others. As Hayek warned over 40 years ago: “The more we try to provide full security by interfering with the market system, the greater the insecurity becomes; and, what is worse, the greater becomes the contrast between the security of those to whom it is granted as a privilege and the ever increasing insecurity of the underprivileged.”¹

The special favors granted by government are not only unfair, they become the justification for yet more futile government attempts to provide security against economic failure.

Once government starts down the road of buffering people against the failures of market activity it becomes difficult to turn back. And the ultimate destination if we remain on this road is a politicized economy lacking both fairness and prosperity because it cannot provide the accountability nor tolerate the freedom which are essential for economic success and honest cooperation. The best hope for preserving the market process is by advancing public understanding of how this process works to promote a broad-based prosperity. Only through economic understanding can we pierce the rhetorical facade of fairness used by organized special interests to acquire political favors. Once this facade has been stripped away, it will be difficult for political opportunists to undermine the freedom and prosperity of all under the pretense of concern and justice.

¹F. A. Hayek. *The Road to Serfdom*, The University of Chicago Press. 1944: p. 130.

The Entrepreneur on the Heroic Journey

April 1, 1997

Dwight R. Lee and Candace Allen

What do you want to be when you grow up? was a question that adults regularly posed to all of us when we were young. Generally, even as children, we imagined ourselves becoming like those whose accomplishments we respected or whose qualities we admired. At a time when sports figures, Hollywood personalities, musicians, and even politicians vie for the hearts of the young, why not honor those among us who provide the energy and strength behind the invisible hand of economic progress?

Entrepreneurs are, in fact, heroic figures, and their accomplishments are worth celebrating. All of us are better off because entrepreneurs have been willing to attempt what others knew couldn't be done, and then persist in the face of adversity. Their visions extend beyond existing horizons, and eventually expand the realm of the realistic, transforming one generation's dreams into the next generation's necessities.

Who Are Heroes?

Who is a hero? For some, a hero represents a person who embodies such age-old values as honesty, integrity, courage, and bravery. For others, a hero is someone who is steadfast or who sets a good example. To many, being a hero means sacrifice, even of life itself, for the sake of others. Increasingly, many people find heroic those who simply gain notoriety or attention.

However, Joseph Campbell, an expert on world mythology, would probably find all of these definitions to be incomplete. Campbell contends that every society celebrates heroes, and in doing so, honors the past, energizes the present, and shapes the future. In studying most known cultures, Campbell has discovered that though details of the heroic path change with time, the typical journey of the hero can be traced through three stages. In our view, the entrepreneur travels through all three.

The first stage involves departure from the familiar and comfortable into the unknown, risking failure and loss for some greater purpose or idea. The second stage is encountering hardship and challenge, and mustering the courage and strength necessary to overcome them. The third is the return to the community with something new or better than what was there before. Ultimately, the hero is the representative of the new—the founder of a new age, a new religion, a new city, or a new way of life that makes people and the world better off.

The Modern Entrepreneurial Hero

In our modern world, the wealth creators, the entrepreneurs, actually travel the heroic path and are every bit as bold and daring as the mythical heroes who fought dragons and overcame evil. With conventional virtues, the entrepreneur travels through the three stages of the classic journey of the hero to achieve unconventional outcomes and should serve as a model of inspiration and guidance for others who follow.

In the first stage of the heroic journey, the entrepreneur ventures forth from the world of accepted ways and norms. He asserts, There is a better way, and I will find it! Unlike those who are overwhelmed by the challenges of their immediate world, the entrepreneur is an optimist, able to see what might be by rearranging the world in creative and useful ways. The entrepreneur refuses to accept the conclusions of others about what is or is not possible.

In this first stage, risk-taking entrepreneurs are motivated by many factors. Some want to become rich or famous. Others desire to better themselves, their families, or their communities. Some seek adventure and challenge. Regardless, they are characterized by energy, vision, and bold determination to push into the unknown.

In the second stage the entrepreneur finds himself in uncharted territory. Everything is at stake. The entrepreneur sacrifices for an idea, purpose, vision, or dream that he sees as greater than himself. Comfort and security become secondary.

Entrepreneurial action is often controversial. An entrepreneurial educator, for example, might leave the state school system to find a better way to provide education to youngsters as an alternative to government schooling. Yet, former colleagues might see him or her as a traitor. Regardless of what the entrepreneur sacrifices during this stage of the heroic quest, he is impelled into risky, unfamiliar territory. He must be resilient in the face of mistakes or failure.

In this discovery stage, the entrepreneur often encounters those who have a stake in maintaining the status quo. Business opponents may even turn to the state, as Netscape has pushed the Justice Department to hound Microsoft for alleged predatory behavior. Professor Don Boudreaux, writing in the *Wall Street Journal*, sees this anticompetitive tactic as a serious abuse of the legal and judicial system in an attempt to prevent entrepreneurs from bringing new products and services to consumers.

The third stage of the classic heroic journey begins when the entrepreneur returns to the community with his product, service, or new process. By buying

the new offerings, the customer acknowledges the entrepreneur's success. The more profit that is generated, the greater the value of wealth produced. Thus, profits are the entrepreneur's reward for increasing benefits to individuals in society. Serving in the capacity as wealth creator, the entrepreneur becomes a social benefactor.

The true heroic entrepreneur will continue to anticipate future challenges. He is no ordinary business person whose main priority is keeping one step ahead of his competitors and maintaining market share. Nor does he seek government subsidy or protection. For him, the quest is to venture forth again and again into the unknown to create and bring back that which other individuals value.

The Bold Quests of Individuals

Not all people who venture forth on such heroic quests succeed. Approximately 80 percent of new businesses quickly fail. But over three-quarters of all new jobs each year come from firms no more than four years old. Though large, well-established corporations are more visible, one finds the most entrepreneurial action and risk-taking activity in small business ventures. Hermann Simon, author of *Hidden Champions: Lessons from 500 of the World's Best Unknown Companies*, argues that many little-known, super-performer companies made up of two, three, or more highly entrepreneurial folks have control over 50, 70, and even 90 percent of the world-wide market for their products. For example, St. Jude Medical has 60 percent of the world's market for artificial heart valves. Today, those individuals (or small groups of them) who are embarked on the bold quests are the ones who are changing the face of society so rapidly. And we can look to the future with optimism, since opportunities abound for further entrepreneurial adventure.

In fact, the changes we have witnessed in our lives since we were children are likely to pale in comparison to the changes we will see in coming decades. Yet, while entrepreneurs are essential for this progress, seldom are entrepreneurs hailed as heroes. To the contrary, typically they are ignored in textbooks, or castigated as robber barons. It's no surprise, then, that most adults know far more about successful politicians than about successful entrepreneurs, and most admire the former more than the latter. How can a society continue to prosper when it views those who transfer wealth as more heroic than those who create it?

Why are entrepreneurs seen as looters and exploiters rather than as heroes? One reason is the political bias against them. As government control over the economy has grown, so has the incentive for politically influential interests to disparage entrepreneurs. Few, if any, economic forces are more disruptive than entrepreneurship. But while this creative destruction, in Joseph Schumpeter's words, is essential to general progress, it harms some individuals and groups whose wealth is tied to the status quo. Each group wants to gain protection against progress that imposes costs on itself. The larger government becomes, the more it acts as a force against progress. While the entrepreneur with a superior idea can draw large numbers of customers from existing corporate giants in market competition, he can't mobilize large numbers of citizens against

government obstacles to that competition.

Of course, entrepreneurs can often overcome political obstacles, but such effort diverts attention and energy from the creative activities that propel economic progress. Moreover, political opponents of economic change frequently vilify individual entrepreneurs. Thus, instead of celebrating entrepreneurs who do the most to push back the frontiers of the possible, the public often seems to single them out for condemnation.

Another reason entrepreneurs are criticized is that the connection between their innovations and economic progress is often indirect and difficult for most to recognize. For example, few people understand the great contributions made by Michael Milken and Bill Gates. Special-interest groups with a stake in the status quo can exploit this lack of understanding to depict entrepreneurs as rapacious scoundrels.

Indeed, few people understand how capitalism works. Most tend to focus on the concentrated costs inflicted by market competition, while taking for granted the diffused benefits made possible by that competition. Trying to explain the workings of the invisible hand is not an easy task. Educating the public is made more difficult by intellectuals who use their positions in academia to criticize capitalism and the entrepreneurial energy that propels it.

Why Individual Entrepreneurs Matter

Even many staunch supporters of the free-market system diminish the importance of entrepreneurs. The economists who have developed the subdiscipline referred to as the new economic history have been among the most effective at explaining the causal links between the market and economic progress. Yet many of these new economic historians dismiss the role of entrepreneurs. For example, Robert Thomas of the University of Washington argues that individual entrepreneurs, whether alone or as archetypes, just don't matter. According to Thomas, a successful entrepreneur is no more important to the economy than the winning runner in a 100-yard dash is to the race. The winner gets all the glory, but if he had not been in the race, the next runner would have won by crossing the finish line a fraction of a second later, and the spectators would have enjoyed the race just as much. Thus, if Henry Ford, Ted Turner, or any other successful entrepreneur had not made his pioneering contribution, someone else would have quickly done so. So, as Thomas tells the story, it is hard to justify special celebration of their accomplishments.

Thomas's view is incomplete. Go back to his race analogy. The argument that a given entrepreneur's accomplishments would, in his absence, quickly be achieved by others assumes an environment that encourages entrepreneurship. If the runners themselves, their training, and their efforts during the race are simply taken as givens, it is no doubt true that removing the winner of the race would do little to reduce the benefits of winning. But the identity of the runners and their preparation and efforts can't be taken for granted. Competitors are influenced by treatment afforded the winner. When champion runners receive public esteem, those with the greatest talent are more likely to become runners, train hard, and run faster. Similarly, public attitudes affect the

entrepreneurship process.

Of course, the entrepreneur profits financially if he is successful, which is one reason critics discount the role of public acclaim. Money is obviously important in directing his efforts into those ventures in which his talents have the greatest social value. But this actually strengthens the case for celebrating entrepreneurs. Failing to do so emboldens politicians, and their special-interest clients, who are constantly looking for justifications to tax away the financial gains of successful entrepreneurs. It is no coincidence that, over the past century, as public respect for entrepreneurs has eroded, so have the constitutional barriers against what is best described as the punitive taxation of economic success.

Thus, just as the society that doesn't venerate winners of races will produce fewer champion runners than the society that does, the society that does not honor entrepreneurial accomplishment will find fewer able people engaged in wealth-creating activities. And that society will be less well off than the one which perceives the wealth creator to be a hero.

One last factor helps explain why entrepreneurs are seldom viewed as heroes. When defining a hero, people often focus on self-sacrifice, rather than benefits received by other individuals and society. Yet the vast majority of entrepreneurial efforts do fail, often with significant loss to the entrepreneur. And when the entrepreneur succeeds, he receives his reward only after having enriched everyone else even more.

Conclusion

Economists tend to focus on what can be seen—the measurable aspects of the economy and mechanical understanding of the marketplace as an efficient resource allocator. But abstract economic models seldom inspire. To paraphrase Schumpeter, economic efficiency is a poor substitute for the Holy Grail. In human entrepreneurs, in contrast, people, particularly the young, can see and appreciate those heroic qualities that continuously create a better world.

Some may criticize romanticizing the entrepreneur. But societies are shaped by the ideals they embrace. If one of our children or grandchildren wanted to emulate an entrepreneur who heroically struggled in uncharted territory and ultimately changed the world for the better, we would be proud.

Constitutional Economics

The Political Economy of the U.S. Constitution

February 1, 1987

During the bicentennial of the U.S. Constitution it is appropriate to reflect on the political wisdom of our Founding Fathers. No written constitution in history has established a more durable or successful democracy than has the U.S. Constitution. A full appreciation of the Founding Fathers, however, requires an understanding of the economic as well as the political consequences of our Constitution. Every economy is a political economy and the enormous success of the U.S. economy has been as dependent on our political system as on our economic system.

Indeed, many of the problems that currently plague the U.S. economy are the result of our failure to hold on to the political wisdom that guided our Founding Fathers. Economic knowledge is obviously important in the effort to promote economic growth and development. But no matter how sound our economic understanding, economic performance will continue to suffer until we once again recognize that political power is a force for progress only when tightly constrained and directed toward limited objectives.

The genesis of the political and economic wisdom of our Founding Fathers is found in the fact that they distrusted government while fully recognizing the necessity of government for a beneficent social order. The cautious embrace the Founders gave government is reflected in their view of democracy as necessary but not sufficient for the proper control of government.

The concerns that led to the colonists' break with Great Britain were very much in the public mind when the Constitutional Convention met in Philadelphia during the summer of 1787. The well known prerevolution rallying cry, "No taxation without representation," reflected a clear understanding of the dangers that accompanied any exercise of government power not answerable to those who are governed. That the government established by the Constitution would be democratic in form was not in doubt. Unchecked democratic rule, however, was anathema to the most thoughtful of the Founding Fathers. A grievance against English rule rivaling that of "taxation without representation" concerned the sovereign authority assumed by the English Parliament in

1767. In that year Parliament decreed that, through its democratically elected members, it had the power to pass or strike down any law it desired. The colonists had brought with them the English political tradition, which dated back at least to the Magna Carta of 1215: the people have certain rights that should be immune to political trespass regardless of momentary desires of a democratic majority. The concern was not only that the colonists were unrepresented in Parliament but, more fundamentally, that Parliament assumed unlimited power to meddle in the private lives of individuals whether represented or not:

Although the Founding Fathers were determined to establish a government that was democratic in the limited sense that political decisions could not ignore citizen input, they had no intention of creating a government that was fully responsive to majority interests. In many ways the Constitution is designed to frustrate the desire of political majorities to work their will through the exercise of government power. The most obvious example of this is the first ten amendments to the Constitution, or the Bill of Rights. These amendments guarantee certain individual freedoms against political infringement regardless of majority will. If, for example, freedom of speech and the press was dependent on majority vote many unpopular but potentially important ideas would never be disseminated. How effectively would a university education expose students to new and controversial ideas if professors had to submit their lectures for majority approval?

Other examples exist of the undemocratic nature of the government set up by the Constitution. There is very little that can be considered democratic about the Supreme Court. Its nine members are appointed for life, and their decision can nullify a law passed by the Congress and supported by the overwhelming majority of the American public. In a five to four decision one member of the court, insulated from the democratic process, can frustrate the political will of a nearly unanimous public. The arrangement whereby the President can reverse the will of the Congress through his veto power is certainly not a very democratic one. Neither is the Senate where the vote cast by a senator from Wyoming carries weight equal to the vote by the senator from California, even though the California senator represents a population fifty times larger than does the Wyoming senator. The senators from the twenty-six least populated states can prevent a bill from clearing Congress, even though it has incontestable popular support in the country at large. Congress is actually less democratic than just indicated once it is recognized that popular bills can be prevented from ever being considered in the full House of Representatives or Senate by a few representatives who serve on key congressional committees.

It is safe to say that the chief concern of the framers of the Constitution was not that of insuring a fully democratic political structure. Instead they were concerned with limiting government power in order to minimize the abuse of majority rule. In the words of R. A. Humphreys, "they [the Founding Fathers] were concerned not to make America safe for democracy, but to make democracy safe for America."¹

¹R. A. Humphreys. "The Rule of Law and the American Revolution," *Law Quarterly*

Prelude to the Constitutional Convention

Fear of the arbitrary power that could be exercised by a strong central government, democratically controlled or otherwise, was evident from the Articles of Confederation. The Articles of Confederation established the “national government” of the thirteen colonies after they declared their independence from England. There is some exaggeration in this use of the term national government, since the Articles did little more than formalize an association (or confederation) of thirteen independent and sovereign states. While the congress created by the Articles of Confederation was free to deliberate on important issues and pass laws, it had no means of enforcing them. The Articles did not even establish an executive branch of government, and congressional resolutions were nothing more than recommendations that the states could honor if they saw fit. The taxes that states were assessed to support the Revolutionary War effort were often ignored, and raising money to outfit and pay the American army was a frustrating business.

Because of the weakness of the national government, the state governments under the Article of Confederation were strong and often misused their power. Majority coalitions motivated by special interests found it relatively easy to control state legislatures and tramp on the interests of minorities. Questionable banking schemes were promoted by debtors, with legislative assistance, in order to reduce the real value of their debt obligations. States often resorted to the simple expedient of printing money to satisfy their debts. Trade restrictions between the states were commonplace as legislators responded to the interests of organized producers while ignoring the concerns of the general consumers. There was a 1786 meeting in Annapolis, Maryland of the five middle states to discuss ways to reduce trade barriers between the states. At this meeting the call was made for a larger meeting in Philadelphia in the following year to discuss more general problems with the Articles of Confederation. This meeting became the Constitutional Convention.

Achieving Weakness Through Strength

It was the desire of Madison, Hamilton, and other leaders at the Constitutional Convention to replace the government established by the Articles of Confederation with a central government that was more than an association of sovereign states. The new government would have to be strong enough to impose some uniformity to financial, commercial, and foreign policy and to establish some general protections for citizens against the power of state governments if the new nation was to be viable and prosperous. In the words of James Madison, we needed a “general government” sufficiently strong to protect “the rights of the minority,” which are in jeopardy “in all cases where a majority are united by a common interest or passion.”¹ But this position was not an easy one to

Review 11937). Also quoted in F. A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960). p. 474.

¹*Records of the Federal Convention of 1787*, Max Ferrand. ed. (New Haven: Yale University Press. 1937) Vol. I, p. 57 and pp. 134-135.

defend. Many opponents to a genuine national government saw little merit in the desire to strengthen government power at one level in order to prevent the abuse of government power at another level. Was there any genuine way around this apparent conflict? Many thought not, short of giving up on the hope of a union of all the states. There were those who argued that the expanse and diversity of the thirteen states, much less that of the larger continent, were simply too great to be united under one government without sacrificing the liberty that they had just fought to achieve.¹

Madison, however, saw no conflict in strengthening the national government in order to control the abuses of government in general. In his view the best protection against arbitrary government authority was through centers of government power that were in effective competition with one another. The control that one interest group, or faction, could realize through a state government would be largely nullified when political decisions resulted from the interaction of opposing factions within many states. Again quoting Madison,

The influence of factious leaders may kindle a flame within their particular States but will be unable to spread a general conflagration through the other States...A rage for paper money, for an abolition of debts, for an equal division of property, or for any other improper or wicked project, will be less apt to pervade the whole body of the Union than a particular member of it...²

A central government strong enough to unite a large and diverse set of states would weaken, rather than strengthen, the control that government in general could exercise.

To the framers of the Constitution weakening government in the sense just discussed meant making sure that government was unable to extend itself beyond a relatively limited role in the affairs of individuals. This does not imply, however, impotent government. The referees in a football game, for example, certainly are not the strongest participants on the field and have limited control over specific outcomes in the game. Yet in enforcing the general rules of the game the decisions of the referees are potent indeed. Government, in its role as referee, obviously cannot lack the authority to back up its decisions. In addition to performing its refereeing function, it is also desirable for government to provide certain public goods; goods such as national defense that will not be adequately provided by the private market. Again this is a duty which requires a measure of authority; in this case the authority to impose taxes up to the limit required to provide those public goods which are worth more than they cost.

How to Impose Control?

In granting government the power to do those things government should do, the Founding Fathers knew they were creating a power that had to be carefully controlled. But how could this control be imposed? It could not be imposed by

¹See Herbert J. Storing, *What the Anti-Federalists Were for: The Political Thought of the Opponents of the Constitution* (Chicago: The University of Chicago Press, 1987).

²Madison in *Federalist 10*. *The Federalist Papers* (New York: New American Library, Edition, 1961).

specifying a particular list of government do's and don't's. Such a list would be impossibly detailed and even if it could be drafted it would need to be revised constantly in response to changes in such considerations as population size, age distribution, wealth, and the state of technology. Instead, government has to be controlled by a general set of constitutional rules within which governmental decisions are made, with specific government outcomes determined through the resulting political process. It was the hope of those at the Constitutional Convention to establish a political process, through constitutional reform, that brought government power into action only when needed to serve the broad interests of the public.

This hope was not based on the naive, though tempting, notion that somehow individuals would ignore their personal advantages and concentrate on the general advantage when making political decisions. While noble motives are seldom completely absent in guiding individual behavior, whether private or public, the Founding Fathers took as a given that most people, most of the time, maintain a healthy regard for their private concerns. The only way to prevent self-seeking people from abusing government power was to structure the rules of the political game in such a way that it would be costly for them to do so. The objective of the framers was to create a government that was powerful enough to do those things that received political approval, but to establish a political process that made it exceedingly difficult to obtain political approval for any action that lacked broad public support.

There were, of course, some powers that the national government was not constitutionally permitted to exercise. The national government was created by the states, and until the Constitution all governmental power resided in the states. Through the Constitution the states relinquished some of their powers to the national government, e.g., the power to impose taxes on the citizens, establish uniform rules of naturalization, raise an army and navy, and declare war. In addition the states agreed to refrain from exercising certain powers; e.g., the power to coin money, pass laws impairing the obligation of contracts, and pass retroactive laws. Important government powers remained in the states, however, with some of them located in the local governments. Thus the powers that could be exercised by government were limited, and the powers that did exist were diffused over three levels of government. The Constitution further diffused power at the national level by spreading it horizontally over three branches of government, the power of each acting as a check and balance on the power of the others.

The intent of the Founding Fathers was to so fragment government power that it would be extremely difficult for any narrowly motivated faction to gain sufficient control to work its political will. Only those objectives widely shared and consistent with Constitutional limits would be realized through the use of government power. The beauty of the political process established by the Constitution is that it is cumbersome and inefficient. According to Forrest McDonald the process is "So cumbersome and inefficient...that the people, however virtuous or wicked, could not activate it. It could be activated through deals and deceit, through bargains and bribery, through logrolling and lobbying and

trickery and trading, the tactics that go with man's baser attributes, most notably his greed and his love of power. And yet, in the broad range and on the average, these private tactics and motivations could operate effectively only when they were compatible with the public good, for they were braked by the massive inertia of society as a whole."¹ Or, as Clinton Rossiter has said of the Founding Fathers' motives in creating the system of checks and balances, "Liberty rather than authority, protection rather than power, delay rather than efficiency were the concern of these constitution-makers."²

The Economic Success of the Constitution

It is hard to argue with the success of the U.S. Constitution. The history of the United States in the decades after the ratification of the Constitution was one of limited government and individual liberty, major increases in the size of the U.S. in terms of population and geography, and unprecedented growth in economic well-being. With the major exception of (and to a large extent, in spite of) the unfortunate legacy of slavery and the Civil War, millions of diverse people were able to pursue their individual objectives through harmonious and productive interaction with one another. The opportunities created by the process of specialization and exchange made possible by limited and responsible government motivated an outpouring of productive effort that soon transformed a wilderness into one of the most prosperous nations in the world. The role the U.S. Constitution played in this transformation was an important one and can be explained in terms of both negative and positive incentives.

Broadly speaking there are two ways an individual can acquire Wealth: 1) capture existing wealth through nonproductive transfer activities, or 2) create new wealth through productive activities. A major strength of the Constitution is that it established positive incentives for the latter activities and negative incentives for the former.

The most obvious form of nonproductive transfer activity is private theft. The thief simply takes through force or stealth something that belongs to someone else. A primary purpose for establishing government is to outlaw private theft. But the power that government necessarily possesses if it is to enforce laws against private theft is a power that affords individuals or groups the opportunity to benefit through public "theft" (legal transfer activity to phrase it more gently). The more vague and ineffective the limits on government authority, the less difficult it is to acquire legal transfers through political activity, and the larger the number of people who will find this activity offering them the greatest profit opportunity.

While those who are successful at the transfer game can increase their personal wealth, in some cases significantly, it is obvious that the country at large cannot increase its wealth through transfer activity. What one person receives is what another person, or group, loses. No net wealth is created, and for this

¹Forrest McDonald, *E Pluribus Unum: The Formation of the American Republic 1776-1790* (Indianapolis: Liberty Press. 1979). p. 316.

²Clinton Rossiter, *Seedtime of the Republic: The Origin of the American Tradition of Political Liberty* (New York: Harcourt. Brace and World. 1953), p. 425.

reason transfer activity is often referred to as a zero-sum game. In fact, it is more accurately described as a negative-sum game. The attempts of some to acquire transfers, and the predictable efforts of others to protect their ' wealth against transfers, require the use of real resources. These resources could be productively employed creating new wealth rather than wasted in activities that do nothing more than redistribute existing wealth. For every dollar that one person receives from a transfer activity the rest of the community sacrifices more than a dollar.

Incentives to Produce

A major virtue of the U.S. Constitution was that it discouraged people from playing the transfer game. By establishing a governmental apparatus that was very difficult to put in motion for narrowly motivated purposes, the Constitution dampened the incentive to use government as a means of acquiring the wealth of others. This is not to say that the government was not used as a vehicle for transfer in the early days of our Constitutional government. Every political decision results in some redistribution of wealth, and no governmental structure will ever completely insulate the political process against the transfer activities of some.¹ But the opportunity for personal enrichment through political activity was limited. Most people found that the best way to increase their wealth was through wealth producing activities.

It was here that the political structure established by the Constitution created positive incentives. Not only did the Constitution establish a climate in which it was difficult to profit from transfer activities, it also created a setting in which productive effort was rewarded. By providing protection against the arbitrary taking of private property (the Fifth Article of the Bill of Rights) people were given assurance that they would not be denied the value generated by their efforts. This provided people with strong incentives to apply themselves and their property diligently. In the words of M. Bruce Johnson, "America was a place where if you were ready to sow, then by God you could reap."²

But the motivation to work hard is not enough for a productive economy. Also needed is information on the objectives toward which effort and resources are best directed, as well as incentives to act on this information. It is the protection of private property that provides the foundation for a system of price communication and market interaction which serves to guide effort and resources into their most valuable employments. To complete this system the concept of private property rights has to be expanded to include the right to transfer one's property to others at terms regulated only by the mutual consent of those who are party to the exchange. The lower the cost of entering into transactions of this type, the more effectively the resulting market prices will allow people to communicate and coordinate with each other to the advantage of

¹For a discussion of the use of government to transfer wealth throughout American history), see Jonathan R. T. Hughes, *The Governmental Habit: Economic Controls from Colonial Times to the Present* (New York: Basic Books. 1977).

²M. Bruce Johnson. ed., *Resolving the Housing Crisis: Government Policy, Decontrol. and the Public Interest* (San Francisco: Pacific Institute for Public Research. 1982). p. 3.

all. The U.S. Constitution lowered these transaction costs by reducing government's ability to interfere with mutually acceptable exchanges and by putting the weight of the national government behind the sanctity of the contracts that resulted from these exchanges.

In what has become known as the "contract clause" of the Constitution, the states are forbidden from passing any "law impairing the obligation of contracts..." In the same clause the states are also forbidden from imposing tariff duties on imports or exports (unless absolutely necessary for enforcing inspection laws). In the "commerce clause" the national government was given the power to regulate commerce "among the several states." Though the commerce clause can be interpreted (and indeed has been in recent decades) as providing the central government the authority to substitute political decisions for market decisions over interstate commerce, the U.S. Congress ignored this possibility until it passed the Interstate Commerce Act in 1887. Prior to the Civil War the commerce clause was used instead by the U.S. Supreme Court to rule unconstitutional state laws that attempted to regulate commerce. After 1868 the Supreme Court made use of the doctrine of due process as expressed in the fourteenth amendment to strike down many government attempts to violate the sanctity of contracts through their regulation of such things as prices, working hours, working conditions, and pay.

In summary, the Constitution created an environment in which private advantage was best served by engaging in productive positive-sum activities. The specialization and exchange facilitated by the Constitutional rules of the game is a system in which individuals can improve their own position only by serving the interests of others. When private property is protected against confiscation, an individual becomes wealthy only by developing skills, creating new products, or innovating better technologies and thereby providing consumers with more attractive options than they would otherwise have. In a truly free enterprise economy, with the minimum government role envisioned by the framers of the Constitution, the rich are the benefactors of the masses, not the exploiters as commonly depicted. Wealth through exploitation becomes possible only when unrestricted government allows negative-sum transfer activity to become more profitable than positive-sum market activity.

Constitutional Erosion and the Rise of Political Piracy

The early success of the Constitution, and the economic system that developed under it, is reflected in the fact that relatively few people felt any urgency to worry about politics. Political activity offered little return as there was little chance to exploit others, and little need to prevent from being exploited by others, through political involvement. People could safely get on with their private affairs without having to worry about the machinations and intrigues of politicians and bureaucrats in faraway places. But this very success can, over time, undermine itself as a politically complacent public increases the opportunities for those who are politically involved to engage in political chicanery.

Motivating people to maintain the political vigilance necessary to protect themselves against government is always a difficult task. The individual who

becomes involved in political activity incurs a direct cost. By devoting time and resources in attempting to realize political objectives he is sacrificing alternative objectives. The motivation to become politically active will be a compelling one only if the expected political outcome is worth more to the individual than the necessary personal sacrifices. This will typically not be the case when the objective is to prevent government from undermining the market process that it is government's proper role to protect. The benefits that are realized from limited government are general benefits. These benefits accrue to each individual in the community whether or not he personally works to constrain government.

Over the broad range of political issues, then, people quite rationally do not want to get involved. This is not to say, however, that everyone will be apathetic about all political issues. This clearly is not the case, and it is possible to predict the circumstances that will motivate political activism. Often a relatively small number of individuals will receive most of the benefit from a particular political decision, while the community at large bears the cost. Members of such a special interest group will find it relatively easy to organize for the purpose of exerting political influence. The number of people to organize is comparatively small; the group is probably already somewhat organized around a common interest, and the political issues that affect this common interest will be of significant importance to each member of the group.

Of course, the free rider problem exists in all organizational efforts, but the smaller the group and the narrower the objective the easier it is to get everyone to contribute his share. Also, the benefits of effective effort can be so great to particular individuals in the group that they will be motivated to work for the common objective even if some members of the group do free-ride. Not surprisingly then, narrowly focused groups commonly will have the motivation and ability to organize for the purpose of pursuing political objectives.¹ The result is political piracy in which the politically organized are able to capture ill-gotten gains from the politically unorganized.

The Constitutional limits on government imposed effective restraints on political piracy for many years after the Constitution was ratified. There are undoubtedly many explanations for this. The vast frontier rich in natural resources offered opportunities for wealth creation that, for most people, overwhelmed the opportunities for personal gain through government transfer activity. Also, it can take time for politically effective coalitions to form after the slate has been wiped clean, so to speak, by a social upheaval of the magnitude of first the Revolutionary War and then the Civil War.² Public attitudes were also an important consideration in the control of government.

Much has been written about how the pervasive distrust of government

¹According to Milton Friedman. "The most potent group in a democracy such as ours is a small minority that has a special interest which it values very highly, for which it is willing to give its vote. regardless of what happens elsewhere, and about which the rest of the community does not care very strongly." See Milton Friedman, "Special Interest and His Law," Chicago Bar Record (June 1970).

²Mancur Olson, *The Rise and Decline of Nations* (New Haven: Yale University Press, 1982).

power among the American people shaped the framing of a Constitution that worked to limit government.¹ What might be more important is that the Constitution worked to limit government because the public had a healthy distrust of government power. For example, in the 1860s the Baltimore and Ohio railroad had its Harpers Ferry bridge blown up many times by both the Confederate and Union armies, and each time the railroad rebuilt the bridge with its own funds without any attempt to get the government to pick up part of the tab. Or consider the fact that in 1887 President Grover Cleveland vetoed an appropriation of \$25,000 for seed corn to assist drought-stricken farmers with the statement, "It is not the duty of government to support the people."² There is little doubt that Cleveland's view on this matter was in keeping with broad public opinion.

The Constitutional safeguards against government transfer activity unfortunately have lost much of their effectiveness over the years. The western frontier disappeared, and a long period of relative stability in the political order provided time for factions to become entrenched in the political process. Of more direct and crucial importance, however, in the move from productive activity to transfer activity has been the weakening judicial barrier to the use of government to advance special interests. The 1877 Supreme Court decision in *Munn v. Illinois* is often considered to be a watershed case. This decision upheld a lower court ruling that the Illinois state legislature had the authority to determine the rates that could be charged for storing grain. This decision, by sanctioning an expanded role for government in the determination of prices, increased the payoff to political activity relative to market activity and established an important precedent for future increases in that payoff.

In *Chicago, Milwaukee and St. Paul Railroad Co. v. Minnesota*, decided in 1890, the Supreme Court imposed what appeared to be limits on state regulation of economic activity by ruling that such regulation must be reasonable. Unfortunately, this reasonableness doctrine put the effectiveness of judicial restraint on government at the mercy of current fashion in social thought. What is considered unreasonable at one time may be considered quite reasonable at another.³ It was unreasonable for the Baltimore and Ohio railroad to consider requesting government funds to repair its Harpers Ferry bridge, destroyed by government forces, during the Civil War. In the 1980s it was considered reasonable for Chrysler Corporation to request and receive a federal government bailout because Chrysler was not competing successfully for the consumer's dollar.

¹Gordon S. Wood, *The Creation of the American Republic: 1776-1787* (Chapel Hill: The University of North Carolina Press, 1969), especially chapter 1.

²Quoted in A. Nevins, *Grover Cleveland: A Study in Courage* (New York: Dodd Mead, 1932).

³In spite of the two decisions just cited, between 1897 and 1937, the Supreme Court made use of the due process clause of the Fourteenth Amendment to reach decisions that served to protect the market process against political intrusions. See Bernard Siegan, *Economic Liberties and the Constitution* (Chicago: University of Chicago Press, 1981). Unfortunately, this pattern of judicial decisions was not solid enough to prevent these decisions from being ignored or overruled when the political climate and prevailing notions of reasonableness changed.

Undermining Constitutional Law

The idea of reasonable regulation significantly undermined the concept of a higher Constitutional law that established protections needed for the long-run viability of a free and productive social order. Once the notion of reasonable regulation stuck its nose into the judicial tent it was just a matter of time before the courts began seeing their task as that of judging particular outcomes rather than overseeing the general rules of the game. Illustrative of this changing emphasis was the legal brief submitted by Louis Brandeis, then an attorney for the state of Oregon, in the 1908 case *Muller v. Oregon*. At issue was the constitutionality of an Oregon law which regulated the working hours of women. The Brandeis brief contained only a few pages addressing constitutional considerations and well over one hundred pages of social economic data and argumentation attempting to establish the unfortunate consequences of women working long hours. It was a judgment on the reasonableness of a particular outcome, women working long hours, rather than constitutional considerations, which were considered of paramount importance and led to a Supreme Court ruling in favor of Oregon.¹ When the constitutionality of legislation stands or falls on the “reasonableness” of the particular outcomes it hopes to achieve, opportunities increase for people to increase their wealth through nonproductive political activity.

In the 1911 case *United States v. Grimand*, the Supreme Court handed down a decision that significantly increased the private return to obtaining transfers through political influence. Prior to this decision, the U.S. Congress had increasingly moved toward granting administrative agencies the authority to promulgate specific rules in order to implement the general policy objectives outlined by Congress. In *United States v. Grimand* the high court empowered these administrative rulings with the full force of law. After this decision, the cost of successfully using government authority to transfer wealth decreased significantly as special interest groups seeking preferential treatment could concentrate their influence on a few key members of a particular administrative board or agency. The typical result of this has been the development of symbiotic relationships between bureaucratic agencies and their special interest clients. A special interest group can thrive on the benefits transferred to it by the ruling of a bureaucracy, and the bureaucracy’s budget and prestige will depend on a thriving special interest group demanding its services.²

¹For a brief but useful discussion of this case see Thomas K. McCraw, *Prophets of Regulation* (Cambridge: The Belknap Press of Harvard University Press. Cambridge. 1984). pp. 87-88.

²The relationship between the U.S. Department of Agriculture and the farm bloc is but one of many illustrative examples that could be cited here. It is clear that those employed by the Department of Agriculture strongly support the agricultural price support and subsidy programs that transfer literally billions of dollars from the American consumer and taxpayer to the nation’s farmers most of this transfer goes to the largest and wealthiest farmers; see Bruce L. Gardner. *The Governing of Agriculture* [Lawrence: Regents Press of Kansas. 1981]. It is by expanding these programs that the Department of Agriculture can justify bigger budgets and more employees, something it has been quite successful at doing. In 1920 when the farm population was approximately 31 million, the Department of Agriculture employed 19,500 people. By 1975 the farm population had declined to less than 9 million,

What we have observed over the years is a slow, somewhat erratic, but unmistakable breakdown in the protection the Constitution provides the public against arbitrary government power. Those who want to get on with the task of creating new wealth have much less assurance today than they did in the past that significant portions of the wealth they create will not be confiscated by government and transferred to those who have specialized in political influence.

Maintaining constitutional constraints on government transfer activity is a task requiring constant vigilance. Once a breakdown in these constraints begins, it can initiate a destructive dynamic of increasing government transfers that is difficult to control. Any change that makes it easier to obtain transfers through government will motivate some people to redirect their efforts away from productive enterprises and into transfer enterprises. As this is done, those who continue to create new wealth find the payoff from doing so is somewhat diminished as more of this wealth is being taken from them. This further reduction in the relative return to productive activity motivates yet more people to use government power to benefit at the expense of others. Furthermore, the burdens and inefficiencies created by one government program will be used as “justification” for yet additional government programs which will create new burdens and inefficiencies.¹ This dynamic can lead to what is best characterized as a “transfer society.”²

Political Piracy and the Transfer Society

Once we start down the road to the transfer society we can easily find ourselves trapped in a situation almost everyone will disapprove of, but which no one will be willing to change. The analogy of piracy is appropriate here. When all ships are productively employed shipping the goods, a large amount of wealth can be generated. But if sanctions against piracy are eased a few shippers may find it to their personal advantage to stop shipping and start pirating the merchandise being shipped by others, even though this reduces the total wealth available. This piracy by the few will reduce the return the others receive from shipping, and there will be an increase in the number finding the advantage in piracy. Eventually the point may be reached where everyone is sailing the seas looking for the booty that used to be shipped but is no longer. No one is doing well under these circumstances, and indeed, all would be much better off if everyone would return to shipping the goods. Yet who will be willing to return to productive shipping when everyone else is a pirate?

but the Department of Agriculture had increased its employment to 121,000 people. This trend toward fewer agricultural workers relative to agricultural bureaucrats has continued into the 1980s.

¹Our Federal farm programs are a perfect example of this process. See Gardner, *ibid*, Early on, James Madison recognized the possibility of this type of legislative chain reaction. In *Federalist 44* Madison states, “that legislative interference, is but the first link of a long chain of repetitions; every subsequent interference being naturally produced by the effects of the preceding.”

²For a detailed and compelling analysis of how the breakdown in constitutional limitations on government activity has moved the U.S. away from positive-sum economic activity and toward negative-sum activity, see Terry L. Anderson and Peter J. Hill, *The Birth of a Transfer Society* (Stanford, California: Hoover Institution Press, 1980).

Obviously, we have not yet arrived at the point of being a full-blown transfer society; not everyone has become a political pirate. There are plenty of people who remain productive, and they still receive a measure of protection against the confiscation of the returns to their efforts by the constitutional limitations that remain on government power. But there can be no doubt that these limitations are less effective today than they were in the past. This erosion is in large measure due to a change in the prevailing attitude toward government. The fear of unrestrained government power that guided the Founding Fathers has been largely replaced with the view that discretionary government power is a force for social good. If there is a problem, government supposedly has the obligation and ability to solve it. Such public attitudes have a decisive influence on the effectiveness of constitutional limitations.

Simply writing something down on a document called the Constitution does not by itself make it so. And, because of this fact, Alexis de Tocqueville, writing in the 1830s, predicted that the U.S. Constitution would eventually cease to exercise effective restraint on government. According to Tocqueville, "The government of the Union depends almost entirely upon legal fictions." He continued that it would be difficult to "imagine that it is possible by the aid of legal fictions to prevent men from finding out and employing those means of gratifying their passions which have been left open to them".¹

But controlling our passions is what constitutional government is all about. In the absence of government we have the anarchy of the Hobbesian jungle in which those who control their passion for immediate gratification and apply their efforts toward long-run objectives only increase their vulnerability to the predation of those who exercise no control or foresight. Granting government the power to enforce general rules of social interaction is surely a necessary condition if a productive social order is to emerge from a state of anarchy. But without strict constitutional limits on the scope of government activity, the existence of government power will only increase the scope of effective predation. The notion that government can solve all problems becomes a convenient pretense for those who would solve their problems, not in cooperation with others, but at the expense of others. Unlimited government reduces the personal advantage to the productive pursuit of long-run objectives just as surely as does anarchy. In such a case, government is little more than the means of moving from the anarchy of the Hobbesian jungle to the anarchy of the political jungle.

The American experience, however, demonstrates convincingly that with a healthy fear of government power and a realistic understanding of human nature, a constitution can be designed that, over a long period of time, will effectively constrain government to operate within the limits defined by the delicate balance between proper power and prudent restraint. All that is needed to restore the U.S. Constitution to its full effectiveness is a return to the political wisdom that guided our Founding Fathers 200 years ago.

¹Quoted in Felix Morley, *Freedom and Federalism*, (Chicago: Regnery, 1959): pp. 138-139.

Conclusion

The U.S. is a wealthy country today in large part because our Founding Fathers had what can be quite accurately described as a negative attitude toward government. They had little confidence in the ability of government to promote social well-being through the application of government power to achieve particular ends. In their view, the best that government can realistically hope to achieve is the establishment of a social setting in which individuals are free, within the limits of general laws, to productively pursue their own objectives.

This negative view of government contrasts sharply with the dominant view today; the view that government is the problem solver of last resort and has an obligation to provide a solution to any problem not resolved immediately in the private sector. Unfortunately, this positive view of government is less conducive to positive consequences than the negative view of the Founders.

According to F. A. Hayek:

*The first [positive view] gives us a sense of unlimited power to realize our wishes, while the second [negative view] leads to the insight that there are limitations to what we can deliberately bring about, and to the recognition that some of our present hopes are delusions. Yet the effect of allowing ourselves to be deluded by the first view has always been that man has actually limited the scope of what he can achieve. For it has always been the recognition of the limits of the possible which has enabled man to make full use of his powers.*¹

The exercise of government can, without doubt, be used to accomplish particular ends. Neither can it be denied that many of the specific outcomes realized through government programs provide important benefits and advance worthy objectives. But, as is always the case, those accomplishments are only realized at a cost, and the pervasive truth about government accomplishments is that those who benefit from them are seldom those who pay the cost. Indeed, much of the motivation for engaging in political actions is to escape the discipline imposed by the market where individuals are accountable for the cost of their choices.

The escape from market discipline is the inevitable consequence of reducing the constitutional limits on the use of government power. The immediate and visible benefits that are generated by wide-ranging government discretion are paid for by a shift in the incentive structure that, over the long run, will reduce the amount of good that can be accomplished. More, much more, has been accomplished by the American people because our Founding Fathers had a strong sense of the limits on what can be accomplished by government.

¹Friedrich A. Hayek, *Law, Legislation and Liberty*, Vol. 1 *Rules and Order* (Chicago: University of Chicago Press, 1973). p. 8.

Liberty and Individual Responsibility

April 1, 1987

Liberty is both a highly valued outcome of a beneficent political economy, and an essential ingredient into it. In some respects a consideration of the role of liberty as both output and input is straightforward. Limited government, serving to maintain the legal environment necessary for an economic order based on private property and voluntary exchange, provides fertile ground for individual liberty. And the lifeblood of a political economy characterized by limited government, private property, and voluntary exchange, is the flow of information that can be provided only when individuals possess a full measure of political and economic liberty.

However, a careful examination of how a political economy based on classical liberal principles both nourishes, and is nourished by, individual liberty reveals a complicated interaction between the social institutions necessary for liberty and the exercise of liberty. The exercise of liberty, unless tempered by a responsibility that can never be imposed entirely by a force external to the ethical convictions of the individual, will with time undermine the social institutions upon which liberty depends. A careful study of the political economy of liberty contains within it a warning of just how fragile is the foundation upon which liberty stands.

Scarcity, Rules, and Liberty

In order to examine the connections between economics, politics, and liberty, it is useful to consider first the most fundamental of economic problems. That problem is scarcity. In a world without scarcity each of us could be entirely independent of others. Each individual could exercise complete freedom in a broad range of activities and have no impact whatsoever on anyone else. Because we live in a world of scarcity, individuals must interact with one another and this interaction is shaped by rules of social conduct. Such rules impose restrictions on the activities of individuals and establish the important distinction

between liberty and license. Without the restrictions imposed by such rules, scarcity itself would impose on us an even more confining set of restrictions.

Consider the fact that although scarcity makes cooperation desirable, it makes competition inevitable. Each of us wants more than he has and the only way to get more is by competing against others for control over limited resources. Competition is commonly seen as the source of a host of social ills, with the replacement of competition by cooperation suggested as necessary for social improvement. What this view fails to recognize is that competition is not the cause, but rather the consequence, of the ultimate social ill, namely scarcity. With no way to eliminate scarcity, the important question is not how to prevent competition, but how to provide rules for social conduct that motivate the type of competitive behavior which leads to productive and cooperative outcomes. Competition can be either productive or destructive depending on the rules that define permissible limits in our dealings with one another.

Consider the possibility of no rules, or more accurately the rule of force. Everyone would be free to do whatever he wanted as long as he possessed the power to force his will on others. In this setting, people would be forced to compete through the exercise of unrestrained brute strength and there would be no freedom in the meaningful sense of “independence of the arbitrary will of another.”¹

If one person had enough physical power he could force others to work for him without compensation, to be his slave. But the master today has no assurance that he will not be someone else’s slave tomorrow.

Neither is the rule of force likely to motivate productive and cooperative outcomes. There would be little motivation to devote one’s effort to the production of wealth since there would exist no protections against its forcible expropriation by others. Competing successfully would depend more on developing the skills needed for plundering and defending against plunder than on developing the skills needed to produce wealth. Even if one were able to survive in such a social environment, one’s standard of living would be low. With resources being devoted overwhelmingly to predation and protection from the predatory activity of others, little would be produced and poverty would be the norm. Life in such a Hobbesian jungle would indeed be “solitary, poor, nasty, brutish, and short.”

Freedom from rules is simply not a viable social possibility. In a society without rules there would be little prosperity and no genuine freedom.

Social Order at the Sacrifice of Liberty

Emergence from the Hobbesian jungle, which finds a “war of each against all,” is necessary if we are to realize the benefits of a civil social order. Underlying any beneficent social order are rules that will impose limits on individual behavior. All rules serve to limit freedom of action. However, when rules are applied

¹The usefulness of this definition of freedom is explained by F. A. Hayek in his *The Constitution of Liberty* (The University of Chicago Press, 1960). See especially chapters I and 2.

generally they can, by limiting the actions of each in predictable ways, expand the liberty of all.²

On the other hand, when they become too numerous and detailed, rules can destroy liberty just as surely and effectively as no rules. And the tendency is in the direction of too many rules. Traditionally the obsession within societies has been the horrors of disorder. With plunder, riot, rape, mayhem, and murder the common experience, the loss of liberty has been seen as the unavoidable cost of escaping disorder. The prevalent human condition throughout history has been subjugation to rigid and brutally enforced rules that specify the type and location of one's work, travel, religious practices, and even social status. The overriding problem of society has been that of maintaining order, and only the most limited amount of liberty has been considered compatible with this objective.

While a rigid social order based on detailed rules concerning every aspect of behavior may be preferred to the chaos that would prevail in the absence of all rules, the shortcomings of such a social order are apparent. The first problem is to find leaders who can be trusted with the power that has to be exercised in a totally controlled society. Such power is subject to enormous abuse. Those who have such power are in a position to advance their interests at the expense of their subjects, and will seldom be able to resist the temptation to do so. The only possible advantage an all powerful government has over anarchy is that the exercise of government power is visible. Moving from the anarchy of no rules to the detailed control of leviathan government is to substitute one thief in the light for many thieves in the night.

The cost in terms of sacrificed liberty is much the same regardless of whether it is sacrificed to anarchy or to unlimited government. One who finds himself forced to toil for the benefit of others is not likely to care who his masters are—the physically dominant brutes in the “jungle” or the politically dominant brutes in the government.

So, traditionally, the social choice appeared to have been between some combination of two undesirable states: the regimentation of detailed rules or the lack of social order. Society could have less of one only at the cost of having more of the other. There appeared to be no realistic hope that individuals living together in a world of scarcity could simultaneously have both more liberty and more social order. It was in the 17th and 18th centuries that philosophers began to give serious consideration to a structure of rules that offered the possibility of overcoming this social dilemma.³

²In the words of John Locke, “The end of law is not to abolish or restrain but to preserve and enlarge freedom; for in all the states of created beings capable of laws, where there is no law, there is no freedom. For liberty is to be free from the restraint and violence of others, which cannot be when there is no law; but freedom is not, as we are told, a liberty for every man to do what he lists. For who can be free, when every other man's humor might domineer over him?” See John Locke. *The Second Treatise of Government*. ed. by Thomas P. Perdon (New York: The Liberal Arts Press, Inc., 1954), pp. 32-33.

³The first recorded awareness that individual liberty could be expanded under a set of universally applied rules (the rule of law) comes from the ancient Greeks, particularly the Athenians during the fifth and fourth centuries B.C. The Greek ideals of liberty were kept alive by Roman writers, such as Cicero, whose work was important to the modern

The Rule of Private Property

It was the writings of John Locke, Adam Smith, Bernard Mandeville, and other 17th- and 18th- century philosophers that gave modern birth to the ideal of compatibility between individual liberty and social order. Crucial to this ideal was a fundamental conceptual shift regarding the role of rules. Social rules were traditionally seen as necessary to force particular outcomes which were required if a productive social order was to be maintained. Fields had to be tilled, cloth had to be woven, cattle had to be tended, and particular services had to be rendered. Concentrating authority in the hands of a ruler who could require these things to be done was seen as the only guarantee that they would be done. The fundamental insight of the aforementioned philosophers was that establishing general rules of social conduct, which ignored particular outcomes, could create an environment in which desirable outcomes emerged from the exercise of individual liberty.

Crucial to this liberating view of social order are rules which clearly define individual rights by providing assurances that individuals can plan and carry out their activities without the return to their activities being arbitrarily confiscated by others. Lacking such assurances, little motivation exists for people to be productive and no basis exists for them to interact with each other in a civil manner.

The rule of private property can now be seen as crucial to the goal of a productive social order that is compatible with, indeed dependent upon, individual liberty. The rule of private property requires that individual rights to property be well defined and subject to transfer from one individual to another by mutual consent of both parties. When liberties are constrained only by the broad limits imposed by the rule of private property, then a system of social communication and cooperation is established within which the liberty of each individual is compatible with the liberty of all. Indeed, under the rule of private property the liberty exercised by one expands the options over which liberty can be exercised by all.⁴

The social cooperation facilitated by the rule of private property, though well known to all serious students of economics, is sufficiently relevant to a consideration of liberty to deserve discussion. When property is privately owned and voluntarily exchanged, market prices emerge. These prices are the means by which each market participant communicates to all other market participants the value he places on the marginal units of goods.

Property Encourages Honesty

In addition to creating a truly impressive network of communication, private property motivates an equally impressive degree of honesty. Honesty can be expected to prevail since it is in no one's interest to be dishonest about the price

development of classical liberal principles.

⁴As Hayek points out, "The benefits I derive from freedom are thus largely the result of the uses of freedom by others, and mostly of those uses of freedom that I could never avail myself of." F. A. Hayek, *op. cit.*: p. 32.

he is willing to pay. The self-interest of market participants insures that they will assess carefully the value they expect to realize from an incremental unit of each good, and then communicate their desire for more only if the incremental unit is worth more to them than the prevailing market price.⁵ Furthermore, each participant in this communication process is motivated to act as if he gives the concerns of others the same consideration he gives his own. When an individual reduces his consumption of a product in response to an increase in its price, he is in effect saying, "Others are saying to me that this product is worth more to them at the margin than it is to me, so I will consume less so they can consume more."

This system of communication and cooperation obviously does not work with perfection. However, even when full recognition is given to what has become known as "market failure," any impartial evaluation must acknowledge that the benefits derived from the rule of private property, and the derivative market process, cannot even remotely be duplicated by any known alternative social role, or set of rules. Because the information and incentives generated by market competition allow each of us to interact cooperatively and honestly with literally millions of people around the globe, we are able to specialize our efforts, direct resources into their most productive uses, and thus generate enormous wealth.

Surely more important than the wealth generated under a system of private property and market exchange is the individual liberty that this system permits. The rule of private property makes it possible to allow people a large measure of liberty because this rule makes people accountable for the consequences of their decisions. Every time an individual puts a resource to use, a cost is imposed; that cost being measured in terms of the value of the resource in the highest valued alternative use. When an individual owns a resource he is fully accountable for this cost, since his use of the resource requires the sacrifice of the highest amount someone else is willing to pay for it. Given this accountability there is no harm, and indeed much benefit, in giving individuals wide latitude to use resources as they choose.

In the absence of private property rights there is a constant clamoring, often with justification, for detailed restrictions on individual behavior. Consider, for example, the fact that it is difficult in the extreme to divide up and parcel out the atmosphere as private property. As a consequence, the atmosphere is a common property resource and individuals are not held accountable for the costs being generated when they use the atmosphere as a receptacle for their auto exhaust, or industrial smoke. The result is broad public acceptance of huge Federal and state bureaucracies imposing a host of detailed restrictions on our behavior in the name of forcing us to act in environmentally responsible

⁵Under certain conditions it is obviously possible for sellers to benefit by misrepresenting their products. But just as obvious is the fact that this problem is mitigated by market forces. Also, specific market arrangements tend to develop that reduce the seller's potential to gain from fraud, because both buyer and seller can benefit from such arrangements. For a useful discussion of such arrangements, and the theory behind them, see Benjamin Klein and Keith Leffler. "The Role of Market Forces in Assuring Contractual Performance," *Journal of Political Economy* (August 1981), pp. 615-41.

ways.

Eliminate the accountability provided by the rule of private property and you eliminate the very basis upon which people can be tolerant of the freedom of others. A reduction in the scope of individual liberty, with detailed directives and regulations replacing general rules of social conduct, is the certain consequence of either the inability or the unwillingness to rely on private property and voluntary exchange to order economic activity.

The Need for Government

The advantages we realize from observing the rule of private property are general advantages. The rule of private property is not designed to generate particular outcomes or to allow particular individuals to benefit at the expense of others. Rather it allows the liberty necessary to accomplish objectives that on balance benefit us all, but which no one could have predicted or programmed ahead of time. However, unless each of us refrains from attempting to infringe upon the property rights of others, the general advantages realized from an economic process which fosters both the production of wealth and a social tolerance for liberty will be diminished for everyone.

Unfortunately, even though we become collectively worse off when property rights are violated, it is possible for each individual to improve his situation by infringing on the property of others. The only parasite on a healthy organism is in an enviable position. It is true that if there is a multitude of parasites attempting to free ride on the same organism no one benefits; the organism perishes, as do the parasites. But this elementary fact provides little motivation for any one individual to cease being a parasite and turn to productive activity. Each individual recognizes that denying himself the immediate gains from plunder will do nothing to preserve the benefits derived from private property and voluntary exchange if there is a general failure to respect property rights. Indeed, in a world where everyone is engaged in plunder it would be the height of folly for an individual to confine his efforts to productive activity.

In other words, the free and productive social order based on private property and voluntary exchange is a public good; a good which when available to one is available to all. As with any public good it has to be paid for by the contributions of individuals, contributions which in this case take the form of sacrificing opportunities to infringe on the property rights of others. As is the case with all public goods, each individual faces the tempting possibility of free riding on the contributions of others. Since individuals know that they can benefit from the free and productive social order that is being paid for by the restraint of others, whether they restrain themselves or not, when left entirely to individual choice we can expect too little respect for private property rights.

Faced with the problem of maintaining social order, each individual is generally willing to exercise restraint if, by agreeing to do so, everyone else is made to do the same. Such collective respect for private property rights has the potential for making everyone better off and, with good prospects for enforcement, will be agreed to almost universally. Enforcement of the social rules of the game is essential here, and it is the need for such enforcement that provides

the rationale for the monopoly in coercion which is granted to government.

It is the legitimate role of government to exercise its power in order to serve as an impartial referee who knows the rules of the game, observes the play of the participants, and imposes penalties on those who violate the rules. Good government, as a good referee, does not strive for particular results, but is concerned solely with facilitating the interaction of individuals each of whom is free to pursue his own purposes as long as he operates within the limits established by the agreed upon set of rules.

By enforcing the rule of private property, government is both performing as a referee and requiring that those who benefit from a free and productive social order contribute their part in maintaining it. Those who persist in violating the property rights of others will, if government is doing its job, be denied their liberty through imprisonment. This has the effect of converting the public good provided by respect for private property into a price-excludable public good. That is, those who do not pay the price are excluded from the benefits.

Up to this point the discussion has been concerned primarily with the protective or rule enforcement role of government. The government has to enforce general rules if liberty and social order are to be maintained. In this capacity the government makes no choices in the sense of weighing the benefits and costs of alternatives. It has only to determine if the rules are being obeyed and to take predetermined measures if they are not. The discussion has, however, touched on a further function of government. Public goods other than social order exist, and the government is also the institution through which members of the community decide which of these goods to finance publicly, and how extensively they should be funded, in this capacity, government is called upon to make genuine economic choices, and to engage in directly productive activities.⁶

The Need to Control Government

The government is then more than the referee in the game; it is a participating player as well. In its capacity as a player government is also subject to rules. This situation presents some rather difficult problems. The fact is that the government is necessarily exempt from certain rules that apply to all other players in the game. The government, in one sense, has the authority to violate property rights by forcing citizens to pay for certain public goods. One can argue that this is not really a violation of property rights since everyone is part of the collective process in which the decision to provide public goods is made and goods are provided in return for payments rendered. This argument notwithstanding, it remains true that government's legal power to compel people to make payments places it outside the rules that apply to private individuals and organizations.

⁶Buchanan makes a clear distinction between the rule enforcement role of government and the role of government as economic decision maker in his discussion of "the protective state" and - the productive state." See James M. Buchanan, *The Limits of Liberty: Between Anarchy and Leviathan* (Chicago: The University of Chicago Press, 19753, Chapter 4.

Not only does government enter into the game under less restrictive rules than are imposed on nongovernment players, but since it is government that enforces the rules on all, it is government that enforces the rules on itself. Letting a player in any game be the judge of his own infractions creates an opportunity for abuse that few can be expected to resist. Of course, the government is not a single player but rather a collection of the members of the community. Even so, in their roles as political decision makers individuals will coalesce around certain objectives and will be tempted to take whatever action is necessary to realize their objectives. Whether acting individually or in groups, people find fewer things easier to do than justify in their minds those actions that advance their interests. As a player in the game the government has to be called to task for violations of the rules just as other players; but how can we be sure that the government will be sufficiently diligent in calling infractions and imposing penalties against itself?

The problem here was clearly seen by James Madison when, in arguing for ratification of the United States Constitution, he wrote:

If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: You must first enable the government to control the governed; and in the next place, oblige it to control itself.⁷

Obliging government to control itself is no easy task. Government power, unless tightly circumscribed, creates opportunities for some to benefit at the expense of others through in voluntary transfers. This abuse of government power tends to feed upon itself. First, government transfers reduce the private return from producing new wealth and increase the private return from acquiring or protecting existing wealth through political influence. This shift in relative returns draws more people out of productive activity and into political activity, which shifts relative returns yet further in favor of the latter. Second, government transfer activity is destructive of the accountability that characterizes an economic order operating in accordance with the rule of private property. As this accountability is reduced the very basis for individual liberty is also reduced and there will be increased pressure for yet broader government control on individual behavior. The power needed by government to maintain a free social order can easily become the force that undermines that order.

Our liberty and prosperity depend on general rules of social conduct. It is government's legitimate function to enforce those rules, as well as to provide a limited number of public goods. In order for government to perform its role properly, the conduct of government also has to be disciplined by general rules. It is important that these rules on government are obeyed. No society will long remain free unless they are. But how do we impose the discipline on government to get it to enforce these rules on itself and ensure that government power is not used to destroy the very liberty it is supposed to protect?

⁷Federalist 51, *The Federalist Papers*.

Constitutional Limits and the Limits of Constitutions

The only genuine hope for controlling government is through constitutional limits on government activity and constitutionally grounded procedures for operating within those limits. It is only by elevating these limits and procedures to the constitutional level that there can be any real prospect of immunizing them against the special interest pressures of ordinary politics.

But while the constitutional approach is the only one that holds promise for limiting government power and for making this power a positive rather than a negative force for freedom, constitutions by no means provide an easy or assured route to responsible government. An effective constitution cannot be created simply by writing words on parchment. The U.S. Constitution, surely the most effective and durable written constitution in history, has served as the model constitution (sometimes being copied nearly verbatim) for numerous political regimes around the world. Few of these cloned constitutions have been particularly durable or effective. A successful constitution has to be derived from customs, beliefs, and ethical understandings that are rooted in a pre-existing social order. A constitution can serve effectively to guard against only those abuses of government power that are widely recognized as abuses. If battered by the force of public approval of particular government practices, constitutional barriers against those practices will soon be breached. As observed by Henry Simons: "Constitutional provisions are no stronger than the moral consensus that they articulate. At best, they can only check abuses of power until moral pressure is mobilized; and their check must become ineffective if often overtly used."⁸

There can be no doubt, for example, that the success of the U.S. Constitution derived from the fact that it was the product of intense and widespread public concern for individual liberty. The 55 delegates to the constitutional convention who met in Philadelphia during the summer of 1787 were not operating from a clean slate. For at least two decades interest in securing liberty had been elevated to an obsession among the American people. According to a colonist writing in 1768, "Never was there a People whom it more immediately concerned to search into the Nature and Extent of their Rights and Privileges than it does the People of America at this Day."⁹

Edmund Burke noted before the House of Commons in 1775 that the colonists' intensive study of law and politics had made them acutely inquisitive and sensitive about their liberties.¹⁰ An outpouring of writing, taking the form of everything from political tracts by the unlettered to celebrated contributions to political philosophy by the intellectual luminaries of the day, were manifestations of the public concerns that found expression in the U.S. Constitution. The protection of liberty was the pre-eminent concern, a concern that saw gov-

⁸Henry C. Simons, *Economic Policy for a Free Society* (Chicago: University of Chicago Press, 19513, p. 20.

⁹Quoted in Clinton Rossiter, *Seedtime of the Republic: The Origin of the American Tradition of Political Liberty* (New York: Harcourt, Brace, and World, Inc., 19533, p. 362.

¹⁰See Gordon S. Wood, *The Creation of the American Republic. 1776-1787* (Chapel Hill: The University of North Carolina Press. 19693. pp. 4-5.

ernment power as a necessary evil and discretionary government power as an unmitigated evil.

There is no way of shifting to a constitution the responsibility for protecting individual liberty against the abuse of government power. Liberty will not long survive the absence of effective constitutional limits on government, but constitutional limits on government will not long remain effective in the absence of public approval of those limits.

Individual Responsibility and Political Restraint

Public approval of constitutional limits that make liberty possible depends ultimately on individuals accepting responsibility for the consequences of exercising that liberty. Responsibility has no meaning in the absence of individual liberty, but liberty has no future in the absence of individual responsibility. In the words of Hayek, "A free society will not function or maintain itself unless its members regard it as right that each individual occupy the position that results from his action and accept it as due to his own action."¹¹

This sense of individual responsibility is not easily maintained. As Hayek also points out, liberty "can offer to the individual only chances and...the outcome of his efforts will depend on innumerable accidents..."¹² When an individual suffers a setback it is always possible for him to find plausible reasons for absolving himself of responsibility. The temptation is strong to petition government for relief through exemptions from the rules of the game that apply to everyone else. The individual may recognize that if such exemptions were generalized everyone would be worse off, but still feel sincerely that in his particular case special treatment is fully justified.

When politicians begin exceeding their constitutional authority in order to provide special assistance to the few, they soon find it impossible to avoid providing special assistance to the many. The sense of individual responsibility that is the only effective bulwark against the abuse of government power will quickly break down in the face of that abuse. Few people retain a strong sense of responsibility for their actions when those around them are seeking to avoid this responsibility through political influence. The destructive dynamic here is clear. An expanding government weakens the sense of individual responsibility, and results in more demands on government and yet further government expansion. And, by increasing the opportunities for people to benefit at the expense of others, an expanding government weakens the rule of private property and thus undermines the accountability upon which individual liberty depends.

There is every reason for concern that the size of government in the western democracies has reached the point of posing a threat to the long tradition of liberty that has made these democracies beacons of hope throughout the world.

¹¹Hayek, *op. cit.*, p. 71.

¹²Hayek, *op. cit.*, p. 71. While acknowledging here the obvious fact that no one can be in complete control of the outcomes that affect him. Hayek continues with the observation that when an individual has to accept responsibility for those outcomes. "it forcefully directs his attention to those circumstances that he can control as if they were the only ones that mattered".

Underlying this development is a fundamental shift in the way the public views government. Rather than seeing government power as a threat that is socially beneficent only when tightly circumscribed, discretionary government power in pursuit of particular ends is now widely seen as the primary force for social progress.

The surface consequences of this shift in responsibility from the individual to the state are clear enough. Expanding budgets and chronic deficits have become ubiquitous features of the modern welfare state, and have raised concern that this fiscal irresponsibility creates the potential for economic adversity. The most troubling thing about chronic budget deficits, however, is not their adverse economic consequences, but the fact that they reflect our inability to exercise political restraint. There is much discussion of the financial burdens our lack of fiscal responsibility is imposing on future generations. But our lack of fiscal responsibility derives from a general lack of political restraint that portends a far greater burden on the yet unborn than the obligation to pay our debts. That burden is the loss of the liberty that we enjoy today because of the political restraint exercised by our ancestors, but which cannot long survive our political intemperance.

Conclusion

Liberty is possible only when adherence to general rules of conduct makes the regimentation of detailed directives and restrictions unnecessary for the maintenance of social order. Liberty can never be license since the unrestrained use of liberty quickly and surely renders inoperative the general rules upon which it is based. The ideal setting for liberty is one in which individuals have internalized an ethic of responsibility and restraint that motivates voluntary compliance with society's general rules. It is because this ideal can never be fully realized, however, that government is granted the power to force compliance on those who would, in the absence of external restraint, threaten the general liberty by abusing their own liberty. Government power is necessary if liberty is to be prevented from cannibalizing itself.

Government power may be necessary to maintain liberty, but it is not sufficient. The ability of government to enforce impartially general rules can be sabotaged by the same lack of individual responsibility and restraint that makes government necessary in the first place. The ability of government to enforce impartially general rules will be sabotaged if the lack of responsibility and restraint reaches the point where government becomes the dominant source of discipline in society. The more necessary government is to the maintenance of the general rules upon which liberty depends, the more insufficient to this task it is sure to be.

There is no avoiding the fact that liberty will perish if the exercise of liberty is not tempered by an ethic of individual responsibility. The affirmation of this fact is the ethical responsibility of those of us who cherish liberty and understand the fragile foundation upon which it stands.

Governments and Markets

The Problems of Halting Economic Growth

April 1, 1976

Dwight R. Lee and Robert F. McNown

Economic growth is no longer a universally accepted goal of economic policy. To be sure there are still plenty of defenders of economic growth, but it has become increasingly fashionable to criticize continued growth as undesirable and unsustainable. The debate surrounding this issue has centered almost entirely on the question of whether our resource base is adequate to support the demands of a growing economy. Without going into detail here, it is our judgment that historical evidence and economic analysis require that this question be answered with a resounding affirmative.

The purpose of this paper, however, is to address an important aspect of the growth versus no-growth debate that has been largely neglected. There has been little discussion of the problems that would be encountered in actually formulating and implementing a policy of zero economic growth. Despite the importance of these problems in assessing the desirability of the no-growth position, they have been brushed aside by those pushing for a halt to economic growth. According to E. J. Mishan, one of the most articulate advocates of zero economic growth (in his words, a steady-state economy):

The actual means whereby a steady-state economy is to be brought into being — the rationing of raw materials, the controls on technology, etc. — and the level of affluence to be sought are important subjects of discussion. But in the existing state of social awareness, they are perhaps premature. . . . The aim of the ecologist and environmentalist is not a no-growth economy per se. It is to win acceptance by the public at large of a no-growth society.

Why Does Growth Occur?

One may also say it is premature to feel an urgency to convince the public of the desirability of a proposal until it has been fully thought through. Certainly a consideration of the implementation and functioning of a zero-growth economy is crucial in assessing the overall desirability of such an economy.

In considering the question of how growth in the economy is to be halted, it is wise to ask why economic growth occurs in the first place. The motivating force behind our economic growth has always been the desire of individuals to improve the economic well-being of themselves and their offspring. Government policy can help by creating a stable political environment, protecting property rights, and not destabilizing the economy with inappropriate monetary and fiscal policy. But without individuals seeking to improve their lot by working, innovating, saving, and investing, economic growth would not take place. This means that achieving a no-growth society would require denying people many of the opportunities and freedoms they now have to improve their situation. The question of how this is to be accomplished poses problems that are crucial in assessing the merits and liabilities of a no-growth economy.

Certain attributes are desirable in any economy, whether growing or not. One of the most important of these is that our resources be used as efficiently as possible to produce those goods and services most valued by consumers. Certainly this has to be considered an important attribute to those who feel that a dwindling resource base makes halting economic growth an imperative. Stopping economic growth clearly shouldn't mean halting technological improvements that allow a given set of consumer desires to be satisfied with reduced demands on our resources. If a no-growth policy restricted this technological growth, it would frustrate the mechanism that has provided us with a growing usable resource base in the past and can continue to do so in the future. And as we are about to see, the implementation of a no-growth policy is very likely to hamper technological advances. In so doing, such a policy would probably hasten the very problems its advocates claim it will postpone.

Market Allocation

In a market economy the efficient use of resources is accomplished primarily by private producers responding to prices of productive inputs and outputs. Output prices provide information on consumer preferences, with the relative price of a good increasing in response to an increase in consumer demand, which in turn motivates producers to increase their production of the good. Prices of productive inputs reflect their value in their most productive employments in the economy. Therefore, with producers responding to these input prices in their attempt to produce as cheaply as possible, the cost of producing commodities is kept to a minimum, with substantial rewards going to those who can innovate more efficient ways of producing. While the market mechanism doesn't always work perfectly, it works better than any other mechanism yet conceived.

But without a large amount of freedom afforded to the individual to spend his money as he desires, and to allocate his productive resources and talents as he sees fit, much of the advantage of the market mechanism is negated. This brings us face to face with the problem of how zero economic growth can be achieved without obstructing the desirable allocation of our resources among competing uses.

How Assure Constant Output?

It may seem quite simple to design an effective policy imposing zero economic growth. The government could pass and enforce a law requiring the value of production to remain constant from year to year. However, some problems come immediately to mind. First of all, what mechanism can the government use to insure that output doesn't increase? One possibility would be to place quotas on the quantity of each good to be produced. If this is done a major problem is that of determining which goods should be produced and in what combination.

As previously discussed, a crucial goal of any economy is that these decisions be made to conform to consumer preferences. These preferences vary widely from individual to individual and change unpredictably through time. It takes an extraordinary amount of information to keep the productive process responsive to these consumer preferences. It is optimistic indeed to hope that any government agency would be able to keep abreast of this information and maintain the desirable production quota system. Optimism would require not only tremendous confidence in the government's ability to keep current on changing preferences, but also great faith in its ability to make decisions independent of political pressures.

Assume, for example, that consumers began to sour on the automobile as the almost exclusive form of personal transportation and that millions of individuals decided that bicycles offered a more desirable alternative. With production decisions being made in response to market forces, we would find a reduction in auto production as auto manufacturers found fewer people willing to buy their product at prices that covered their cost. On the other hand, with increasing numbers of people willing to spend money on bicycles, producers of bicycles would expand output in response to higher profits.

Problems of Control

It's hard to imagine this adjustment occurring so smoothly if the decision of auto versus bicycle production was under the control of a government agency. Under these circumstances automobile manufacturers would find it to their advantage to invest heavily in lobbying against any reduction in their production quotas. They could come up with any number of "justifications" for maintaining high production levels for autos. Of course, bicycle manufacturers could, and probably would, lobby for an increase in their production quotas; but being much smaller and less influential politically, they would have an uphill task getting their quota enlarged at the expense of the automobile quota. The bicycle manufacturers certainly wouldn't get any help from the oil industry or the highway lobby, both of which would take an active interest in the issue. Meanwhile, the consumer, who should be the important decision-maker, will hardly be heard from in the decision-making process.

Extend our example of autos and bicycles to include razor blades, running shorts, motor boats, tennis balls, insect repellent, shoe repair services, dental repair, textbooks, soy beans, and the like, and it is clear that vesting

government with the authority to determine the allowable production of each conceivable good and service would be a frightfully clumsy and wasteful way to halt economic growth.

But there are further difficulties involved in direct government control. Once the quota for a good has been established, decisions as to which producing units are to fill that quota would have to be made. Suppose, for example, that an individual developed a new technique for making sleeping bags, and as a result thought he could give consumers a better bag than was currently available and at a lower price. Operating under the market mechanism, this individual could invest his money in manufacturing and promoting his sleeping bag. If his assessment of his bag wasn't consistent with that of the consumer, he would soon find it advantageous to direct his talents and money elsewhere. On the other hand, if consumers did find his sleeping bag preferable to existing bags, his production and revenue would expand while the production and revenue of his competitors would fall. Eventually our innovator's techniques would be imitated and all producers would be producing better bags for less, much to the consumer's benefit.

The Consumer's Interest

If a government agency rather than the market was responsible for deciding for each product which firms could expand output and correspondingly which firms had to reduce output, it's doubtful if the interests of the consumer would be promoted. For practical purposes it would be impossible for a government agency to have the information on changing productive techniques necessary to know, for each product, which firms should be expanding and which should be contracting. Not having this information, the agency would soon find itself relying on the expertise of the existing firms in each industry in order to make its decision. Each firm in an industry would soon learn that in order to protect or enlarge its market share, it has to appeal to the judgment of the regulatory agency rather than that of the consumer. Technological improvements and product innovations would be found less useful to the aggressive firm than its lobbying activities and influence with the right regulators. Unfortunately, this wouldn't create the type of environment that a new firm with an improved product or lower price will find very hospitable. Well-established firms in the industry could be expected to use their influence to prevent such intruders from ever getting their product to market.

This is more than idle conjecture. We unfortunately have had plenty of experience with government agencies regulating such things as market share and entry in many of our industries. For example, since the Civil Aeronautics Board was established in 1938 to regulate our airline industry, not one new airline has been permitted to enter into long haul competition with the existing airlines.

Another example comes from the Interstate Commerce Commission (ICC), an agency of the federal government charged with regulating interstate ground transportation. In 1961, Southern Railroad had developed a grain-carrying car that allowed them to cut their freight rates on grain by 60 percent and requested

the ICC to permit this reduction. It was estimated that this innovation would save consumers millions of dollars annually. Yet the ICC, in sympathy with barge lines, trucking firms, and other railroads, all of which competed with Southern Railroad, refused to allow the rate reduction Southern requested. It wasn't until 1965, after the case was nine times before lower federal courts and twice before the U.S. Supreme Court, that the ICC quit fighting the rate reduction and allowed it to go into effect. Many other examples could be given indicating the tendency of agencies charged with regulating industries to completely lose sight of the consumer interest. But by now our point should be clear. Attempting to halt economic growth by controlling the permitted output for each good and service would be inconsistent with the goal of using our resources as efficiently as possible to produce a combination of goods and services compatible with the preferences of consumers. The cost of halting economic growth in this way would be so high that only the most enthusiastic no-growth advocate would find it acceptable.

Let Consumers Choose, But Limit Total Income

Having a government agency decide on the combination of goods and services to be produced, isn't the only way zero economic growth could be imposed. Another possibility is to let consumers spend their incomes as they see fit, but limit the total income that can be earned in the economy. This would seem to have the advantage of allowing consumers to decide what should be produced and encouraging producers to be innovative and efficient with their use of resources. But, of course, we now have the problem of controlling incomes. And, unfortunately, for this approach, there is a strong relationship between how consumers exercise their preferences for goods and services and how individuals earn their incomes.

People earn their incomes by responding to the desires of consumers, producing and perfecting those things on which consumers are most anxious to spend their money. As we have already pointed out, this provides the incentive for producers to use resources efficiently and creatively in order to provide consumers with better products at lower prices. But people get rich doing this, and in so doing they invariably enrich countless others by creating highly productive jobs and permitting consumers to obtain more with less effort.

So any attempt at controlling the incomes consumers have to spend will require strict controls or strong disincentives against creative responses to the wishes of consumers. This doesn't necessarily mean that the government would have to apply direct restrictions on innovative behavior. A high enough tax on profits or investment returns could sufficiently discourage investment in capital and technological improvements to be consistent with a no-growth economy. But whatever the means, only by discouraging producers from responding to the consumers' desire for better products at less cost will it be possible to prevent incomes from increasing.

It's hard to see, therefore, where this approach to controlling economic growth has eliminated the disadvantage of direct controls on output. Both approaches will have the effect of insulating the actions of producers from the

desires of consumers.

Reducing Income Mobility

Attempting to control incomes and dampen investment presents another, but related, problem. The necessity of controlling innovative responses to consumer preferences means controlling one of the most important sources of income mobility in the economy. Despite much ridicule of the Horatio Alger “myth” the evidence indicates a substantial amount of income mobility in the U.S. from one generation to the next. There are plenty of opportunities for the ambitious and capable individual to become wealthy even though born into poverty. Likewise, being born into wealth is no guarantee that an individual can remain both indolent and affluent for long. The primary source of this mobility is that those who are productive are rewarded while those who are unproductive aren't. Attempts to control income would surely reduce income mobility in our society by hampering the mechanism that produces it. Restricting people's ability to develop more productive techniques or train for more productive employment would restrict the means by which individuals have been able to improve their economic situation. It also restricts the competition that forces those who have achieved economic success to either remain responsive to consumer desires or move down the economic ladder. With perhaps a little cynicism, we note that no-growth advocates are seldom positioned in the bottom half of the income distribution. Designing and enforcing a policy to halt economic growth would be a difficult task. If such a policy were actually imposed, many of the consequences would be unfortunate. It would reduce the influence that consumers have on the choice of what is to be produced. Coupled with that is the stifling influence the implementation of such a policy would have on motivations to produce efficiently and creatively. We would also find a more regimented society, with far less chance for the relatively disadvantaged in society to improve their situation through ingenuity and hard work. The likely consequence of this calcification of society would be disruptive social unrest or the emergence of a caste system in which people knew their place and accepted it.

If the advocates of eliminating economic growth feel we are faced with an imperative, they had better come to grips with the serious problem of implementing their proposals. It is our judgment, however, that they have first failed to establish the imperative for a no-growth policy, and secondly, have no positive proposals on how such an economy could be implemented without unfortunate consequences.

Labor Unions Aggravate Inflation by Lowering Wages

April 1, 1981

It is commonly believed that labor unions generate inflation by increasing the wages of workers. This is not the case. Labor union activities do aggravate inflation, but they do it by reducing the real wages received by workers, not by increasing them. An understanding of why this is true requires, first of all, a brief explanation of the cause of inflation.

We are currently experiencing inflation for the same reason that any economy, at any time, has ever experienced inflation: the money supply has been growing more rapidly than the growth in production. Assume, for example, that the production of goods remained the same but the number of dollars we have to spend on these goods doubled. We would all be willing to spend approximately twice as much on each good as before. But this means that the price of goods would also double, as would the general price level. Increase the growth in the money supply and reduce the growth in productivity and inflation will result.

Since monetary growth is subject to much larger changes than productivity growth, it is a rapidly growing money supply that explains most of our inflation. It is the federal government that controls the money supply, so the major blame for inflation can be placed on government activity. Labor unions aggravate inflation however, by engaging in practices which impair economic productivity.

It is only by imposing restrictions on the economy which reduce productivity that a union can provide an economic benefit to its members. In a free and open labor market a worker will be able to receive a wage that reflects his productivity and which is no higher than what comparably skilled workers are receiving elsewhere in the economy. A higher wage would attract additional workers thus driving the wage back down to the competitive level. Of course, this competitive process increases the productivity of the economy by directing workers into those employments where their contribution is greatest. And it is productivity that has increased over time in response to the incentives and direction provided by competitive markets that, at least until recently, made U. S. workers the best paid in the world.

But union leaders cannot attract dues-paying members by getting them a wage rate that they could earn without a union. And the only way unions can provide their members with higher than competitive wages in some occupations is to restrict the competition from nonunion workers. While this may increase union wages in the short run, it does so at the expense of lower wages for other workers. Higher union wages and prices in one sector of the economy are effectively offset by lower wages and prices elsewhere in the economy.

In order to realize this relative wage advantage for its members, organized labor has consistently fought for legislation which reduces, if not eliminates, the opportunity for nonunion workers to secure jobs that would otherwise be available to them. Organized labor's struggle for the closed shop (only union members can be employed) and their bitter opposition to state right-to-work laws (which eliminate union membership as a requirement for employment) are clear examples of union attempts to protect their workers against competition. Other examples are union efforts to restrict imports and obtain legislation restricting the movement of large employers from the unionized NorthEast to the less unionized Sun Belt states.

Competition Reduced

To the extent that organized labor has been successful in these restrictive activities, the economic competition and mobility that is a major source of increased productivity has been reduced. And strong evidence of the success of unions in protecting their members against productive competition is seen in the featherbedding practices they are able to impose, practices which could never survive open competition. Unions have long inflicted costly featherbedding practices on the railroads, with the requirement that firemen remain on diesel locomotives being a well-known example. The building, theatrical and oceanshipping industries, as well as many others, also suffer from union featherbedding requirements.

A typical example is that of a construction job which required the use of several very small gas-powered generators. Because of union requirements, each generator had to be attended by an operating engineer, an electrician, and a pipefitter. The engineer had to start the engine a few times each day, the electrician pushed wire plugs in the generator's sockets if they were moved, and the pipefitter was there, "just in case." Obviously, such practices further the negative effect organized labor has on our economy's productivity.

It is this impact on productivity that explains why the overall effect of organized labor is to reduce real wages. Productivity is the source of all income, including wages. Real wages depend on the wage earner's ability to buy goods and services. It cannot be purchased unless it is first produced. Furthermore, for a given rate of monetary growth, the lower our productivity the higher the inflation rate. So unions have an inflationary impact by reducing productivity and thus lowering, not raising, the general level of real wages.

Market Efficiency Hampered

The best way to increase productivity, improve the living standard of all workers, and help retard inflation is to allow competition in free and open markets. Unfortunately we can expect little support in this direction from organized labor. Union leaders cannot tolerate the efficiency of competitive markets because what they have to offer their members comes from their ability to reduce the free market opportunities of others.

The very existence of organized labor depends on its ability to use its political influence to sabotage the efficiency of the free enterprise system. If allowed to operate freely, the market process would simply circumvent union efforts to impose inefficiencies on the economy. This would leave union leaders with little to justify their healthy incomes, but also with little ability to undermine productivity, aggravate inflation and thereby reduce, in the long run, the real incomes of us all, union and nonunion workers alike.

Controlling Inflation by Controlling Government

June 1, 1981

Inflation has become such a chronic problem that many people now believe no one knows what causes it or how to eliminate it. In fact, the cause of inflation has been known for centuries, and it is very simple to eliminate. Inflation is a persistent increase in the prices of the products we buy and is always the result of the money supply increasing more rapidly than the output of these products. With a rapid increase in the money supply, inflation is inevitable. Without a rapid increase in the money supply, inflation is impossible. The federal government can eliminate inflation simply by bringing monetary growth under control.

But if this is true, why has not the government eliminated inflation long ago? Politicians have consistently told us that inflation is our major economic problem and have unveiled a series of plans for solving this problem. These plans all have one thing in common. They have not worked. Inflation has gotten worse, not better. We are left with the suspicion that the government has not been serious in its fight against inflation.

Additional support for this suspicion comes from the fact that creating more money, and therefore causing inflation, is a convenient way for the government to obtain more of the wealth that you and I produce. The way this wealth transfer occurs is in all important respects identical to the way an individual in a position to personally increase the money supply could increase his wealth at the expense of others.

An Easy Way to Make Money

Consider the situation in which you have the legal right to print money and put it into circulation by spending it. Every evening you can start up your printing press and run off stacks of 20s, 50s, 100s, and 1,000s for the next day's purchases. The desire to maintain productive employment will vanish as your job provides only a pittance of what you can, in a few moments, make at home. Also, you will find that the demanding task of spending your money is a

full-time job. Overnight you will have become enormously wealthy. But notice that the total wealth produced in the economy is not any larger than it was before. In fact it is slightly less since, having quit your job, you are producing less than before. So your increased wealth means a reduction in the wealth of others. The additional goods and services you are buying are not available for others to buy.

But even though you are making others worse off by creating money and spending it, you need not worry about being blamed for this. To the contrary, you will surely be sought after and held in high esteem as one, who is contributing to the wealth of the community. Your large expenditures will be a very visible source of income for those selling you yachts, resort homes, jet planes, and lavish vacations. Those who are on the receiving end of your purchases will be encouraging you to increase, not reduce, the amount of money you print and spend. And with these people now having additional money, they will be able to spend more, thus providing more income for others. Because of you, everyone will have more money.

But it is because of this additional money that others are being made worse off. With the additional money being spent, but with no more products to spend it on, prices will increase. Even with more money the inflation will reduce the amount others can buy. Since you are buying more, others have to be buying less. But even though you are causing the inflation you can be confident that your victims will place the blame elsewhere. People will blame higher prices on those who are selling the higher priced products. It is ironic that it is those who are helping to hold down increasing prices by continuing to make products available who are most likely to be blamed for inflation.

Adding to the irony is that many of those you are impoverishing with inflation will urge you to increase your purchases; particularly your purchases from them. Your ability to increase the money in circulation will be seen as the way to compensate for higher prices. And you will probably be sympathetic with this "solution," having noticed how much less a couple of billion dollars buys now in comparison with how much it would buy when you first started printing money. What could be more appropriate than increasing the amount of money you print each evening?

Can the Temptation Be Resisted?

How many of us, finding ourself with the ability to legally increase the money supply, would be able to restrain our desire for more? The opportunity to make ourself and our family wealthy, while being honored as a great benefactor of the community, would be a difficult one for most of us to resist. And if you or I could not resist such a temptation, can we expect more restraint from those in government? The answer is surely no. The only difference between you and me as individuals, and government, is that the federal government really is in a position to acquire wealth by expanding the money supply. It is clear that this is an opportunity the government has not been able to resist. Those who benefit from a growing government sector have pushed consistently and effectively for public policies that generate inflation and reduce our wealth. The

problem is not that the government does not know how to eliminate inflation. The problem is that the government has not wanted to eliminate inflation.

We are currently witnessing an attempt to control the inflationary policies that have become the hallmark of Washington over the last several decades. This heroic effort deserves and needs our unflagging support. It is an effort which will be stoutly resisted by one politically influential interest group after another, each hoping to benefit from more inflationary government spending. They will argue that inflation requires that the federal government increase their price support program, increase their agency's budget, increase aid to their city, increase welfare payments, etc. Each group will argue that the government spending they favor will provide benefits for all. In fact each expansion in government spending will add to inflationary pressure, transfer wealth to a few, and reduce the economy's capacity to generate more wealth for us all.

But the natural tendency of government is to give in to the special interest groups. In fact the special interests are hard to distinguish from government interest. Those in government have found that the safest way to expand and perpetuate their power, control, and wealth is to provide concentrated benefits to politically organized groups while spreading most of the cost over us all with inflation. The only way to stop this destructive process is to restrain government.

The hope has been to vote for politicians who are sympathetic to the need for controlling government. In other words, vote for a government that will restrain itself. But as important as it is to elect responsible representatives at all levels of government, we cannot depend on this alone to do the job. Our elected representatives answer to the voters only periodically, but they are under constant pressure from entrenched special interests pushing for more government spending. When appealing for votes almost all politicians argue for limited government, but how many remain true to their campaign promises once the election is over? And we have almost no control over those in the bureaucracy, and the special interest groups with which the bureaucrats identify.

Restraining Government

The time has long since arrived for us to re-establish effective constitutional limits on the scope of government activity. Our founding fathers knew that government could not be trusted to limit itself, and our Constitution is testimony to their profound insight. Unfortunately, the limits the Constitution imposed on government for over 100 years have, in recent decades, been severely eroded by judicial interpretations guided by the false notion that wide-ranging governmental discretion is a force for social good. Few are naive enough to believe that an individual, given the ability to confiscate the wealth of others, would be blind to personal advantage and trustworthy to use this ability to promote only the public interest. Yet the "sophisticated" view of many of our intellectual elite is that the collection of individuals who comprise government can be trusted with enormous, and unrestrained, power to promote the public interest.

Despite the wishful thinking that often passes as scholarship, there is a

desperate need for the enforcement of clear constitutional limits on the federal government's ability to create and spend money. Without such limits we can be sure that an undisciplined federal government will continue inflating the currency and expanding its wealth at the further expense of the productive sector of the economy. We may want to debate the form the restraint should take: a return to the gold standard, a balanced budget amendment, a limit on government spending, or some combination of these and other restraints. But only the most naive would argue that we can continue to trust the government to restrain itself.

Patience and Property: Corporate vs. Union Management

August 1, 1990

Dwight R. Lee and Robert L. Sexton

"Managers who anticipate a short tenure with their firm unsurprisingly have little interest in long-term solutions to its basic problems. Their goal is to look as good as possible in the immediate future."

— *Robert Reich, The Next American Frontier*

It is a commonly held belief that corporations, in pursuit of short-term profits, shortchange the future. This alleged emphasis on the short run is seen to create a host of problems such as an eroding industrial and human capital base, a productivity crisis, a lack of competitiveness in world markets, the energy crisis in the 1970s, mounting levels of corporate debt, and environmental pollution. The solution advocated by Robert Reich and others is to substitute more control by representative government and labor. However, this would be a terrible mistake.

Property Rights and Incentives

Individual decision makers, whether acting as managers, union leaders, politicians, or workers, will appropriately weight the future when it is in their interests to do so. This is the reason why private property ownership is critical to efficient, future-oriented economic decisions. If property rights are well-defined and enforced, then current owners will benefit from any foreseeable increase in the future value of resources they control. And, if private ownership rights are transferable, this will provide the incentive for individuals to concern themselves with outcomes that extend far into the future.

With corporations, transferable property rights exist in the form of shares of stocks. Since corporate stocks are easily transferable, any management decision that is considered to inhibit a corporations long-run wealth position will be translated quickly into lower stock prices. On the margin, it only takes

a few to recognize the short-sighted business policies of management. Once this mismanagement is translated into lower stock prices, even relatively uninformed shareholders will notice and understand that it may be time to call their broker. Thus, transferable property rights in the form of stock reflect the future consequences of corporate decisions.

However, unions do not have the equivalent property rights, and that is why the long-run wealth effects of present decisions are not clearly registered in a way that feeds back into unions decisions. This leads to several important implications. One, without transferable property rights (which reflect the present value of employment opportunities in a firm or industry) the control of union members over union management is restricted. To some extent, union members have control over union management through their right to vote on some issues and on their union leaders. Therefore, members can restrict union management from deviating too far from the collective interests of the members. However, any union-member voter has little motivation to be informed since a single vote will not likely have a decisive impact on any decision, and each worker's time horizon extends only as long as his employment tenure.

This is not the case with corporate stockholders. They have much more control over their agents than union members have over theirs. The stockholder has the ability to buy and sell stocks. In order for union members to protect themselves in an equally effective way against poor union management decisions, they would have to change jobs and move to an employment setting with either a different union or no union at all. Hence, union leaders have a greater ability to maximize their personal goals and advantages and promote their own agenda than corporate managers, since union members have little or no effective recourse. In other words, unlike the market for corporate control, the market for union control is very ineffective.

Consequently, union decisions on many issues do not correspond with the interests of the members. The position unions take is often at odds with the political preferences of their members. Professors Dan Heldman and Deborah Knight found that in a majority of questions posed to union members in opinion polls, their positions differed (sometime diametrically) from the positions which their union leaders were lobbying in Congress.

But, even if unions were perfectly responsive to the concerns of union members, they would still tend to be insensitive to future wage and salary decisions. Since workers don't own transferable "employment stock" that reflects the long-run value of their jobs, they have little incentive to take the long view when balancing current wage demands against the long-run gains from maintaining and expanding a productive capital base. But owning employment stocks would require that workers own their jobs with the right to sell them to whomever they please. This would remove the control over employment decisions from those who have supplied the capital and hence would greatly increase the costs of raising large amounts of capital.

However, when workers are in charge of management decisions, this often leads to myopic investment practices. For example, in worker-managed firms in Yugoslavia, employees are entitled to residual profits, but claims are retained

only if the worker remains with the firm. So, it is in the workers' best long-term interests to take their higher wages out of the firm in order to invest in items which have a permanent title (for example, furniture or jewelry) rather than investing in the long-term capital needs of the firm. This is true even when the returns on capital far exceed those of alternative investment opportunities.

Under reasonable property rights arrangements, workers will be less sensitive to the long-term employment effects of current salary, wage, and investment decisions than will corporate managers whose current compensation and future prospects are directly tied to the performance of the firms they manage, as reflected in stock prices. It is current compensation that is often used as a monitor of union effectiveness. And union leaders who cannot extract current wages and benefits from employers will fall under the wrath of their members.

Political Influence of Organized Labor

Unions have been adept at influencing the political process in support of legislation that increases their control over business decisions. There are two explanations for their political influence. One, members of labor unions are intensely concerned about short-run wages and fringe benefits. Such narrowly focused groups are more easily organized and generally are more politically effective than are groups with more diverse interests. Two, political action is best when an organized self-interest is able to disguise itself with the rhetoric of a noble cause. This is particularly evident in labor unions that work under the guise of struggling for the well-being of workers. But higher wages in the union sector tend to depress wages in the nonunion sector, so it is easy to see that union workers' gains come at the expense of nonunion workers. Thus the real battle that unions wage is not against business but rather against nonunion workers, who often would be willing to work for less than the union scale.

Unions have effectively been able to project the image, however, that they are dedicated to the protection of workers' rights against the arbitrary so-called power of big business. Union-supported legislation that restricts the discretion of capital owners or corporate management is often politically popular because it is perceived as a justifiable means of curtailing exploitative business practices. This may explain the political appeal of minimum wage laws, ' hour restrictions, and other legislation that limits the ability of employers to negotiate with employees.

Unions also have been active in support of political measure to restrict corporate practices that serve to motivate corporate managers to concentrate on the long run. For example, takeovers, mergers, stock options, and bonuses provide important incentives for management to consider the future consequences of current decisions. Another example is a corporate arrangement call "golden parachutes" where corporate executives are compensated if their jobs are terminated as a result of a takeover or merger. It is argues that this type of arrangement provides incentives for corporate executives to take risks in line with what their diversified shareholders would consider appropriate and not to fight takeovers that would be in the shareholders' interests.

Union myopia will affect future productivity in at least two ways. First, in

anticipation of a union's negative impact on the return to capital, one would predict that the projected equity value of a newly unionized firm, or one threatened with unionization, will fall. Second, in those industries in which union power is strongest, one would expect that wage demands eventually will reduce the industry's competitiveness and, in the absence of government bailouts and protections, push it into serious decline.

The filing of a union election petition and the results of that action can impose significant costs on a firm. Based on data from 1962 to 1980, a successful union drive against a firm lowered the firm's stock by 3.84 percent. According to Professors Richard Ruback and Martin Zimmerman, even the threat of unionization in the form of an unsuccessful union effort resulted in a 1.32 percent decline in the firm's stock price.

The reduction in returns to current and potential investors reduces an industry's investment appeal. Hence, capital formation will be retarded by the effects of unionization. Also, lower profitability in union firms will hamper the internal market for capital, a very important source of efficiency within firms.

One way to reduce the burden of union wage demands is by substituting capital for labor. And, indeed, one can be sure that the ratio of capital to labor will, over time, increase in response to excessive wage requirements. Whether this substitution will motivate an absolute increase in the amount of capital isn't clear a priori. But, even if the amount of capital in the industry actually increases, it will be the result of a union-induced distortion in the capital labor mix that will reduce both the efficiency of the industry and its ability to compete.

The union myopia that motivates excessive wage demand has been detrimental to the long-run well being of all interests in the economy — consumers, providers of capital, and employees alike. But this economically destructive shortsightedness is the completely predictable consequence of political action that increases the power of unions over business decisions and over the allocation of business profits. Political attempts to rescue unions from the plight in which they find themselves — attempts which ordinarily involve granting them yet more power and imposing still more restrictions on business decisions — will prove just as self-defeating in the long run as have previous attempts.

Labor unions already have given worker representatives more control over business decisions than most people realize. This control has hampered the ability of business management to pursue long-run goals through far-sighted and productive investment commitments. Private business concerns may not give the future the weight that, in some ideal world, would be considered appropriate. But a realistic assessment of the motivations driving labor union activity leads to the unmistakable conclusion that giving more control over business decisions to labor unions will shorten the planning horizon of business firms.

As long as owners and managers of private businesses are free to allocate revenues among shareholders, employees, and capital investment in response to market forces, decisions will be made that promote capital formation and lead to long-run economic growth. Unfortunately, government regulation of labor

relations has increasingly diminished businesses' (and therefore consumers') control over decisions relevant to capital investment, and passed that control to union officials. As a result, government has shortened the planning horizon of business decisions, allowed excessive wages to be substituted for capital formation, and reduced the long-run competitive vitality of major sectors of the U.S. economy.

Politics, Economics, and the Destructiveness of Deficits

January 1, 1991

Are chronic budget deficits a threat to the economy? The general public believes that budget deficits are something to fear, but economists are not so sure, and Congress doesn't seem to care.

It is difficult to argue that either Congress or economists are wrong, given their respective concerns, even though the public is justified in its worry over the economic consequences of persistent Federal deficits. The public's concern is real, but it's an unfocused background concern that fails to translate into significant political pressure. So why should the concern over deficits by members of Congress go beyond rhetoric when they can spend the Federal budget into one large deficit after another and still look forward to re-election rates in excess of 98 percent?

Economists don't have to worry about being reelected, but they are worried about making obviously foolish predictions, and they have noticed that the huge budget deficits of the 1980s have precipitated none of the adverse consequences predicted by deficit doomsdayers. Economists are concerned with explaining the effect of budget deficits on such economic variables as interest rates, inflation, and the savings rate. These variables have not responded to large deficits as predicted by standard macro-economic models, and economists have been busy developing alternative models explaining why they haven't. A major conclusion of these models is that budget deficits are almost completely neutral in their effect on the economy. An increasing number of economists have concluded that deficits have little effect, either positive or negative, on the economy, and see public concern over deficit spending as unfounded.

While economic analysis can provide useful insights, it is always risky to dismiss the concerns of the public. The public may not have a sophisticated understanding of economic analysis, but this is not necessarily a liability. Sophistication in the analysis of narrow economic relationships can divert attention from broader features of the political economy that are more relevant to our economic prospects. In particular, budget deficits may reflect flaws in the

political decision-making process that are a threat to economic performance quite apart from any direct economic impact of the deficits themselves.

In this essay we discuss briefly the argument that budget deficits are unlikely to have the adverse economic effects commonly attributed to them. It is pointed out, however, that the theoretical basis for the view that deficits are benign is hard to reconcile with the undeniable fiscal impulses of politicians. And given these impulses, the greater the political latitude to rely on deficit financing the greater will be the level of government spending. Even if deficits do not, for example, noticeably crowd out investment directly through interest-rate increases, the political opportunity afforded by deficit spending can facilitate the expansion of public sector activity, which necessarily crowds out private sector activity. The consequences of substituting the less productive public sector for the more productive private sector may not register immediately in statistical measures of key economic variables. But the long-run economic consequences of such a substitution are no less destructive because they go unnoticed by econometric studies and the myopic political process.

Do Deficits Matter?

What is the effect on the economy of an increase in deficit spending? The best known answer to this question is given by the standard Keynesian model which predicts that increasing the deficit will increase aggregate consumption demand, thereby reducing the total savings in the economy and increasing the real interest rate. With a higher interest rate there will be a reduction in investment, and the deficit spending will have crowded out some productive capital.

Harvard economist Robert Barro has attacked the standard Keynesian view by arguing that, under what he believes are plausible conditions, it makes no difference whether government spending is financed by taxing or by borrowing.¹ The argument begins with a proposition that dates back to the early 19th century, when it was put forth by the English economist David Ricardo. Ricardo argued that if government financed, for example, an additional \$100 of spending by borrowing, then, instead of being responsible for \$100 in tax payments immediately, taxpayers would be responsible for \$100 plus accumulated interest at a later date. But the present value of the \$100 plus interest later is equal to \$100 now, so the taxpayer who expects to be paying taxes later will find deficit financing no less costly than tax financing. The taxpayer will be indifferent as to whether borrowing or taxing is used to finance government spending.

If borrowing versus taxing is a matter of indifference to taxpayers, then it is also a matter of indifference as far as important economic variables such as the interest rate and investment are concerned. Assume that government increases the budget deficit by reducing taxes without reducing spending. Taxpayers will recognize that even though they experienced an increase in current disposable

¹Robert J. Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy*, Vol. 81 (1974), pp. 1095-1117.

income, they have also experienced an equivalent increase in the present value of their future tax obligations. Because they are no better or worse off, there is no reason for them to increase current consumption and so the entire tax reduction will be saved. Consumption and saving therefore will not be affected by the increased deficit; both private and public consumption remain the same, and the increased public debt will be exactly offset by increased private saving. This being the case, increasing the deficit, with government spending held constant, will not reduce long-run economic productivity by exerting upward pressure on the interest rate and crowding out private investment.

Of course, as recognized by both Ricardo and Barro, complete indifference between taxation and government debt requires that everyone alive when government increases its debt be responsible for all of the future tax increases that servicing the debt requires. But many people realize that they will no longer be alive when the future taxes required by current deficit spending come due. Why won't these people treat the deficit as a real reduction in their tax burden (with a corresponding increase in the tax burden of future generations), and respond by saving less and spending more?

Barro confronts this question by arguing that most people will be reluctant to increase their consumption when debt is substituted for current taxation even if they know that they will not be alive to pay the higher future taxes required by the debt. According to Barro, this reluctance is based on the obvious fact that people are concerned with the well-being of their children beyond their own lifetimes. This concern is reflected in the investment parents make during their lifetimes in their children's human capital and the bequests they make to their children. Given this bequest motive, Barro argues that parents will recognize that substituting debt for taxes in the financing of government expenditures will reduce the well-being of their offspring by increasing their future taxes. In other words, parents will realize that the value of the taxes they will avoid because of increased reliance on deficit financing will represent a reduction in the value of their bequest to their offspring. The natural response to this is for parents to increase their bequests, and therefore their saving, by an amount equal to the tax burden that is passed from them to their children because of the increased deficit. The substitution of debt for taxation therefore leaves total saving in the economy unchanged with no crowding out of private investment and no reduction in the long-run productivity of the economy.

Barro recognizes that bequest adjustments will not offset completely the effects of deficit spending, but he argues that these adjustments are more complete than most people would expect. But Barro ultimately rests his case on what he sees as empirical support for the economic neutrality of deficit spending, with this support consisting of sophisticated econometric studies that find little connection between budget deficits and interest rates.

No amount of empirical testing will ever provide conclusive support either for or against the Barro thesis. Aggregate economic data are always of questionable accuracy, and empirical techniques are always less powerful and robust than would be desirable. Fortunately, additional evidence can be brought to bear on the relevance of Barro's proposition to fiscal policy without having to

rely on economic data and sophisticated econometric techniques. This evidence comes from the dearly observed behavior of politicians and it suggests caution in accepting the Barro position. Furthermore, this behavior suggests that we be concerned about budget deficits for reasons not addressed either by Barro or by economists in general.

The Political Cost of Deficits

If the cost to the taxpayer is the same whether government spending is financed through taxes or deficits, then politicians should be indifferent as to the mix of these two means of financing. The evidence is clear that they are not. Why, for example, are politicians so reluctant to respond to the public's general disapproval of large deficits (a disapproval that is hard to square with the idea that debt and taxation have equivalent effects on the well-being of both current and future taxpayers) by simply financing all government expenditures with taxation? The proposition that deficits are economically neutral is simply inconsistent with the obvious reluctance of politicians to reduce deficit spending significantly.

The attractiveness of persistent budget deficits to politicians suggests strongly that current taxpayers do not believe that the future taxes they will have to pay because of additional government debt are as costly to them as the current taxes that the debt replaced. If this is the case, then over some range politicians will find it is less costly politically to finance spending through debt than through taxation. This suggests that the existing combination of debt and taxation prevails because it is the combination that allows existing spending levels to be financed at the least political cost. This being the case, it is clear that politicians will be reluctant to reduce deficit spending unless the political cost of deficit financing is increased. Also clear is that any increase in the public's tolerance of deficit spending will lower the political cost of government spending and, therefore, motivate both larger deficits and greater spending. Can anyone doubt seriously that government spending would increase if increased public tolerance of deficits lowered the political cost of further expanding deficit spending?

There is no obvious direct measure of the marginal political cost of deficits, so it is difficult to imagine a direct test of the proposition that a decrease in that cost will increase government spending. But a testable implication of such a response to a reduction in the marginal political cost of deficit spending is that an increase in the ratio of deficit financing to tax financing will be associated with an increase in government spending as a percentage of the Gross National Product (GNP). The budget experience of the federal government is consistent with this implication. Yearly Federal budget data from 1960 to 1988 show that when the ratio of deficit to non-deficit financing (almost all of which is tax revenue) increased by 1 percent, government spending as a percentage of GNP increased by .087 percent. There can be little doubt that the political cost of deficit financing has been reduced by the political embrace of a simplistic version of Keynesian policy prescriptions, an embrace which began with the 1960 election of John F. Kennedy and lasted, though with reduced enthusiasm,

into the 1980s. There can be even less doubt that the decrease in the political cost of deficit financing, whether caused by Keynesian economics or not, is largely responsible for the increase in the relative size of the federal government since 1960 (from 18.2 percent of GNP in 1960 to 22.3 percent of GNP in 1988).

The Economic Cost of Deficits

The connection between deficit spending and the relative size of government suggests a cost associated with deficits that is easily overlooked by standard investigations of the economic effect of deficits. The expansion in government that is facilitated in a regime of chronic budget deficits reduces economic productivity and growth. To argue that government expansion reduces economic growth is not to deny that over some range government is a source of improved economic performance. A few government activities are necessary to establish an economic order that promotes productive specialization and exchange. But it also has to be recognized that organized interests persistently exert pressure in favor of expanding the scope of government activity beyond productive limits. These interests are often quite successful owing to the fact that the cost of expanding government is typically diffused over a dispersed and unorganized public, which lowers the political cost of this expansion below the social cost. The result is that governments at all levels have expanded well into the range where, at the margin, they are reducing our economic wealth.

Recent cross-national studies of the relationship between the relative size of government (as measured by government expenditures as a percentage of Gross Domestic Product) and economic growth provide a quantitative dimension to the negative marginal impact of government. One such study of 115 countries by economist Gerald Scully found that a 1 percent increase in government expenditures (as a percentage of GNP) reduced average annual economic growth by one-tenth of a percent.¹

Using Scully's estimate of the connection between government size and economic growth and our earlier estimate of the connection between the ratio of deficit spending to taxation and government size, it is possible to make a ballpark estimate of the cost, in terms of forgone GNP, associated with increased deficit spending: If the ratio of deficits to tax revenue doubled from 10 to 20 percent (at the Federal level this ratio averaged about 3 percent during the 1960s, while from 1980 through 1988 it averaged 22.5 percent) then our earlier estimate predicts that government spending as a percentage of GNP will grow by 8.7 percent. This means that if government spending began at 20 percent of GNP it would have increased to 21.74 percent of GNP, which according to Scully's estimate would reduce economic growth by .174 percent. With a GNP in the U.S. of approximately \$5 trillion, this reduction in growth is ap-

¹Gerald W. Scully, "The Size of the State, Economic Growth and the Efficient Utilization of National Resources," *Public Choice*, 63, (1989), pp. 149-64. Scully's findings are supported by similar studies. For example, see Daniel Landau, "Government Expenditures and Economic Growth: A Cross-Country Study," *Southern Economic Journal* (January 1983), pp. 782-92; and Michael L. Marlow, "Private Sector Shrinkage and the Growth of Industrialized Economies," *Public Choice*, 49 (1986), pp. 143-54.

proximately \$8.7 billion per year. This may appear to be a relatively modest amount as government budget numbers go, but with the figure increasing each year with economic growth, and accumulating over time, this deficit-related cost is of genuine significance.

While reasonable people can disagree over the magnitudes involved, it is hard to deny that the easier it is to engage in deficit spending, the lower the political cost of increasing government spending. Equally hard to deny is that the increased spending that will result, other things being equal, transfers resources out of the productive private sector and into the far less productive public sector. The clear conclusion is that there is a cost associated with deficit spending that is not the direct economic result of deficits themselves.

By attempting to determine the direct effects increased deficits have on such economic variables as interest rates and savings, economists have been ignoring what may be far more important consequences of deficit spending. Even if deficits have little direct economic effect, they can still be economically costly. It is not the deficits per se that are the problem, but rather the political environment that is created when politicians face little resistance to relying on deficit financing. The move to such an environment increases the control politicians have over productive resources, reduces the responsibility imposed on them in exercising that control, and, as a consequence, diminishes the productivity of our economy.

Public Interest Is Usually Special Interest

August 1, 1991

Special interest groups have been quick to tap the public till. Of course, they usually aren't so blunt as to demand tax money for their personal benefit. They have found a more effective strategy: obtain government subsidies for their pet project by arguing that it will benefit everyone in the community. Their project, in fact, is something we all "need." It's amazing what a person will "need" when someone else is picking up the tab.

A natural response is: "If your project is so desirable, why do you have to come to the government to get it funded? If everyone needs a good or service so much, why aren't they willing to pay for it?" (In which case some enterprising entrepreneur will gladly supply it.)

Most special-interest advocates have a couple of answers. They argue that most people aren't aware of all the benefits they will receive from the project, or that the project is a public good and deserves support on that basis.

The first answer should persuade very few. If you don't benefit from a private good, it's because you don't care enough to purchase and consume it. Of course, there are always people who feel that you aren't very bright if you don't like the same things they do. But how you spend your money is your concern, not theirs.

If the lobbyist claims public-good status for his or her proposal, at least two questions need to be asked. Does the project convey important benefits to the community at large? Is it impossible to deny these benefits to anyone once the project is completed? Few projects meet these standards. But you would be amazed at the number of projects that are funded at public expense because they are supposedly public goods.

For example, many big cities have built large sports arenas at taxpayer expense. Supporters claim that a sports arena, with the major-league teams that usually go with it, brings recognition and fame and revenue to the city. Furthermore, supporters assert, this will benefit everyone in the city, whether they are sports fans or not, because they will be living in a more prestigious community. And this justifies coercing everyone to pay for it.

Clearly, this is a weak argument. The people who benefit the most from a sports arena are the fans who use it. But it's easy to prevent someone from receiving this benefit if he doesn't buy a ticket. And it isn't true that everyone will benefit. For example, sports arenas create traffic congestion that many find objectionable.

It's probably true that some people who never attend a sporting event may feel a little better just knowing that they can, or knowing that their city makes national news occasionally for something other than a rising crime rate. But does this justify commandeering funds from everyone in the city to build a sports arena? What about fine restaurants? Certainly fine restaurants enhance the reputation of a city. Many people are happy to know that one is nearby, waiting to serve them, whether they visit it or not. But most people would find a proposal to build publicly financed restaurants a little farfetched. If desirable side effects justified government subsidies, then well-kept yards, hair styling, pretty dresses, face lifts, car washes, toothpaste, deodorants, smiles, ice cream parlors, and athlete's-foot medication would all qualify for a handout.

We need to recognize that special interest groups expend a lot of effort to get subsidies for things that they enjoy. The sports arena is only one example. The more "cultured," and usually wealthier, denizens of many cities have managed to obtain government support for symphonies, operas, ballet, and the performing arts in general.

The justification they give is similar to that for subsidizing sports arenas. Supposedly, everyone in a community will benefit, even those who prefer to sit home with a can of beer and watch all-star wrestling on television.

There are many other examples of special interest groups seeking public funds for goods and services that primarily benefit them. Just follow the proposals and requests that come before meetings of locally elected officials. You probably will be surprised at the number of "socially concerned" people who have identified some urgent public "need."

Greed and Gravity

October 1, 1995

People have a tough time discussing self-interest in a morally neutral way. While morally charged arguments about self-interest can be philosophically intriguing, they are usually beside the point. Self-interest, or greed as it is often called, is like gravity: a pervasive force remarkably unaffected by philosophical discussions of right and wrong. When confronted with such a force one should recall the Alcoholics Anonymous prayer, “Lord, give me the courage to change the things that can and ought to be changed, the serenity to accept the things that cannot be changed, and the wisdom to know the difference.” Discussions of self-interest typically reflect little serenity and even less wisdom.

Although self-interest does have its defenders, its detractors are far more numerous and influential. Self-interest is commonly seen as a negative characteristic that people should try to overcome. In this view, self-interest and greed are synonymous, and the world would be a better place if people discarded them as they would bad habits. Some people distinguish between greed (bad) and “enlightened self-interest” (good). But the person who applies the adjective “enlightened” often does so to champion action that he approves and which commonly does more to promote his well-being than that of those urged to take the recommended action.

The defenders of self-interest base their arguments on deeper philosophical insight into human nature, and have made a strong case for narrowly focused self-interest—what most people would refer to as greed. Those who defend narrow self-interest recognize that people are capable of malevolence as well as benevolence when concerning themselves with the interests of others. And given the history of man’s inhumanity to man, malevolence is probably a stronger impulse than benevolence.

In Defense of Commerce

Indeed, the major advantage some eighteenth-century writers saw in the emerging market-based economy was that it motivated people to substitute commer-

cial avarice (or greed) for more disruptive passions, such as the lust for power and conquest. This view was succinctly captured by Samuel Johnson when he observed, "There are few ways in which a man can be more innocently employed than in getting money."¹ In his famous 1748 treatise, *Spirit of the Laws*, the French political philosopher Montesquieu stated: "It is almost a general rule that wherever manners are gentle there is commerce; and wherever there is commerce, manners are gentle."² The Scottish historian William Robertson wrote in 1769, "Commerce tends to wear off those prejudices which maintain distinctions and animosity between nations. It softens and polishes the manners of men."³ More recently, even John Maynard Keynes saw virtue in narrowly focused self-interest:

Dangerous human proclivities can be canalized into comparatively harmless channels by the existence of opportunity for money-making and private wealth, which if they cannot be satisfied in this way, may find their outlet in cruelty, the reckless pursuit of personal power and authority, and other forms of self-aggrandizement. It is better that a man should tyrannize over his bank balance than over his fellow-citizens...⁴

But the defenders of self-interest, and their arguments, are not widely known. Most people see the defenders of self-interest as villainous characters. Certainly popular entertainment promotes the view that self-interest, particularly commercial self-interest, is a corrupting influence in society. According to one study, during the 1980s almost 90 percent of all business characters on television were portrayed as corrupted by greed.⁵

Politicians do the most to foster and exploit the negative view of self-interest. They constantly rant against the greed of those who put their private interest above the public interest. Invariably when a politician engages in such a diatribe, he is rationalizing the failure of some public policy that he favors. Few things would do more to discredit silly political statements and derail pernicious public policies than to recognize that self-interest is not good or bad, it just is.

Imagine an aeronautical engineer who kept designing airplanes that either never got off the ground or crashed almost immediately if they did. Consider our response to such an engineer if she claimed that there was nothing at all wrong with her engineering, and that her planes would fly just fine if it weren't for gravity. She would immediately be dismissed as a raving lunatic. But is

¹James Boswell, *The Life of Samuel Johnson* (Middlesex, England: Penguin Books, 1979), p. 177.

²Quoted on p. 1464 of Albert O. Hirschman, "Rival Interpretations of Market Society: Civilizing, Destructive, or Feeble," *Journal of Economic Literature*, December 1982, pp. 1463-1484.

³Quoted in Albert O. Hirschman, *The Passions and the Interests: Political Arguments for Capitalism Before Its Triumph* (Princeton University Press, 1977), p. 61

⁴The *General Theory of Employment, Interest and Money* (London: Macmillan, 1936), p. 374. Also quoted in Hirschman (1977), *op. cit.*, p. 134.

⁵See page 146 of Robert Lichter, Linda Lichter, and Stanley Rothman, *Watching America* (New York: Prentice Hall, 1990).

her argument really any sillier than those we hear from politicians and statist policy wonks every day?

Recall the recent health-care debate. Government policy has led to health-care arrangements where most medical services are paid for by third parties, with neither patients nor physicians having much motivation to take costs into consideration. The predictable result has been escalating prices for health-care services and, of necessity, increasing health-insurance premiums. But the constant refrain from the health-care engineers in Washington is that the problem is greed, not the collectivization of healthcare decisions. Indeed the recommendation has been for more collectivization. The recommended health-care system would work just fine, with the finest care at the lowest prices for all, if only physicians, drug companies, and insurance companies weren't so greedy.

As government has grown larger, controlling an increasing share of the national income, organized interests have predictably devoted more effort to influencing government policy. The noble objectives that it is easy to imagine being achieved by an expansive government invariably fall victim to perversities of interest-group politics. Yet good-government types are convinced that bigger government could be the source of bigger benefits if only the greedy special interests would quit putting their narrow concerns ahead of the general welfare. Greed is the problem, not the design of government programs and policies. So all that is needed is the right campaign reform and lobbying restrictions to banish the corrupting influence of greed from politics.

Other examples could be given of social engineers blaming greed and self-interest when their policies fail to achieve liftoff, but the point is clear. The public would be well served if politicians and policy makers began recognizing that self-interest is not good or bad, but an unalterable fact of life. Until they do, they will continue to design cumbersome and costly public policies that do far more harm than good, and then blame their failures on greed.

Should Profits Be Shared with Workers?

June 1, 1997

When most people argue that firms should share profits with workers, they are not interested in the general distribution of business receipts.¹ Rather, they are pointing to firms experiencing exceptionally high profits and claiming that fairness requires that most of those profits be passed on to workers. For example, management consultant Alfie Kohn states, If a company has had a profitable year, I see no reason those gains should not be distributed to the employees; after all, their work is what produced the profits.²

At a superficial level, it may seem only right that when a firm is doing well, its good fortune should be shared with the workers who made it possible. And, indeed, workers do benefit when their firms are profitable and expanding because their jobs are more secure and opportunities for promotion are greater. But shouldn't firms making high profits directly share some of those profits with their workers by increasing their wages much more than in leaner times? Workers and their union representatives are frequently quick to use high profits as justification for demanding large wage increases, but is it wise to acquiesce?

It is generally true that those fortunate enough to work for highly profitable firms receive higher wages than those who work for barely profitable firms.³ But

¹ At one level the answer to the question in the title of this paper is, of course profits should be shared with workers. The only durable source of compensation for any worker (whether in the private or public sector) is the revenue earned by profitable businesses. Indeed, by a wide margin, most of the national income goes to pay workers. In 1994, for example, employee compensation made up 73.4 percent of the national income, with corporate profits coming to 9.9 percent and proprietors' and rental income (not all of which can be counted as business profits) amounting to 9.2 percent. The rest of the national income in 1994, or 7.5 percent, went to net interest. These figures are found on page 39 of Herbert Stein and Murray Foss, *The New Illustrated Guide to the American Economy* (Washington, D.C.: The American Enterprise Institute Press, 1995).

² See page 183 of Alfie Kohn, *Punished by Rewards* (Boston: Houghton Mifflin Company, 1993).

³ This does not necessarily mean, however, that highly profitable firms are more generous in sharing profits with their workers than are less profitable firms. More likely, highly profitable firms are paying higher wages to attract workers more skilled than those working for

this is not the same as a firm giving its workers a large wage increase whenever it experiences a large profit increase. Firms seldom do this for reasons of efficiency, fairness, and the best interests of their workers.

Efficiency

Consider first the efficiency of sharing profits with workers. Although many people see profits as nothing more than rich people accumulating more wealth, profits serve a vital function in creating wealth by allowing consumers to communicate how they want scarce resources allocated among competing productive activities. A firm earning a large profit is using resources to create more value (as measured by what it sells its output for) than those resources could create elsewhere in the economy (as measured by what the firm has to pay for its inputs). The total value of production can then be increased, with the same use of resources, by reallocating resources to highly profitable firms and away from less profitable firms elsewhere in the economy. And this is exactly the reallocation of productive resources financed and motivated by high profits. Firms typically reinvest high profits right back into the productive activity that generated them by bidding resources, both human and non-human, away from less profitable activities. Output expands in the high-profit firms (driving their rate of return down) and contracts in the low-profit firms (driving their rate of return up) until additional inputs are worth no more in the former than in the latter.

This efficient reallocation would be impossible if a firm that began making high profits, say because of an increase in the demand for its product, used those profits to increase the wages of its workers. Firms are forced by competition to pay their workers at least as much as they are worth in their best alternative employments. If a firm devoted its high profits to paying its current workers more than is justified by their productivity, it would be unable to attract the additional resources it needs to expand. The workers receiving the higher wages would be obviously better off in the short run, but their gains would be more than offset by the losses (forgone opportunities) suffered by others in the economy.

Fairness

Quite apart from the adverse effects on efficiency, paying workers higher wages when the profits of the firm they work for are high forces firms to behave in ways that will be widely seen as unfair. If, because of high profits, a firm offers wages well in excess of their opportunity cost (the amount needed to attract workers with the appropriate skills from other employments), more people will want to work for that firm than it can afford to hire. This creates a situation where firms find themselves having to choose workers on the basis of non-economic considerations. Regardless of how firms make those choices, they will be criticized for practicing favoritism and unfair discrimination by those who are not chosen, and maybe with justification. Certainly the fairest approach,

less profitable firms.

and the one that penalizes discriminating on non-economic grounds, is to give all workers the opportunity to compete for jobs on the basis of their productive ability. This opportunity is denied to most workers when some are being paid more than their productivity warrants.

But even those who would get large wage increases because they work for firms creating high profits would probably not benefit from a policy of sharing in those profits, and certainly not if the policy were fairly implemented. If workers receive large wage increases when their firm is making large profits, then fairness would require that they also receive wage cuts when profits decline. Indeed, if workers favored a consistent policy of sharing in the profits, then they should be prepared to give money back (receive negative wages) when their firm (as firms often do) loses money. But workers obviously would not be happy with such a policy. It would expose them to all the risks that confront the owners of the firm, risks that few workers are willing to bear. People willing to accept large risks typically start their own businesses, or invest in businesses that others start, in return for a higher average, but very uncertain, return. Workers are typically more risk averse, as evidenced by the fact that they choose to work for others for a lower average, but more certain, return in the form of a fixed salary or wage.

Of course, some firms have attempted to motivate workers to be more productive through arrangements that give them some ownership in the firm. But these plans are not what those calling for sharing high profits with workers have in mind, since they can impose losses on workers when profits decline. For this reason, these profit-sharing plans are not widespread. Furthermore, when they do exist, profit-sharing plans are typically rather limited because even under the best of circumstances they do little to motivate workers to be more productive.

The Free-Rider Temptation

Profit-sharing arrangements are easily frustrated by the free-rider temptation. Although it is collectively rational for all employees to work harder in response to profit sharing, it is not individually rational to do so. Each worker will recognize that if others work harder, that he will reap the benefits from higher profits without extra effort. Each worker also recognizes that if others don't work harder, then his share of the additional profit generated by extra effort is too small to be worth the effort.

For example, assume that there are 1,000 workers in a firm, each earning \$15.00 per hour. Also assume a profit-sharing plan is established that would increase total worker productivity, and therefore worker compensation, by \$40,000 per week if all workers reduce their shirking on the job by one hour per week. This is clearly a good deal for the workers, since each one stands to receive \$40 for putting in just one more hour of genuine effort. But consider the payoff each individual would realize from his decision to shirk an hour less. The individual who puts in one more hour of work would be responsible for increasing total compensation by \$40 (assuming that each individual's impact on productivity is the same as everyone else's, and independent of what others

do). But since the additional \$40 is spread over all 1,000 workers, his share, in the form of higher wages is only \$.04. How many would be willing to give up an hour of on-the-job leisure for \$.04? At that hourly rate a person would have to work an entire 40-hour week to make enough to buy a small box of popcorn at the movies.

So having workers share consistently in the profits of their firm is not a policy many workers would find attractive. Such profit-sharing arrangements do little to motivate more productive effort, while imposing risk on workers that few are comfortable accepting. This explains why profit-sharing arrangements are often short-lived.

Consider the experience of Du Pont's fibers division. In 1988, Du Pont began an incentive pay plan for its fibers division workers. Workers were to commit some of their annual pay increases to an at risk pot until it contained 6 percent of their annual compensation. They were to share in the profits through bonuses based on how well the division did compared to a target of a 4 percent real growth in profits. If, for example, profits increased by 5 percent, then workers would be paid the 6 percent of the pay they contributed plus another 6 percent. If profits increased by 6 percent, workers would be paid their 6 percent plus the maximum bonus of 12 percent. On the other hand, if the division just made its profit target of 4 percent, the workers would get just their 6 percent back, with no bonus. And if the division's profits fell to 80 percent or less of its profit target, then the workers lost the 6 percent of the pay they put at risk.¹

Even though the risk the Du Pont plan imposed on its workers was less than a complete profit-sharing plan would have imposed, some workers expressed concern about gambling with a significant amount of their annual pay before the plan went into effect.² This concern was temporarily disregarded, however, when in 1989 profits exceeded the target and workers received \$19 million in bonuses. Few people complain about the risk when they are holding a winning hand. But in the 1990 recession, the fibers division's profits were not meeting the target and workers were going to lose some of their at-risk pay under the incentive pay plan. The prospect of this loss did not sit well with the division's 20,000 workers, most of whom took something other than an entrepreneurial attitude toward the downside of risk. Faced with complaints and problems with worker morale, Du Pont canceled the incentive plan, letting the workers avoid the type of loss that those who want to share in profits have to be willing to accept.³

More recently, Wal-Mart Stores has experienced some difficulties with its profit-sharing plan. Probably no other U.S. company has used stock incentives more than Wal-Mart to motivate hard work and loyalty from its workers. And for years it worked as Wal-Mart stock steadily increased in value (100 shares

¹For more details on the plan, see Nancy L. Perry, *Here Come Richer, Riskier Pay Plans*, *Fortune*, December 19, 1988, pp. 50-58.

²See *All Eyes on Du Pont's Incentive Pay Plan*, *Wall Street Journal*, December 5, 1988, p. A-1.

³Richard Koenig, *Du Pont Plan Linking Pay to Fibers Profit Unravels*, *Wall Street Journal*, October 25, 1990, p. B-1.

of Wal-Mart stock, which cost \$1,650 in 1970 when it first went public, were worth \$3.5 million in February 1993). But then the stock experienced a decline, going from \$34.125 a share in February 1993 to \$20.875 on the first trading day in 1995. During this decline, the profit-sharing plan became a source of worker complaints and demands for more pay and union representation. As reported in the Wall Street Journal, The world's largest retailer is also discovering the risks in a profit-sharing plan heavily invested in its own stocks.¹

Unless workers are willing to take the losses that are inevitable in business activity, as well as the gains, the argument that fairness requires that workers share in the profits of their firms is an empty one. Many workers, and their representatives who call for sharing profits with workers, seem to believe that fairness means heads I win, tails you lose. All workers are better off, and treated more fairly, when most profits are retained by firms to expand the production of goods and services that consumers are communicating with those profits that they want more of.

¹See Bob Ortega, What Does Wal-Mart Do If Stock Drops Cut Into Workers' Morale? Wall Street Journal, January 4, 1995, p. A1.

Markets and Freedom

September 1, 1998

The social cooperation that emerges in free markets permits the specialization on which prosperity depends. We would be much poorer without the specialization that is possible only when large numbers of people can coordinate production and consumption through market exchange. But even more important than the material wealth we realize from the marketplace is the benefit of freedom. We would soon be deprived of most of our freedom without the accountability and discipline possible only in market economies.

Freedom is easy to take for granted, especially in the United States where we have enjoyed what people in many other countries can only dream about. Freedom is a lot like good health: people tend not to appreciate it until they lose it. Just as healthy people can destroy their health by yielding to short-run temptations, free people can destroy their freedom by opting for short-run political advantages that undermine the conditions on which freedom depends.

Also, as important as wealth is, it is secondary to both good health and freedom. Wealth is of limited value to those without the health or the freedom to enjoy it. Furthermore, good health and freedom are important elements in the production of wealth, with freedom being absolutely essential. Sick people can be productive, but without freedom the productive cooperation of the marketplace is impossible.

So I shall discuss two separate but related points in this column. First, the productive cooperation of the marketplace depends on freedom, and second, freedom depends on the productive cooperation of the marketplace. Economists typically have the unpleasant task of pointing to the tradeoffs that are the inevitable consequence of scarcity. But with wealth and freedom, there is no tradeoff; they reinforce each other in market economies, with it generally impossible to have one without the other.¹ Attempts to increase wealth with political policies that reduce freedom invariably end up reducing both.

¹I have qualified this statement to account for the situation where a country possesses great wealth because of natural resource endowments and has an autocratic political regime, suppressing the freedoms of its subjects. But even in this case, the lack of freedom prevents

Markets Require Freedom

Markets work their magic by allowing people to communicate the benefits they realize from the efforts of others and the costs of their efforts to benefit others. Ultimately, all benefits and costs are subjective, depending on people's preferences and circumstances, which only they can accurately evaluate. This is obvious in the case of benefits. Who but the person who consumes a good, or avails himself of a service, is in a better position to judge the value of the benefits realized? But if benefits are subjective, then so are costs, which are nothing more than the value of forgone benefits. And since they are subjective, people can accurately communicate costs and benefits to one another only by having the freedom to enter into, or exit, different markets as they see fit, and to buy and sell at any mutually agreeable price. Government price controls restrict our freedoms as both buyers and sellers, and destroy wealth by censoring our communication with one another.

Central planning fails because people don't have the freedom to act on the local information that only they possess. When the central direction of political authorities is substituted for the market choices of individual producers and consumers, economic decisions are necessarily made in an informational vacuum. A productive economy requires the use of information that is dispersed throughout the population, and that information cannot be used without individual freedom. Destroy freedom and you destroy the information flows that are the essence of market economies.

Freedom Requires Markets

The connection between freedom and markets also runs the other way. Just as the market depends on freedom, so freedom depends on the market. Certainly private property, which is fundamental to all market economies, protects individual freedom. If the state owns all of the auditoriums and printing presses, how much freedom do you have to speak out against government policy? If the state owns all the means of production, how much freedom do you have to launch your own business? Start eliminating private property, and undermining the market that depends on it, and you start eliminating freedom.

But the market also protects freedom by establishing the only setting in which it can be tolerated. Freedom without responsibility is mere license, indulgence, and privilege, and will not long be tolerated. Real freedom, and the only freedom that can survive, is exercised in ways accountable to the concerns of all. The only freedom that satisfies this requirement is that which is subject to the discipline of the marketplace. Eliminate markets, and you eliminate the accountability necessary for freedom to survive.

For example, pollution problems result directly from not having markets in the use of the environment as a dump. If such markets existed, polluters would have to pay prices that reflected the cost their emissions imposed on others. Polluters would be accountable to others, and we could tolerate the

the country from realizing the full benefit from its resources, and undermines the productivity necessary to expand, or even maintain, its wealth.

freedom to discharge waste products into the environment. But because we don't have pollution markets, we accept government restrictions on polluting activities that would be unacceptable in most areas of our lives.

Our Freedoms Are Vulnerable

Freedoms are seldom taken away all at once. They are typically lost a little at a time, with people seldom noticing the loss. Even when freedom is reduced directly, as when government imposes occupational licensing in the name of protecting consumers, few people notice, and even if they do, they don't see the restrictions as affecting them. But as the great Austrian economist F. A. Hayek pointed out, "The benefits I derive from freedom are...largely the result of the uses of freedom by others."¹ For example, those who suffer the most when people lose their freedom to become barbers without having to pass state exams on the chemical composition of hair are not aspiring barbers, but people who need haircuts.

Also, there is an insidious dynamic to the loss of freedom. Direct restrictions always reduce freedom by more than is apparent because every restriction imperceptibly undermines the accountability of the marketplace that makes freedom possible.

Thomas Jefferson was correct when he said, "Eternal vigilance is the price of liberty." People are more likely to exercise vigilance in protection of their freedom when they understand the inextricable connection between it and the market.

¹See F.A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960), p. 32.

Distrust and Verify

February 1, 1999

Dwight R. Lee and J.R. Clark

Perhaps the most positive legacy of the Clinton administration will be that it further eroded the public's trust in the federal government. Trust has declined significantly since the Great Society programs of the Johnson administration. According to University of Michigan surveys, the number of people who responded that the federal government does what is right "always" or "most of the time" has dropped from 75 percent in 1964 to less than 30 percent in the mid-1990s.

Our view is that this decline in trust is a good thing because it mirrors rather accurately the performance of a government that has become less trustworthy. However, before making our case for less trust in government, we acknowledge that most people see the decline in this trust as a serious problem.

The Cart Before the Horse

People have worried about lack of public confidence in government for a long time. For example, Benjamin Franklin fretted that:

"Much of the Strength and Efficiency of any Government, in procuring & securing Happiness to the People, depends on...the general Opinion of the Goodness of that Government."

This was no doubt a legitimate concern in Franklin's day, when the federal government was undergoing a controversial birth and controlled little of the people's wealth. But today, with the federal government commanding over 20 percent of our income directly through spending, and significantly more through regulation, some are still concerned that confidence in government might be too low to allow it to seize more of our resources. For example, Joseph Nye, dean of Harvard's Kennedy School of Government, worries that "if people believe that government is incompetent and cannot be trusted, they are less likely to provide [critical] resources. Without [these] resources, government can't

perform well.” Studies investigating the decline in trust, and fueling concern about the consequences, have been published recently by the Kennedy School, University of Virginia, and Pew Research Center for the People and the Press.

These studies sometimes admit that government’s performance leaves something to be desired, but suggest that the best way to improve its performance is by restoring trust in it. This puts the cart before the horse. Where is the advantage in placing more trust in an organization whose performance does not justify trust? How many people needing heart bypass surgery would trust a surgeon who kills most of his patients on grounds that he will become a better surgeon only if more people trust him?

The only sensible way to restore trust in government is by making it more trustworthy. And a trustworthy government is more likely to be undermined by too much trust than by too little. Indeed, a major reason government performs so poorly is that persistent political influences encourage citizens to put far too much trust in it.

The Arithmetic of Voting

Public trust is easily transformed into political power that will be used to promote private advantage at public expense. The reason is rooted in the simple arithmetic of voting. Voting is an important civic responsibility, and nothing here is meant to suggest otherwise. But in state and national elections, the probability of your vote deciding the outcome is far less than that of being injured driving to the polls. This means that favoring one candidate or proposal costs you almost nothing in terms of sacrificing the alternative. Only in the rare case of a tie is your vote decisive; only then does your vote for one alternative cause you to sacrifice the other.

This arithmetic is important because it explains why charisma and emotion can trump substance in politics. Registering support at the polls for a superficially attractive candidate or a superficially compassionate proposal allows a voter to identify with the glamorous or feel virtuous with little concern about cost or effectiveness. For example, if voting for a proposal to combat “global warming” (or for a candidate who supports the proposal) makes you feel good, you might be tempted to shelve any doubts and vote regardless of the cost to you if it passes, since your vote is not decisive. The more people trust government, the more virtuous they feel when voting for a wide range of government initiatives that end up costing far more and delivering far less than promised.

Exploiting the Public’s Trust in Government

The nature of government programs enables well-placed interest groups to capture private benefits at public expense. The Environmental Protection Agency (EPA) has increased the size of its budget by championing command-and-control approaches to reducing pollution. Market-based measures are more effective and cheaper, but require fewer bureaucrats and have been resisted by the EPA. Industry groups (such as the eastern coal industry) have also supported command-and-control approaches to protect themselves against com-

petition (from low-sulfur western coal), at the expense of consumers (higher electricity prices) and environmental quality (more sulfuric oxides in the atmosphere). The list of government activities supported by well-intended citizens, but perverted by organized interests, is painfully long.

Every interest group wants to convince the public that government can be trusted to promote the general well-being by increasing some spending or regulating. The result is a steady stream of rhetoric aimed at making people feel good about trusting government to solve almost every imaginable problem.

Unfortunately, a widespread belief that discretionary government power can and should solve every social problem is incompatible with government's performing well. Such trust leads to politically compelling demands for government to do lots of things it has no business doing, with the result that it does poorly the few things it should be doing.

The best way to make government more trustworthy is for voters to resist the temptation to achieve a cheap sense of virtue by voting for every "virtuous" proposal that comes along. The real virtue is in voting against most government programs (and the politicians who support them), no matter how virtuous those programs are supposed to be.

We need plenty of public skepticism toward government to counter the voters' tendency to support government activities that purport to "do good" with power that will invariably be captured and corrupted by special interests. A trustworthy government requires a healthy measure of public distrust.

Costs Should Be Revealed, Not Concealed

May 1, 1999

Making sound economic decisions is impossible without information about opportunity costs. Thinking about the cost of doing anything is crucial; it amounts to considering the value of the alternatives.

A major advantage of the market process is that it gathers up information on costs and transmits it to market decision-makers through prices that cannot be ignored. In contrast, the political process fails either to transmit cost information to political decision-makers or to motivate the proper use of this information. It fails partly because organized interest groups want to ignore the costs of their pet projects, and partly because political institutions are unable to acquire and communicate information on cost. Markets promote wealth-creating decisions by revealing costs, while politics promote wealth-destroying decisions by concealing costs.

Revealing Lots of Little Costs

The costs of doing anything—for example, buying a pencil—result from tiny sacrifices made all over the world. Leonard Read's primary point in his justly famous 1958 article "I, Pencil" is that making something as simple as a pencil requires the coordinated efforts of thousands (probably millions) of people with a wide range of specialized knowledge that no one person could ever possess. This coordinated effort is possible only because of the guidance provided by market prices. Read's example also illustrates how the opportunity costs incurred by everyone involved in getting a pencil to the consumer (both in terms of the value of their time and other resources) is incorporated into its price. The consumer is thereby implicitly aware of the value of every tiny sacrifice made in producing it.

All prices reveal a similar collection of diffused costs to consumers. Therefore, each product is consumed only to the point where consumers value another unit by an amount equal to the value sacrificed to make it available. As I've emphasized before, the market generates a pattern of cooperative interaction

by people pursuing their own advantages in ways that take into account the concerns of others. If only the diffused costs of government action could be collected through the political process and revealed to decision-makers with the same compelling clarity as in the marketplace! That the costs of government decisions are commonly ignored goes a long way in explaining the perversities of so many public policies.

Concealing Lots of Little Costs

When the costs of government action are spread wide, as they commonly are, they are generally ignored. For example, a tariff that protects a domestic industry against foreign competition will cost consumers far more in higher prices than it benefits the industry. But while the benefits are easily attributed to the tariff and concentrated on a relatively small number of people, the costs amount to only a few dollars a year for each of millions of consumers, few of whom will notice the extra costs or the connection with the tariff. And even if a consumer does know of these costs, his share is so small that it doesn't pay him to actively oppose the tariff.

The benefits of any special-interest proposal are communicated through the political process loud and clear. The costs, however, are borne in silence and therefore largely ignored by politicians. Organized interest groups are aware that lots of small, widely diffused costs are difficult to register through the political process, and they aggressively exploit this fact to capture benefits at others' expense. But the inability of the political process to collect and concentrate diffused cost would result in popular support for perverse public policies even without interest-group lobbying.

For example, after an airplane crash in Sioux City, Iowa, in the late 1980s, in which an infant was killed when torn from his mother's arms, pressure arose for the federal government to require that all infants have their own airplane seats. The benefit to children on planes was obvious; they would be safer. But what was the cost? The cost of an extra seat is obvious. Other costs, however, were less obvious because they were diffused and remote. If families with infants faced higher costs for airline travel, more infants would travel in cars instead of airplanes. This would result in more infants being killed in automobile accidents than would be saved in airline accidents, since car travel is many times more dangerous per passenger mile than air travel. Several studies suggested that the cost of saving one child with the seat requirement would have been the lives of four to six children lost in car accidents. Fortunately, the requirement never became law, but that it was seriously considered illustrates the difficulty the political process has perceiving widely dispersed costs and concentrating them on the relevant decision-makers.

The Cost of the 55-MPH Speed Limit

Enactment of the 55 MPH speed limit on the grounds that it saves lives also shows the tendency of the political process to conceal rather than reveal costs. We have all heard that the speed limit reduced traffic fatalities, which then

increased when it was raised. But what were the costs of the 55 MPH limit? One cost was the additional time people had to spend on the highway, a cost that came to billions of hours per year (20 extra hours a year on the road for 200 million people is 4 billion hours). Evaluated at the minimum wage, this amounts to \$21 billion. Because this cost was spread over the entire population, it was largely ignored.

Unfortunately, an even greater cost—also politically ignored—was the cost in lives. The claims that traffic fatalities were reduced by the speed limit are based on fatalities on the interstate highways, which, because they are multilane divided highways, are the safest roads. But when the limit was imposed, traffic was diverted to two-lane state roads that are far less safe. This diversion occurred because the speed limit of these roads became relatively higher than before, and they were not policed as effectively as the interstates. The result was an overall increase in traffic fatalities even though interstate fatalities decreased. It has been estimated that when states were allowed to raise the speed limit on interstates outside the cities, fatalities on all roads declined by 3.4 to 5.1 percent. (See Charles Lave and Patrick Elias, “Resource Allocation in Public Policy: The Effects of the 65-MPH Speed Limit,” *Economic Inquiry*, July 1997, pp. 614–20.)

If the market did as poorly as government at collecting information about dispersed and fragmented costs and imposing them on those responsible, we would live in an impoverished economy. Governments are tempted to meddle precisely because of their ability to conceal costs, and their inability to reveal them. That’s why the benefits from government action are low and the costs high.

How Government Prevents Us from Buying Safety

December 1, 2000

There is a limit to how much people will voluntarily pay to reduce the risk of accidental injury or death. In other words, the marginal value people place on their lives is finite. We accept some risks to take advantage of opportunities to do things that, at the margin, provide more value than the expected sacrifice in health and life expectancy. In effect, people routinely put a price on their lives. They do it every time they go skiing, roller blade in the street, spend too much time in the sun, drive to the store, walk across the street, overeat, stay up late, go swimming, or do any of a thousand other things.

But saying that there is a limit to how much people will pay to reduce risk implies they are willing to spend something. People value safety just as they value other things, and they will purchase it up to the point where, in their estimation, its marginal value equals its marginal cost (the value of what has to be sacrificed to get the additional safety). In fact, we are buying more safety now than ever before because we are richer and can afford more of almost everything.

For example, our jobs are far safer now than they were in the past. In part this reflects the shift away from jobs demanding manual labor (like farming and mining) and into office jobs where paper cuts are the biggest hazard. But employers also spend more to provide safer conditions on all jobs because workers would rather have the additional safety than the higher salary and wages that otherwise could have been paid. We spend more on smoke alarms, slip-resistant bathtub interiors, air filtration systems, and outside lighting to make our homes safer. We demand levels of sanitation in the food we eat, the water we drink, the air we breathe, and the clothes we wear that would have been considered ridiculous a couple of generations ago, and unimaginable in many poor countries today. Airline travel is far safer now, with the number of miles traveled increasing as the number of airline fatalities is decreasing. And the car you drive today is safer than the ones available a few years ago because they are better designed, have better brakes, and contain more safety features.

Our increased demand for safety, and the response to that demand, is explained primarily by marketplace incentives. Without the cooperation and coordination created by market incentives, we would not have experienced the growth in wealth that increased our demand for safety. And when our demand for safety increases we can communicate that demand through prices and profits to those best able to respond. An automobile company that tried to sell cars no more safe than those made in 1970 would quickly go bankrupt, as would an airline with the same safety as 30 years ago. Some people will object that government regulations have forced automobile manufacturers, food processors, the airlines, building contractors, and employers to provide the additional safety. It cannot be denied that government regulations have had an impact, but it has been a far less desirable impact than most people realize.

Governments often enact regulations requiring more safety only after the private sector has started providing the desired amount. Indeed this is about the best we can hope for, even though government regulations commonly increase the cost of providing more safety by specifying one-size-fits-all approaches rather than allowing firms to use approaches best suited to their situations. But government regulators often require that we pay for far more safety than we want because of the tendency toward bureaucratic expansion, the desire for greater power, and the demands of politically organized groups. For example, some Environmental Protection Agency regulations are estimated to cost over \$4.5 billion per life saved, and some Occupational Safety and Health Administration regulations that are estimated to cost over \$72.7 billion per life saved.¹

The CAFE that Kills

Unfortunately, while some government regulations are making us buy very little safety at exorbitant cost, others are discouraging us from buying a lot of safety at low cost. Consider federal Corporate Average Fuel Economy (CAFE) regulations that require automobile manufacturers to produce vehicles that average no less than a specified number of miles per gallon. CAFE now requires that new cars average 27.5 miles per gallon and that new light trucks (pick-ups, minivans, vans, and sport utility vehicles) average 20.5 miles per gallon. These regulations were imposed in 1978 to force us to conserve gasoline—after the federal government imposed gasoline price controls that denied people the information and incentive to conserve more efficiently on their own. More recently, environmentalists have lobbied for increasing the required mileage to cut down on the emission of pollutants and alleged greenhouse gases.

It is not clear that CAFE standards do much, if anything, to reduce either gas consumption or pollution. To the extent that the standards increase gas mileage, the cost of driving will go down and people will drive more miles. Also, because the standards increase the cost of new vehicles, particularly the larger ones that are artificially restricted in supply, people drive their old cars

¹I discussed these and other examples of extremely costly safety regulations in my October column and explained why they result in less, rather than more, safety.

longer than they otherwise would, and older cars commonly get poorer gas mileage and almost always pollute far more than new cars. But it is clear that CAFE standards do increase traffic fatalities by preventing people from buying additional safety at very little cost.

Because of CAFE standards, automobile manufacturers have had to produce cars that are smaller and lighter on average than consumers want to buy. Straightforward physics insures that, everything else equal, smaller and lighter vehicles are less safe than large heavy ones—occupants are closer to windshields and dashboards and they are surrounded with less cushion. Not surprisingly, a recent study using government and insurance data found that for every mile per gallon added because of CAFE, 7,700 additional lives are lost in traffic accidents.¹

One has to conclude that there is a stronger bias in the political process to expand regulations than to increase safety. What other explanation is there for simultaneously imposing regulations that provide almost no safety at ridiculously high costs and preventing people from significantly reducing their risks at the cost of a few gallons of gas? Unfortunately, CAFE is not the only regulation that prevents people from buying more safety at low cost. For example, thousands of people have died needlessly in the United States because of federal Food and Drug Administration restrictions on buying medicines that have been widely and successfully used in other countries to reduce the risks of heart attacks, strokes, and other diseases. Details on these restrictions will have to wait until a future column.

¹This study was discussed by Murray Weidenbaum, "Saving on Gas Costs Us Money—and Lives," Chicago Sun-Times, September 17, 1999, op-ed page.

The Market Makes Diversity Worth Celebrating

January 1, 2002

The mantra on university campuses today is “celebrating diversity.” There are good reasons to encourage a greater appreciation of the rich diversity in the world. We are increasingly part of a global community; it’s important that we interact cooperatively with people of diverse backgrounds, understandings, skills, and motivations. But we should keep in mind that emphasizing our differences carries at least as much potential for conflict as for cooperation. Every day, in multicultural hot spots around the world, people celebrate their differences with bloody barrages of high-octane fireworks.

Also, much of what is promoted under the banner of diversity on campuses today ignores, and often disparages, the most effective force for fostering multicultural harmony—the market economy. Market economies, based on private property and voluntary exchange, are now acknowledged to excel in the production of wealth. What people often fail to recognize is that market economies are so productive because they allow us to make the best use of the differences between people and countries. People are rewarded in market economies for seeking out those who are different and taking advantage of those differences through specialization and exchange.

The best way to celebrate diversity on campuses is by promoting a better understanding of the free-market economy that makes diversity worth celebrating. But you will look in vain for a multicultural course that emphasizes our ability to cooperate across cultural divides through market activity. Instead, the most vocal advocates of cultural diversity on campuses see the political arena, not the marketplace, as the best setting for bringing people together. Unfortunately, politicizing our differences is far more likely to make diversity a source of conflict than a cause of celebration.

If people and countries were all the same, the world would be a very impoverished place—impoverished and boring. If everyone had the same skills, attitudes, cultural norms, interests, and backgrounds, and if all countries had the same resource endowments, weather conditions, and cultural heritages, the

opportunities to gain from specialization and exchange would be far less than they are. Individuals, and the countries they live in, would end up having to produce more themselves of what they consumed, being jacks of all trades and masters of none. With less specialization, and less of the increased productivity that comes from it, we would all be poorer. And quite apart from the reduction in wealth, the world would be a less interesting and exciting place. People would have less to contribute to, and learn from, one another, and the opportunity for personal growth from travel and social interaction would be diminished. The world is a more wondrous place in every way because of its diversity.

But to take advantage of the specialization that diversity makes possible we must be able to share information with countless other people on what we can best do for them and they can best do for us, and respond to this information as if we were as concerned with the welfare of others as we are with our own. This sharing of information and cooperative response is possible only through market prices. The market is a multicultural collage of global cooperation that not only allows people from all over the world to serve the interests of one another, but also motivates them to do so. Free-market capitalism penalizes parochialism and cultural isolation and rewards those who expand their markets by accommodating a wide variety of culturally influenced interests and tastes.

Scarcity and Conflict

I don't want to leave the impression that markets completely eliminate conflict and replace it with the harmony of all joining hands and singing "We are the world." We live in a world of scarce resources, and the greater the diversity the greater the variance in views on how those resources should be used. True, in markets the best way for you to get more things you want is by helping others get more things they want; conflict is diminished by allowing everyone to become better off. Thus market exchanges harmonize diverse preferences to a degree rarely possible in the political arena.

When people pursue their objectives through the political process, they usually achieve success by convincing authorities to take resources away from others. No more is produced—what one person gains, others lose. Worse, people devote resources to lobbying politicians that could have been producing more of what people want, so the winners gain less from political action than the losers lose.

This explains why political decisions are often controversial, with opposing sides pitted against each other. Each side finds it is more successful mobilizing public opinion and support for political action by presenting its case as a crusade for virtue, which makes it is easy for members of opposing sides to see each other as enemies. When one side loses, its tendency is to see the loss as a personal rebuke and a triumph of evil by those on the other side.

In contrast, conflicts over scarce resources in the marketplace are generally impersonal. The market is often criticized for being impersonal, but that is actually one of its advantages. When you end up with less of something than you had planned on because the price goes up, it is not the result of anyone's

intentionally taking something from you. The price increase is the effect of countless people responding to a wide variety of considerations, with it doubtful that any of them are giving you any thought at all. Because price changes are impersonal, people are far less likely to respond with animosity when they end up with less than if they knew that their loss was the intended result of political action that permitted others to gain at their expense.

People in Texas use less gasoline than otherwise because the gasoline usage of New Yorkers drives up the price they pay. But few Texans feel animosity toward New Yorkers when filling up with gas. But imagine if gas were allocated politically, and the Gas Allocation Commissar told Texans that they had to reduce their gasoline use so New Yorkers could increase theirs. This would surely increase the sensitivity of Texans to the differences between them and New Yorkers, but it would be the sensitivity of a raw nerve.

In general, the more diversity in a community, the more socially divisive political decisions will be. Fortunately, most decisions can be made individually in the marketplace since they involve choices that people can make largely independently of one another. The less we rely on government the more we can tolerate diversity, indeed thrive from it. If only this were understood by those who see more collectivism as the best way to promote (and celebrate) diversity.

Public Interest or Private Interest?

May 1, 2002

That private interest dominates market decisions is widely accepted, if not always applauded. Farmers don't get up early on cold mornings in Nebraska to plant crops because of concern over world hunger, but because they want more income for themselves and their families. People don't invest in pharmaceutical firms because they want to help the sick, but because they believe those investments will increase their retirement incomes more than will alternative investments.

Farmers and investors occasionally claim that feeding the hungry and curing the sick provide much of their motivation, and certainly people do feel good about contributing to the well-being of others. But who doubts that if farm incomes and pharmaceutical profits dropped sharply, there would be fewer farmers plowing the fields and fewer dollars invested in medical research, regardless of the sickness and hunger in the world? The advantage of market economies is not that they motivate people to sacrifice their private interest for the public interest, but that they motivate people to pursue their private interest in ways that best promote the public interest.

On the other hand, government decisions are commonly thought to be motivated by noble social concerns like helping the poor, protecting the environment, improving education, and promoting economic growth. Of course, government decisions are made by people, just as market decisions are, but supposedly when people move from market roles to political roles they experience a moral metamorphosis, discarding their private interest to better promote the public interest. Serious people would acknowledge, if confronted with the issue, that no such metamorphosis occurs, yet the view that political officials care deeply about us and our problems is remarkably common.

A far more accurate, and useful, perspective on political decisions is that they are motivated by private interest just as market decisions are. True, people often vote for policies, or candidates who support those policies, on the basis of public concern, but that can be explained by the minuscule probability that

any vote will affect the outcome of an election. So voting is a great way to feel socially concerned at low cost. (I discussed this “expressive voting” last month.) If voters were really willing to sacrifice for public benefit, they would make sure the money spent by the programs they favor accomplished their stated goals. But that would be costly. Having voted to “do good,” few voters ever know whether any good is actually done.

But because every government program affects politically organized groups, these groups do follow up on how programs are designed and implemented. And because the political influence of these groups is significant, their members make sure that government programs serve their private interest, even when this means doing less to accomplish noble public objectives.

The best evidence on who benefits the most from government programs supposedly dedicated to worthy public objectives is to consider the following two questions. First, can government best accomplish desirable social goals by downsizing bureaucracy and reducing transfers and privileges to an organized interest group? Second, can you think of a government initiative to accomplish a desirable social goal that downsized a bureaucracy or reduced transfers and privileges to an organized interest group?

The answer to the first question is clearly yes, as we are about to see. The answer to the second question is, it’s difficult. I can think of very few examples. The elimination of the Civil Aeronautics Board, the Interstate Commerce Commission, and the military draft are possible examples, and I challenge readers to come up with additional draft examples and e-mail them to me. With few exceptions, when governments attempt to accomplish a public benefit, they undermine the attempt by making sure that the interests of politically influential groups (including government bureaucracies) are well served. This means that, if public authorities were seriously concerned with promoting the public interest, there would be lots of ways they could do so much more effectively by reducing spending and special-interest privileges. Don’t hold your breath.

Doing Good by Doing Less

Politicians have so persistently expressed their deep desire to help the poor, and their belief that only government can provide that help, that many Americans now believe that without the federal government, masses of poor people would be starving in the streets. But removing all import restrictions and eliminating all agricultural price supports would do more to help poor Americans (by lowering prices) than all the social-welfare programs combined. Welfare programs have done little, if anything, to alter the distribution of income; instead they have reduced economic growth, thus probably leaving the poor worse off.

As I discussed at length in previous columns, we could do more to protect the environment, and do it more cheaply, by shifting from command-and-control to market-based policies to reduce pollution. But doing this would greatly reduce the budget and power of the Environmental Protection Agency and remove protections against competition that current policies provide to politically influential businesses and labor unions—such as those involved in mining eastern coal.

Politicians never tire of stressing the importance of improving the education of our youth and promising meaningful education reform. Yet simply giving students and their parents educational choice would do far more to improve education in America (particularly for children in the poorest neighborhoods) than all the money spent by the U.S. Department of Education and all the methods courses taught in college education departments combined. But allowing parents to make schools compete for their dollars by providing better education at lower cost would destroy the control of politically powerful teachers' unions and undermine the rationale for thousands of bureaucrats.

If the federal government really wanted to promote economic growth, it would eliminate our impossibly complex tax code and replace it with a far simpler tax with one low rate on income and few, if any, exemptions. The tax system can never be quite as simple as some suggest, but it can be far less complicated and do far less to distort economic decisions and reduce economic growth than our current system. But with a simple tax system, politicians would lose their power to provide (read sell) special-interest tax breaks, and hordes of lobbyists, tax accountants, lawyers, and employees of the Internal Revenue Service would have to find more productive work.

There are many more examples of how governments, if they really were motivated to promote noble social goals rather than serve the private interest of the politically influential, could accomplish more by doing less. As my friend, and well-known economist, Murray Weidenbaum likes to tell government authorities, "Don't just stand there, undo something."

The Bias Favoring Governments over Markets

June 1, 2002

The thrust of my columns could be summarized as follows: We would be better off increasing our reliance on the voluntary cooperation of the marketplace and reducing our reliance on government commands. This is not an idle assertion reflecting blind ideology or religious zeal, as some would claim. It is based on an impressive foundation of theory and evidence. For over 225 years, dating back at least to Adam Smith's *The Wealth of Nations*, economic theory has explained how markets coordinate the actions of countless people, even when each is motivated by narrowly defined self-interest, to serve the public interest far more effectively than government action, no matter how well intended.

And the evidence is clear that individual freedom disciplined by market incentives is closely connected to widespread wealth. Markets and the freedom they allow are far more important to the prosperity of nations than natural resources. Many countries rich in natural resources have been impoverished by the substitution of government compulsion for market freedom (consider Argentina, Russia, India, China, and any number of African countries). There are also many countries poor in natural resources that have prospered by relying primarily on market forces (Japan, Hong Kong, Switzerland, and Singapore).

But if the market is so superior to government, why do people respond to almost every problem, real or imaginary, by demanding a government solution? Why have governments relentlessly taken ever more responsibility for their citizens' welfare, and ever more of their paychecks, in unsuccessful attempts to make everyone better off at the expense of everyone else? No complete answer to these questions can be given in a short column. But at the heart of any answer is an irony—markets are criticized for the very reason that they create wealth, and governments are applauded for the very reason that they destroy wealth.

Markets work their wonders by creating in each of us an intense interest in taking actions that increase the welfare of others. Few of us give much thought

to the well-being of more than a few of the hundreds of millions of people who in various and indirect ways benefit from our work and investments. But we are vitally concerned with the salaries we are paid and the profits we receive, and in markets our salaries and profits rise or fall with the value of our contributions to others. So by adjusting our efforts and investments to improve our conditions, we also improve the conditions of countless others.

The well-known implication of this is, as Adam Smith pointed out in 1776, that though each person “intends only his own gain, ...he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.” But immediately before this famous statement, Smith made another, less celebrated, observation that each individual “neither intends to promote the public interest, nor knows how much he is promoting it” (emphasis added). Because the benefits from our efforts are so dispersed over so many people in so many ways, we can never know how much we benefit others, even if we cared. And because the benefits we realize from others are similarly spread over so many, none of us notice, or can identify, the particular contributions others are making to our welfare. The benefits generated through markets are largely unappreciated because they are distributed so broadly and impersonally. And even when these benefits are appreciated, people seldom understand that they are made possible only by the cooperation created by market incentives.

Little Credit Given

While the market receives little credit, or appreciation, for the benefits it provides, it is constantly attacked for the very thing that makes those benefits possible. The inevitable consequence of the market’s rewarding those who do the most to benefit others is that it imposes losses on those who don’t. Firms suffer losses and bankruptcy when they fall behind the competition in catering to consumers, releasing scarce resources to those making better use of them. Similarly, those who invest in, and work for, firms that aren’t continually giving consumers better products at lower costs find their portfolios shrinking and their jobs disappearing, again shifting resources (including labor) to more productive activities. Although everyone, including those who suffer these costs, is better off living in an economy that imposes them unrelentingly, the pain that results is undeniable. And because the pain is concentrated it is easily seen, readily associated with the market forces that caused it, and invariably criticized as a market failure that calls for corrective government action.

So the success of markets is easily overlooked, or taken for granted, while the discipline that makes that success possible is easily depicted as an unnecessary and unacceptable cost. We have all seen the nightly news lamenting the horrible disruption people suffer when the major employer in their communities goes out of business. But how many have seen a follow-up on the millions who are a few dollars a year better off because the bankruptcy freed up resources to produce more valuable goods and services elsewhere in the economy? We have become wealthy because these adjustments create more benefits than costs. But because the benefits are dispersed and the costs are concentrated, the market is seldom given credit for the former, but constantly blamed for the

latter.

On the other hand, government programs destroy wealth because their benefits are typically concentrated, and therefore easily noticed, while their costs are widely dispersed and easily ignored. The political benefit-cost ratios of these programs are greater than their social benefit-cost ratios, so they are invariably expanded far beyond the point where their marginal value covers their marginal cost. Obviously, the group receiving most of the benefits from a program will appreciate it, know which politicians support it, and reward them for expanding it. Even taxpayers who pick up the tab for wasteful special-interest programs commonly favor them because the benefits are so apparent and easily connected to the particular program that provides them, and the cost of any one program to any one taxpayer is typically too small to notice.

Finally, political authorities like providing government benefits even when doing so destroys far greater benefits in the market. Politicians and bureaucrats are in the business of taking credit for things, and they cannot take credit for the benefits generated through the market, and receive little if any blame when programs reduce those benefits.

We shouldn't laugh at the dog that bites the hand that feeds it. When expanding government programs that distort and discard market incentives, we are not only biting the hand that feeds us, we are also feeding the hand that bites us.

The Disconnect Between Political Promises and Performance

April 1, 2006

What can politicians do to create more higher paying jobs? Politicians must think that most of us believe the answer is: a lot. One of the most persistent campaign promises is the creation of good jobs at good wages. I shall argue that politicians can do quite a number of things to increase high-wage employment. But this does not mean that I favor politicians trying to keep their high-wage promises, because the things politicians can do to improve jobs are not the things they will do.

Politicians can enact policies from two general categories to achieve desirable outcomes, including the creation of high-paid jobs: 1) policies that work, but in ways that do not benefit politicians, and 2) policies that don't work (and typically make matters worse), but which create the mirage of working in ways that do benefit politicians.

Under prevailing democratic arrangements, electoral survival demands that politicians appear to promote desirable social objectives with direct and decisive action that caters to organized interest groups. Even when such special-interest policies are socially harmful, as they invariably are, they still do more to promote the interests of politicians than policies that would promote broad social benefits indirectly by creating a setting in which people can pursue their various interests through productive interaction. The political problem with the indirect approach is twofold: 1) the benefits are created so gradually and spread so widely that few will notice them, and 2) even if the benefits are noticed, it will be difficult, if not impossible, for politicians to claim credit for them. As F. A. Hayek pointed out in volume three of *Law, Legislation and Liberty*, politicians “who hope to be reelected on the basis of what their party during the preceding three or four years has conferred in conspicuous special benefits on their voters are not in the sort of position which will make them pass the kind of general laws which would really be most in the public interest” (emphasis added).

When we look at policies aimed at creating high-paying jobs, we easily

find examples where politicians preferred conspicuous “benefits” that actually harmed the public to inconspicuous benefits that really were good for the public.

Many policies would increase the number of high-paying jobs indirectly, and many would appear to increase the number directly but actually reduce those jobs and lower wages. The former policies all do the one thing necessary for higher wages and salaries—increase labor productivity—while the latter policies all reduce, or retard, labor productivity, and so reduce wages below what they would be otherwise. The political bias against effective policies is readily apparent from the following list and brief discussion. Consider first some policies that would increase wages.

Eliminate restrictions on imports: One of the most effective things the federal government could do to increase labor productivity and wages is eliminate tariffs and restrictions on imports. Reducing import restrictions increases real wages in two ways. First, it reduces the price workers have to pay for those goods and services that could be produced at less cost in other countries than they can be domestically. Second, it increases the competition domestic producers face from foreign producers, which directs workers into those employments in which they are most productive—in which they have a comparative advantage.

Increased productivity is both necessary and sufficient to increase wages, at least in general. No serious person can deny that there are costs associated with workers moving to more productive jobs, or that a few people will be unable to find new jobs that pay as much as the ones they lost. But no economy can prosper without open competition, which keeps all resources, including labor, moving from less-valued to more-valued employments (in the eyes of consumers) in response to constantly changing conditions. And even those who end up with lower wages because of the particular adjustments they are required to make still earn far higher wages than they would in an economy where they, and everyone else, are protected against having to make such adjustments.

End corporate welfare: Import restrictions are a form of corporate welfare, but unfortunately not the only form. Eliminating all forms of corporate welfare would increase high-wage jobs by reducing taxes and their distorting influence (see below), and allowing both domestic and foreign competition to direct labor and capital into their most productive uses, as determined by consumers, not by politicians catering to their special-interest clients.

Lower marginal tax rates: No matter how efficient a government is, it has to raise revenue to finance its activities, and that means imposing taxes. Unfortunately, all other taxes reduce economic productivity by 1) putting a wedge between the price suppliers receive and demanders pay, thus preventing mutually beneficial exchanges from occurring, and 2) motivating people to make decisions to avoid taxes rather than create wealth. These distortions are commonly called deadweight losses and are an inevitable cost of taxes over and above the opportunity cost of the money raised. Reducing the deadweight loss from taxation increases the effectiveness of exchanges between employers and employees at directing workers to where consumers would value them most, and increases the general level of productivity, both of which increase the real wages

of workers. So an effective way of increasing the number of high-paying economy jobs is by lowering the marginal tax rate and expanding the tax base by eliminating loopholes, reducing the deadweight loss of taxes for a given amount of revenue raised. The lower the marginal tax rate the smaller is the wedge between what sellers receive and buyers pay, and the fewer the tax loopholes (along with a low marginal tax rate), the less the tax benefit from diverting resources from high-valued production to low-valued tax avoidance.

Avoid inflation: The federal government can do a lot to increase high-paying jobs by avoiding inflation. Inflation erodes labor productivity and lowers real wages, just as surely as it erodes the value of the dollar. The most destructive thing about inflation is that it distorts the information communicated by market prices, reducing the ability of market exchange to direct resources, including labor, into their most productive uses. Just as a yardstick ceases to be useful for measuring and comparing distances if its length is subject to sporadic change, so market prices are less useful for expressing and comparing values when the value of money is subject to sporadic changes. Also, inflationary distortions make it almost impossible to know what interest rate is appropriate when people borrow and lend money to finance long-term investments. So in an inflationary environment, many efficient capital investments that would increase the future productivity of labor—and increase future wages—never get made.

Avoid the Pork

Reduce pork-barrel spending: There can be no doubt that reducing pork-barrel spending would increase real wages by increasing the productivity of the economy. A major portion of federal spending is motivated by the ability of particular congressional districts or organized interest groups to capture benefits by spreading the costs over the entire taxpaying public. With those receiving most of the benefits paying only a small portion of the cost, the pressure is to expand spending well beyond the socially efficient level. Resources are transferred from higher-valued uses to lower-valued uses (for consumers), reducing the real value of salaries and wages. Excess government spending is a negative externality, just like excess pollution, and the former is no less likely to erode real wages than the latter. If politicians worried about the negative externalities of pork-barrel spending as much as they claim to worry about those of excess pollution, the result would be less wasteful government spending and more high-paying jobs.

Eliminate the minimum wage: This would increase wages by increasing the human capital that, for many young people, is best acquired through on-the-job training. Minimum-wage legislation clearly creates unemployment among young people who, for a variety of reasons, including being trapped in dysfunctional public schools, don't have skills worth the legally imposed minimum wage. The result is not just unemployment, which may be a short-term problem, but a reduction in the opportunities for many young people to acquire the skills and attitudes that will make them more productive over the long run. Even those who do get a job at the minimum wage are less likely to get one in which the employer invests in them by providing training opportunities at

the cost of some immediate output. The minimum wage prevents many young people with little opportunity to continue their formal education to develop the skills necessary to earn a good income in the future by working at a low wage when they have few financial responsibilities. Eliminating the law would make it legal for our less-advantaged youth to have much the same opportunity for higher-paying future jobs as more fortunate youth get through college subsidies.

Reduce the power of labor unions: Eliminating some of the legislative privileges that empower labor unions would be an effective way to increase wages. Labor unions can, and do, increase the wages of some workers. But they do so by reducing the wages of others by enough to reduce wages in general. Because of legal privileges that unions receive, it is difficult (and sometimes impossible) for workers to qualify for some jobs without being members of a union. Thus unions can increase some wages by restricting entry into some occupations and rendering those workers less efficient with rigid work rules.

All these practices reduce the productivity of the general labor force. Restricting entry into some occupations increases the wages of union members who work in those occupations, but it increases the number of workers in other occupations where their skills are less valuable. This not only lowers their wages, but reduces the productivity and wages of workers in general by preventing them from moving into their highest-valued employments. By reducing the flexibility of employers to shift workers from one task to another in response to changing conditions, rigid work rules also reduce the productivity, and wages, of workers.

Industry-wide labor unions have also lowered general economic productivity through cartelization of workers. If the firms in an industry explicitly agreed to reduce their output to increase their prices, they would be in clear violation of antitrust law (from which unions are exempt) and subject to harsh penalties—including prison time for senior managers. On the other hand, the firms in an industry have little to worry about if output is reduced because of a strike by its union. So both industry profits and union wages can be increased by the inefficiencies of a cartel “agreement” that remains within the law only because it is brokered by a labor union. (I am not arguing for antitrust laws. Even if antitrust laws could be rendered immune to political considerations, which they have never been and never will be, they would still reduce the competitiveness of the economy because of the static textbook notion of perfect competition on which they are based.)

All these union-induced inefficiencies reduce output below competitive levels and therefore reduce real wages. These inefficiencies would be reduced and the real wages of workers would be increased by reducing the power of labor unions.

As I have noted, all the policies discussed have one thing in common—they would increase wages by increasing economic productivity. They also have another thing in common—they would increase wages broadly, indirectly, and gradually by establishing an environment in which people productively cooperate with one another through markets in ways that best serve their collective interest. This means that the better jobs and higher wages will not be readily

noticed, and even when they are, they will not be seen as the result of can-do government actions for which politicians can easily take credit. So the effectiveness of these policies at creating the type of jobs that politicians are constantly promising to provide does not translate into much political support for them. Politicians would rather receive credit for appearing to create better jobs with counterproductive policies than not get credit for policies that actually allow better jobs to be created. We now consider some policies that are politically popular because they give the appearance of increasing high-wage jobs while actually reducing them.

Policies That Reduce Wages

Restrict imports: When politicians argue for increasing an import restriction or against reducing a restriction, they invariably claim that they want to protect high-paying jobs. An import restriction does protect some high-paying jobs, but at the cost of reducing the emergence of other, even higher paying, jobs, because of the general reduction in productivity that lowers average real wages. But the protected jobs are currently held by relatively few identifiable workers who are typically well represented politically and are fully aware of the benefits they receive from politicians who vote for a trade restriction protecting them from foreign competition. The resulting loss of even more productive jobs can be safely ignored by politicians since it is widely dispersed and not easily noticed—it is hard to miss what we never had. And even if the loss is noticed, the cause—the import restriction—is not easily seen.

Put corporations on the dole: Politicians oscillate between attacking business and praising it, depending on the political issue and climate. But they are constant in dispensing large quantities of corporate welfare that the general public pays for through higher taxes and lower economic productivity. The most common justification for this welfare is that it creates jobs. And indeed it does, but only by destroying the chance for more productive jobs that would have emerged if competition had not been restricted and consumers had been allowed to spend the money paid in taxes to buy what they valued most instead of paying for corporate welfare. Unfortunately, the jobs that are created are visible and easily seen to be the result of government policy, while the higher paying jobs that don't emerge are invisible—it is difficult to miss what never was created.

Raise taxes: Politicians often call for higher taxes as the best way to promote economic growth and create more and better jobs. Supposedly higher taxes will reduce the budget deficit, which will reduce interest rates by reducing government borrowing. The popularity of raising taxes to increase good jobs seems to contradict the thesis of this article. It suggests that politicians are willing to take an unpopular action—raising taxes—to provide a general benefit—widespread economic growth and job creation. But raising taxes is not an effective way to increase economic growth and create jobs. Even if raising taxes did reduce the federal budget deficit, it is not likely to have much effect on interest rates. Interest rates are determined in a worldwide capital market, with rates often falling when the federal budget deficit is increasing and rising when

it is decreasing. Second, increasing taxes seldom reduces the budget deficit, at least not for long. Even when higher taxes raise more tax revenue, the additional money is invariably used to expand government spending and pork-barrel programs, with spending growth typically outpacing revenue growth. The effect is to substitute public spending guided by political influences for private spending guided by economic considerations—a sure prescription for reducing productivity and lowering real wages. Also, with higher tax rates, special interests are willing to pay politicians more for tax loopholes, which introduce more productivity-reducing distortions in the allocation of spending and investments. The political cost of increasing taxes is more than offset by the political benefits from the plausible pretense that good jobs are being created while securing more of the national income to buy more electoral support.

Increase government spending: The list of benefits from more spending on highway construction, recycling, education, agricultural subsidies, parks, airport expansion, water-diversion projects, and so on always includes additional jobs. But the jobs created are a major cost of these spending projects, not a benefit. The jobs necessary to build a road or recycle aluminum cans are filled by workers who are not producing value in other activities. Unless this cost is considered, the jobs created will be destroying wealth at the margin, since the value created by workers on government-funded projects will be less than the value (in terms of consumer preferences) they could be creating elsewhere. Political incentives make this misallocation of labor inevitable.

Regulate labor markets: Politicians can take credit for protecting and creating jobs by imposing a number of productivity-reducing restrictions on labor markets. To list two: affirmative-action enforcement pressures employers to hire workers on the basis of the racial mix of the communities in which they operate and increases the difficulty of dismissing unproductive workers; politically mandated employee benefits reduce the flexibility of employers to adjust compensation in ways that attract the best mix of workers to their firms at the least cost. (We've already discussed the minimum wage.)

The advantage of the policies that would create more high-paying jobs indirectly is that they do so by creating a positive-sum setting in which people interact in increasingly productive ways. The same increase in productivity that raises real incomes also increases the general level of wealth, enhancing our lives in a host of ways. For example, as wealth increases, infant mortality decreases, life expectancies (and the quality of life) increase at all age levels, poverty declines, the environment becomes cleaner, access to the arts increases, more leisure time becomes available, and jobs become safer, more pleasant and higher paying.

The problem with policies that try to create more high-paying jobs directly is that they do so with government transfers and protections that are negative-sum. Yet this negative-sum approach is politically compelling because politicians receive much of the credit for the benefits, while receiving little of the blame for the larger losses.

Just Wait Until It's Free

January 27, 2012

Dwight R. Lee and J.R. Clark

The quip “If you think it’s expensive now, just wait until it is free” is funny because of the unfortunate truth it contains. The truth is unfortunate less because it’s impossible to provide benefits without costs than because politicians constantly try to convince voters otherwise. To paraphrase Thomas Sowell: The first law of economics is that there’s no such thing as a free lunch; the first law of politics is to disregard the first law of economics.

Politicians convince only the naive that government can provide free benefits, but the political process creates a lot of naivety. This naivety in turn allows politicians to enact policies that make it rational for consumers to act as if they believe government has lowered the cost (often to zero) of goods even when they know better. As the joke suggests, however, the more the “as if” cost of a good is reduced, the more its real cost is increased. This can be explained by making use of the important distinction between the total cost consumers pay for a good and the marginal cost they pay—that is the additional amount they pay to buy one more unit of the good.

The most obvious way the government can make people act as if the cost of a good has been reduced is to lower its price. The most direct way to do that is by imposing a price ceiling below the market price. We mention a price ceiling briefly only to explain why we do not consider it in detail. When the price of a good is legally lowered, the amount supplied will decrease, so consumers cannot act as if the cost has been lowered by purchasing more, despite their desire to do so. Also, it quickly becomes clear to consumers, once the aggravation of longer lines, poorer service, and declining quality is considered, that the cost of the good has become higher, not lower.

A more lasting way for politicians to give the impression they have lowered the cost of a good is to subsidize its supply. This can be done by transferring an amount covering all or part of the cost to suppliers for every unit of a good sold to consumers. This per-unit subsidy would cause a corresponding drop in the cost of production and thus in the price of each unit of the good. We assume

the supply curve is horizontal—that is, prices won't rise to offset increased consumer purchases in response to the price subsidy.

For example, the entire cost of providing a year of K-12 government schooling is subsidized, and parents can send all their children to a government school regardless of how many they have. There are, of course, restrictions on which school parents can send their children to, and they have little control over who teaches their children. Similarly, government medical care subsidies, whether provided through Medicaid, Medicare, or tax advantages bestowed by not taxing employer-provided insurance as income, lower the price paid directly for medical care. Here again, relatively few restrictions on the amount of medical care people demand have been imposed, but this is likely to change rather significantly in the future.

If they give it any thought, most people recognize that any market prices they pay directly for government schooling and medical care are far less than the total amount they actually pay for these services. But they seldom know how much they are paying over and above the direct out-of-pocket price, and even if they did, it would not influence how much of the subsidized services they demand. This begins the explanation of why subsidizing goods increases their cost.

When politicians subsidize the supply of a good, they reduce its marginal cost to consumers by increasing the amount they pay in taxes to finance the subsidy. The marginal cost—the additional amount paid when another unit is purchased, as determined by the now-lower price—is the only cost consumers pay attention to. The total subsidized cost, in the form of higher taxes and/or insurance premiums, also increases when a consumer buys another unit of the service, but that increase is spread over all consumers, often many millions of them. So the increase in this cost is effectively zero to a consumer deciding how much of a subsidized good to buy, and is therefore ignored.

In other words, subsidizing the supply of a good creates an external cost of the type that is referred to as a “market failure” when it results from private activity (think of pollution, which is really the result of the absence of markets), but is referred to as protecting consumers against market exploitation when intentionally created by government policy. The subsidy creates a situation in which each consumer can benefit by shifting much of the cost of her consumption to the rest of the population—the larger the subsidy the larger this external cost. The result is excessive consumption of the subsidized good as each consumer expands her consumption beyond the point where the marginal value she receives becomes less than the marginal cost of producing the good—that is, less value is received from additional units than is sacrificed to produce them.

Some argue that subsidizing certain goods is justified because their production and/or consumption generate external benefits and would therefore be underconsumed if not subsidized. It is possible that a government subsidy can increase consumption of a good by exactly enough to offset the underconsumption due to an external benefit that would otherwise exist. But a realistic view of the knowledge political authorities possess, and the incentives they face,

raises serious doubt that such goods can be correctly identified, or the right subsidy applied if they were. For example, there are private firms that generate both external costs (say in the form of pollution) and external benefits when producing a good. It is easy to model a situation in which efficiency requires that such a firm's production should be subsidized despite the pollution it creates. However, we challenge any government agency to determine when such situations exist, as they surely do, and then accurately determine what the efficient subsidies are. And even if such information were available, it would be largely ignored since the political considerations that determine what goods are subsidized, and by how much, seldom have much if anything to do with economic efficiency.

The point is that no matter why government subsidizes a good, whether to improve economic efficiency or, more likely, to satisfy some constituency under the pretense of reducing the good's cost, the effect is invariably to increase its cost. Even though the immediate effect is to decrease the good's price by the subsidy's per-unit amount, with the per-unit cost (price plus the cost of the subsidy) remaining the same, the lower price will quickly motivate an increase in the amount demanded. This will cause the price, and therefore the per-unit cost, to increase for at least three reasons, even if, as we have assumed, the supply curve is horizontal.

First, consumers have little motivation to shop carefully because the price, or direct cost, is often a small percentage of the total cost. In some cases, such as government schools (where the price is zero), consumers typically are not allowed to compare alternatives, but are assigned to a particular supplier (school). Even when consumers can choose their suppliers, they have little motivation to ask about the cost of the good, as is the case of medical care—the direct cost of which is only about 13 percent of the total cost in the United States. With consumers paying little attention to the cost of the goods they consume, suppliers have less motivation to compete on price and greater latitude to direct their customers into costly options that add little if any value.

Second, the less of the total cost consumers pay directly for a good, the less control they have over its quality or the convenience with which it is delivered. The result is that the quality of subsidized goods declines relative to their increased cost. Indeed, government schools provide a clear example of declines in educational quality, particularly in the inner cities where parents are less able to afford private schools, while cost has increased significantly. By most measures the quality of American medical care has improved, as access to improved drugs and the availability of technically advanced medical devices have increased, but at a greater cost than necessary. And the extra cost has not resulted in life expectancies equal to those in some countries with lower per-capita spending on health care, although there are many factors other than such spending that affect life expectancy. And it should also be pointed out that in countries where medical care is provided by the State, there are longer waits for that care than in the United States.

What can be said with confidence is that the control people have over the medical care they receive is becoming more like the control pets have over the

medical care they receive. In both cases, the ones receiving the care are not the ones paying directly for it. Doctors consider those paying directly their customers, and primarily cater to their desires (and instructions). We might have some advantage over our pets in this regard since we still pay directly for a portion of our care. But when considering our diminishing control over health care decisions that affect our lives, we should ask ourselves: Are the bureaucrats representing those paying for most of our medical care as concerned with our well-being as we are for the well-being of our pets?

A third reason why subsidizing goods increases their cost is the burdensome red tape that invariably accompanies the production and consumption of such goods. It is customary for people to complain about the forms that have to be filled out and records that have to be kept by teachers and their students, and doctors and their patients. There is also the accompanying cost of the hoards of bureaucrats necessary to formulate, enforce, and keep records on all the rules and regulations, most of which have no obvious connection with doing a better job educating and healing. But such complaints, and the promises of politicians to reduce red tape, have no effect because there is a good reason for much if not all of it. One of the unappreciated advantages of market exchanges is that when consumers pay with their own money and suppliers have to compete for that money by producing value, people are motivated to make decisions that benefit others. This market accountability is destroyed when suppliers are being paid by third parties for most of the cost of making a good available to consumers. Red tape is a poor substitute for market accountability, as is evident from the fact that it does not prevent the cost of subsidized goods from increasing. But if markets are not allowed to function, the alternative to red tape would be an almost complete lack of accountability. The only way to reduce red tape is to eliminate the subsidies and restore the effective and efficient accountability that only a market can impose.

Even though most of the cost of a subsidized good is paid indirectly, it commonly increases to the point where there is a noticeable and negative public reaction. When this happens, the political response to public complaints about the escalating cost is almost always to increase the subsidy, not to reduce or eliminate it. This will be accompanied by political attempts to convince the vast majority that a relatively few rich taxpayers will pay the subsidy thanks to efforts to make them “pay their fair share.” The reality is that almost everyone ends up paying more one way or another. The total cost continues to go up, as do the inconvenience and red tape imposed on consumers and suppliers by government, which then provides more jobs for both government and private-sector bureaucrats.

When the cost-increasing effects of ever larger subsidies overwhelm the ability of politicians to convince voters that the cost is being paid primarily by others, political efforts are made to reduce the cost. But these efforts typically involve more bureaucratic control, which imposes yet more restrictions on the types of goods and services available, who is eligible to receive particular types, and the amount of compensation received by suppliers.

This has clearly been the case with health care. Since government began

to provide significant health care subsidies, reform has consistently meant increasing the size and scope of the subsidies and the legislative detail imposed on health care decisions. It is interesting to note that physicians experienced large income increases with the big boost in medical subsidies beginning in 1965 with Medicaid and Medicare. Their increased compensation was part of the general increase in medical costs as consumers became less concerned with the cost of their care and demanded more of it. Not surprisingly, physicians are less enthusiastic about the 2010 Affordable Care Act, which is threatening to reduce their incomes. But consumers have the most to lose from increased government control over health care decisions. Without market prices determined by free exchange and undistorted by government subsidies, goods will have to be rationed by government authorities. They won't be called death panels, but they will be making decisions that will result in shovel-ready action.

The experience in government education is different from that in medical care for the obvious reason that it has long been financed entirely by government subsidies. Therefore, cost increases in government education cannot be obscured with increased subsidies. Also, school choice has been far more limited than the choice of doctors and hospitals. This may be why providing consumers more choice has been recommended as the best way to reduce educational cost and improve its quality. Privatizing schools would be the most effective way of achieving these improvements by insuring that people are paying the full cost of education directly with their own money. A clearly second-best approach would be providing parents of school-age children educational vouchers that could be used to pay for tuition at any school, private or public, that parents chose. Even this second-best approach has been effectively resisted by the government-school lobby, which has so far been able to convince the public that competition would reduce the quality of education. Fortunately, more people are starting to see this lobby as the biggest obstacle to genuine educational reform.

Most people would like to have their purchases subsidized by government. Once we start down that road, however, it is hard to keep the subsidies from spreading to a wide variety of things almost everyone purchases. The result is we find ourselves heading toward the situation described by Frédéric Bastiat, the nineteenth-century economist, when he said, "The state is the great fictitious entity by which everyone seeks to live at the expense of everyone else." Such an attempt to reduce the cost to everyone is clearly a guaranteed way to increase the cost of everything. If you think it is expensive now, just wait as the politicians continue to disregard the first law of economics.

The Tyranny of Utility

October 3, 2012

*Behavioral Social Science and the Rise of
Paternalism*

It is clear from Saint-Paul's opening pages that he wants to prevent the "gradual elimination of individual freedom as 'social science' makes progress in documenting behavioral biases, measuring happiness, and [favorably] evaluating the effects of coercive policies, while information technology provides ever more efficient tools of control to the government." But he argues that trying to make the case for freedom on instrumental, or utilitarian, grounds will fail as new theories and evidence, such as those found in behavioral economics and happiness research, undermine the unitary individual assumption on which economic analysis rests. As the view of rational, utility-maximizing behavior is undermined, it is replaced with support for paternalistic policies.

Throughout the book Saint-Paul provides examples of paternalistic policies eroding freedom. He gives little hope, however, that this paternalistic trend can be contained, much less reversed. I kept hoping to find some discussion of Public Choice to inject political realism into how paternalistic policies would actually work. Only in the book's final semi-optimistic pages is there a discussion of political agency, followed up with reasons why such arguments are "not likely to be very convincing to the paternalists." Surely true, but maybe they'd be convincing to others.

Saint-Paul recognizes that standard economics provides justification for a liberal social order where social welfare is tied closely to individual welfare, and even when markets are seen to fail, economics suggest they are best remedied by policies that minimize restrictions on freedom. Yet in terms of protecting freedom, he sees the "fundamental philosophical flaw of the economic approach [as being] that it does not value individual freedom per se." His explanation for this statement is the consequentialist approach of economics, according to which economics only cares "about the allocation of resources at the end, not about the process by which resources were allocated" (emphasis added).

This seems to me as if Saint-Paul is giving up the game as far as protecting

freedom is concerned. Again quoting him, “Once the premises of consequentialism are accepted, we can only object to some government intervention on instrumental grounds...This stands in contrast to principled objections, which state that the intervention violates some fundamental principle upon which society is built” (emphasis in original).

Process is important in ethical arguments, but while freedom is a consequence of markets (not necessarily defined in terms of strict *laissez faire*), it is also an essential ingredient in the market process. Moreover, it is a fundamental principle on which society is built and which paternalistic policies violate, as Saint-Paul’s discussion and examples make clear. Indeed, at the end of his book he sees hope in achieving “[l]imits to government...not...from the fear that excess government intervention might get out of control and have harmful consequences but from the principle that one cannot interfere with freedom of choice and individual responsibility.”

But why shouldn’t the fight for freedom also include an instrumental concern about, and attack on, the harmful consequences of excessive government? After all, Saint-Paul’s book is loaded with examples of instrumental arguments for paternalistic policies that have apparently been effective. As he states, “There are countless examples of a public debate about a law that would strip people of their individual rights revolving around the existence or lack of academic studies showing that exercising that right has a statistical effect on undesirable outcomes.” Saint-Paul reemphasizes this point after briefly discussing three examples with the comment, “In all these cases the arguments are purely instrumental.”

It was known long before the work of behavioral economists and happiness scholars that real-world markets failed to achieve textbook efficiency. But as Public Choice scholars began pointing out in the 1950s, the relevant question with regard to this failure is: Compared to what? And when the realistic alternatives (primarily some type of political or collective process) are subjected to the same analytical scrutiny that uncovers market failure, those alternatives are found to generate their own failures. Of course that suggests a consequentialist approach in which those failures must be compared against some measure of good or bad. Again, despite his criticism of consequentialism early in his book, Saint-Paul recognizes its potential in the fight against paternalism when he states, “[W]hile paternalism may help solve some behavioral biases on paper, it ignores the actual workings of government. Thus the consequentialist approach should also be applied...”

Even though my comments have focused mainly on the concerns I have with Saint-Paul’s presentation, I recommend this book to anyone who, like myself, appreciates insightful critiques of what seems to be an endless supply of arguments in favor of expanding government to accomplish good, without any consideration of the harm caused by the accumulating restrictions on our freedom.

Capitalism and Freedom

October 3, 2013

*A 50th Anniversary Tribute to Milton
Friedman*

It is difficult for younger people (those who reached college age after 1980) to fully appreciate Milton Friedman's contributions in his 1962 book, *Capitalism and Freedom*. Friedman's proposals for relying less on government coercion and more on market incentives and freedom to address problems have not been shockingly outrageous to those who came of age at the beginning of the Reagan administration or later. Whether or not these younger people agreed with Friedman's policy recommendations, most knew they were being taken seriously by important people. The older of us can more fully appreciate Friedman's contributions today because we can recall that his ideas were either unheard of or dismissed as ridiculous when put forth in *Capitalism and Freedom*.

For example, I majored in economics in college and took my first principles course (macroeconomics) in 1960. The course emphasized the Keynesian model and how this model made it possible to moderate the business cycle with fiscal policy. The role of money was hardly mentioned since the model suggested that the real economy was unaffected by the money supply and inflation was entirely explained by excess aggregate demand. Friedman probably was not mentioned in this course. He probably came up in subsequent courses, in passing, as an example of someone who continued to believe in things like the ability of market forces to bring an economy out of recession or depression without government intervention.

Never mentioned in any of my classes were proposals found in *Capitalism and Freedom*, such as increasing reliance on market competition by eliminating occupational licensing, replacing the draft with a market for military personnel, and requiring government schools to face market competition for students by providing parents with educational vouchers. In the principles and intermediate microeconomics courses, the graphical presentations were accompanied with comments noting that the material had little relevance to public policy.

In 1962 Friedman was a voice in the wilderness making the case for markets

and freedom when the vast majority of academic economists believed that the best (if not the only) hope for economic progress was government spending guided by Keynesian fiscal policy. Fortunately Friedman's voice was amplified by the impressive logic and clarity of his arguments. But before 1962 his arguments were targeted exclusively toward academic economists, most of whom tried to ignore or belittle them, though the best knew they had to pay attention to Friedman whether they agreed with him or not.

Poking Holes in Keynes

In 1941, before Friedman became well known to leading economists, he considered himself a Keynesian. But at the University of Chicago, where he taught from 1946 to 1976, he started seeing problems with Keynes's model that were overlooked by the rest of the profession. In 1957 he published *A Theory of the Consumption Function* using longitudinal data to show that the marginal propensity to consume did not decrease as national income increased, as Keynes had argued, and Friedman provided a theoretical explanation for this empirical result. This book undermined the popular Keynesian argument that as a country's income increased, more government spending would be required to maintain aggregate demand and prevent underconsumption from causing persistent unemployment.

In 1963 Friedman published an article and a book that created further skepticism about the validity of Keynesian economics. With David Meiselman he published "The Relative Stability of Monetary Velocity and the Investment Multiplier in the United States, 1897–1958," which estimated a Keynesian multiplier of zero, meaning that an additional dollar spent by the federal government would simply substitute government spending for the same amount of private spending, doing nothing to stimulate economic activity. That year, 1963, also saw the publication of *A Monetary History of the United States: 1867–1960* by Friedman and Anna J. Schwartz, the fruit of 15 years of data collection and careful analysis. Despite the best effort of Keynesians to discredit this book, its powerful empirical and theoretical case made it embarrassing for economists to continue dismissing the importance of money supply changes on short-run economic activity and the long-run price level.

Friedman's 1967 presidential address to the American Economic Association (published in the *American Economic Review* under the title "The Role of Monetary Policy") examined an empirical finding known as the Phillips Curve, which indicated high inflation was associated with low unemployment and low inflation with high unemployment. This seemed to support the Keynesian position that the only way to reduce unemployment is by accepting more inflation and the only way to reduce inflation is by accepting more unemployment. Friedman acknowledged that the Phillips Curve effect existed in the short run but used monetary theory to explain how both inflation and unemployment can simultaneously increase (or decrease) in the long run, something the Keynesian model cannot explain. Within a few years of this address, the American economy was suffering from both escalating inflation and unemployment, and

it became increasingly apparent that Keynesian economics had been seriously damaged by Friedman's intellectual assault.

Reputation and Fame

These examples of Friedman's destruction of the Keynesian consensus are but a small sample of his contributions to our understanding of economics. But they are enough to explain the towering professional reputation Friedman had achieved by the mid-1970s, a reputation demanding that his recommended policies in *Capitalism and Freedom* be taken more seriously than they were in 1962. But they also suggest another factor in his influence on public policy.

As impressive as Friedman's professional reputation was by the mid-'70s, the stagflation (economic stagnation with increasing unemployment and inflation) that characterized the American economy in the last half of the decade extended his reputation among the general public. Friedman established a public following in the 1960s, primarily through his *Newsweek* column, which started in 1966. This was surely a factor in the increased recognition that came his way in the form of talks on campuses, talks to business groups (he was invariably critical of business's seeking political protections against competition), and a well-publicized 1973 interview in *Playboy*. But this public recognition made a quantum leap with his receipt of the Nobel Prize in economics in 1976, followed by the widespread recognition that he had explained and anticipated the stagflation that was dominating the economic news and puzzling Keynesian economists. In addition to columns and interviews in magazines, Friedman appeared on highly rated television shows such as the Phil Donahue Show. Friedman was probably the only economist in the world who could attract a large audience when there were only three TV networks, each aimed at a mass viewership.

The point is that when stagflation undermined confidence in Keynesian policies, public attention turned to Friedman and the alternative economic policies he had spent years developing and popularizing. Friedman recognized this as a critical factor in his influence when he stated in the preface to the 1982 edition of *Capitalism and Freedom*: "Only a crisis—actual or perceived—produces real change. When that crisis occurs, the actions that are taken depend on the ideas that are lying around. That, I believe, is our basic function: to develop alternatives to existing policies, to keep them alive and available until the politically impossible becomes politically inevitable."

In 1979 Paul Volker, the new Federal Reserve chairman, knew that curing economic stagflation required something other than Keynesian policies, and he followed Friedman's advice by attacking stagflation with tight monetary policy. As Friedman (and the Phillips Curve) predicted, the initial effect was to increase unemployment. But as Friedman also predicted (as opposed to the Phillips Curve), after a lag needed to erode inflationary expectations, both inflation and unemployment started falling and the rate of economic growth increased.

Keynes's Enduring Appeal

This is not to argue that Friedman won the battle against Keynesianism in the political arena. Just because Keynesian economics is in retreat among academic economists does not automatically reduce its appeal to politicians. Few politicians can resist policies that give the superficial appearance of addressing problems quickly in ways that generate political support even if they are counterproductive. Keynesian policies satisfy these conditions. Keynesians consider aggregate demand to be the primary force driving economic growth, and they believe that people can increase their demand quickly in response to government spending that increases their incomes. This spending can be targeted to concentrate immediate benefits on particular interest groups in ways that save the jobs of identifiable people who will be aware, and appreciative, of the politicians who supported the spending. It is far more difficult to trace the widespread reductions in spending by others—and the jobs lost or simply never created—to those politicians, much less to the Keynesian policies they supported. In contrast, Friedman's policy recommendations work through markets by effectively increasing the economy's productive capacity with the understanding that consumption comes before production only in the dictionary. But these policies work indirectly, over the long run, to provide dispersed and incremental improvements in our wealth. Thus this benefit goes largely unnoticed, and politicians cannot easily take credit for it even if it is noticed.

This takes us back to the importance of Friedman's observation on the importance of alternative policies being available when events make it clear that existing policies aren't working. The failure of Keynesian policies during the Great Recession first eroded public support. It is doubtful that a majority of American politicians today would claim to be Keynesians—many advocate reduced federal spending despite high unemployment. How effectively this will translate into action remains to be seen, but events have clearly shifted the center of political gravity in Friedman's direction.

His proposals extend to more concerns than macroeconomics, and when they have succeeded politically it typically has been because events made them politically salient. One of the most politically successful of the policies proffered in *Capitalism and Freedom* is the all-voluntary military, a policy enacted in January 1973 and catalyzed by the unpopularity of the Vietnam war. One of the book's least politically successful attacks on public policy is against occupation licensure, even in medicine, which Friedman argued is inconsistent with the principles of a free society. Arguably this lack of success is explainable by the absence of any event that focused public concern on the problems with occupational licensure, not any deficiency in the power of Friedman's argument.

The second-longest chapter in *Capitalism and Freedom* is devoted to education and school choice. No one can deny that school choice has become an important political movement in the United States, having gone from being completely ignored by the government school lobby to being considered a serious threat. On the other hand, the movement has met with powerful political opposition and numerous setbacks. Government education (K-12) has not reached a crisis point, instead declining incrementally. Its biggest victims have

been the relatively poor, whose votes can be taken for granted by political representatives who consistently cater to the special-interest demands of teachers' unions.

Space prevents me from giving additional examples to show that the political success of Friedman's proposals is determined largely by events that impact the public. This is not to deny that the power of Friedman's ideas has been critically important to their political success. But when ideas run as counter to political incentives as Friedman's do, they face enormous difficulty in getting a political hearing, no matter how brilliant they are. Yet the brilliance with which Friedman made his arguments in *Capitalism and Freedom* was essential, if not sufficient, to achieving political success.

International Trade

Free Trade to Benefit the Many

October 1, 1997

*Free Trade to Benefit the Many—Not Fair
Trade to Benefit the Few*

When asked, most politicians claim that they favor free trade. But they quickly add the qualification that it must also be fair trade, which generally means that we should open our markets to another country's products only if their markets are equally open to our products. This qualification makes sense politically because people are easily convinced that it makes sense economically. Why should we give other countries the opportunity to increase their employment at our expense unless they reciprocate? Unfortunately, this view misses entirely the real advantages of international trade. Furthermore, it reflects a serious political bias that distorts government decisions over a wide range of issues.

The advantage from trade with other countries does not come from selling more to them than they sell to us so we can create more jobs. The key to a successful economy has never been simply the creation of jobs. The ability to consume always exceeds the ability to produce, so there is never a lack of work to do. The key to a successful economy is directing people into the most productive jobs, those that create the most value for consumers. This is the real advantage of international trade. We create more productive domestic jobs both when we sell and when we buy from other countries, and the more open the international trade arrangements the better for all countries. When country B restricts the import of American products it reduces its productivity as well as ours. But we only add to our productivity loss if we respond by restricting the ability of our citizens to buy products from country B.

Consider the fact that, despite political rhetoric, when we buy foreign products we create American jobs. It would actually be better for Americans if this weren't true. When Americans buy products from, say, Japan, we end up with products we value more than the dollars spent could have bought elsewhere, and the Japanese end up with more dollars (actually the one who sells yen to American importers to pay for the Japanese products ends up with more dol-

lars, but this doesn't meaningfully alter the story). What do the Japanese do with these dollars? It would be nice if they treated them as collector's items, to be kept and admired. Then Americans could obtain valuable products by doing nothing more costly than printing up dollars, something so easy that even the federal government does it well. But the Japanese produce goods for Americans not because they want dollars, but because of what dollars can buy. Those dollars eventually come back to America as claims on goods produced by American workers, or as investments in America that create domestic employment opportunities. They may not all come back directly from Japan, but they do come back.

I don't deny that by restricting foreign imports we can save some American jobs. But because these jobs, by definition, cannot survive the demands of international trade they obviously don't create as much value as those American jobs that would have been created without the import restrictions. Foreign trade eliminates only those jobs that are producing goods which domestic consumers can import cheaper by shifting their effort into more productive employment elsewhere in the economy.

Unfortunately, the general benefits from unrestricted imports (lower prices for consumers and a more productive economy) are largely ignored by the political process, which sees imports as a threat to existing jobs. The problem here reflects a distortion inherent in the political process. Relatively small groups organized around a common concern, such as protecting profits and jobs in a particular industry, are well positioned and strongly motivated to communicate through the political process with a loud, clear voice. On the other hand, the general consuming public is too large and too diverse in its concerns to communicate a clear and consistent message through the political process. If something threatens to concentrate a cost on an organized few while spreading a benefit over the unorganized many, politicians will hear from the few but not from the many.

This bias in favor of special interests over the general interest explains a host of political perversities. It explains, for example, the difficulty politicians have cutting spending programs, which tend to concentrate benefits on organized interest groups, in order to reduce the burden on the general taxpayer. And it certainly explains the political perspective on free trade, which emphasizes the advantage in protecting existing jobs over the far greater, but much more general, advantage of better choices for consumers and improved economic productivity.

If politicians could feel the gain of the unorganized many as intensely as they feel the pain of the organized few, a large number of government restrictions on our economic choices would be quickly eliminated. Restrictions on our ability to buy the best products at the lowest prices, whether produced at home or abroad, would be among the first to go.

Politics and Foreign Trade

December 1, 1999

The case for free trade is overwhelming, both theoretically and empirically. My last two columns developed the theoretical case, which is based on the concepts of opportunity costs and comparative advantage. Even if the people of a country have an absolute advantage in producing everything, they still gain from foreign trade because they cannot have a comparative advantage in producing everything.

Ample empirical evidence backs up the theoretical arguments in favor of free trade. The more that countries permit international trade to direct their productive efforts into their comparative advantages, the more they prosper relative to those that restrict trade. Despite this evidence, almost no country has followed a policy of free trade. With rare, and typically short-lived exceptions, governments reduce economic productivity and their citizens' prosperity by either taxing or imposing quotas on imports. Why? Answering that question is the purpose of this column.

Cooperation vs. Confiscation

Given the advantages of free trade, no government would erect barriers to imports if the political process allowed the same degree of social cooperation as the market process. When trade restrictions are eliminated consumers gain but some workers and investors lose, most temporarily but some permanently. Even those who would lose permanently from eliminating their industry's trade protections would still be better off living in an economy with completely free trade than in one where all domestic industries were protected. Even though individuals may benefit from their industry's protection, they would lose far more as consumers from the protections of everyone else.

Those in an industry subject to intense foreign competition will want government to protect them if they don't have to consider the costs it imposes on others. But protectionism would not occur if an industry had to pay these

costs because the burden to consumers is always greater than the benefits to the protected industry.

Unfortunately, when people obtain benefits from government they do not have to pay prices reflecting their costs, as they do for benefits received in the marketplace. The cooperation of the marketplace comes from the market's ability to collect, aggregate, and communicate costs that are widely dispersed over many people so that they are taken into consideration by those responsible for them. In sharp contrast, when the costs from politically provided benefits are dispersed over many people, those costs are likely to be ignored. So government commonly becomes the means by which people can gain private advantage through confiscation rather than through cooperation.

Weakness of the Many

A trade restriction concentrates benefits on the few in the protected industry at costs that are thinly dispersed over the entire consuming public. With the cost of a trade restriction spread over millions of consumers, few if any will be aware of the little extra they are paying for the protected product. After all, consumers buy hundreds of different products, and a little increase in the price of one product typically has little impact on the well-being of any one of them. Even if a consumer is aware of the extra cost, she will seldom know that it is caused by a trade restriction. And if by some chance she does know the reason for the extra cost, she has little motivation to respond politically. Even if she could eliminate the trade restriction, the effort might cost as much as or more than the restriction. While the total benefit from eliminating the restriction is huge, most of it would go to other consumers whether they took political action or not. But her political action is unlikely to do any good if she acts alone.

Of course, if a large percentage of the consumers act in unison they would surely have a decisive political influence. But because the number of consumers is so large, with each having such a small stake in the outcome, it is almost impossible to organize them for political action. As is often the case, the larger the number of people harmed by a policy, the weaker their political influence.

Power of the Few

On the other hand, because a relative few benefit from a trade restriction, they will be effective in lobbying for it. The benefit to each person will be significant, and each will be aware of both his own gain and the source of that gain. Also, because of the small number of beneficiaries, they are relatively easy to organize for political action. Indeed, they will generally be organized already through industry and occupational associations. So when a trade restriction is being considered, politicians will hear plenty from those favoring the restriction and little if any from those harmed by it. The result is a bias toward providing concentrated benefits and ignoring much larger, but dispersed costs. Therefore, it is often the case that the smaller the number of people benefiting from a policy, the more powerful their political influence in its favor.

With small, organized groups able to capture benefits at the expense of the general public through restrictions on trade (and many other special-interest policies), little social cooperation is achieved through the political process. For that reason, government is a constant threat to the social cooperation that comes from free-market activity.

Considering Some Costs

The costs of trade restrictions are more difficult to identify than indicated above. Consider restrictions on steel imports. Few people buy steel directly. Rather they pay for it indirectly when they buy products made from steel. Also, when an import restriction increases steel prices, employment opportunities are reduced in industries relying on steel as an input. Those who don't get jobs because of a trade restriction will seldom know the reason. It has been estimated that limiting steel imports to 15 percent of the U.S. market would cost American consumers \$189,000 a year for each steel job saved, and that for every U.S. steel job saved, over 3.5 U.S. jobs would be destroyed because of higher steel prices.¹

If such costs were revealed, rather than concealed, by the political process, we would never reduce our prosperity with trade restrictions. The advantage we all receive from free trade is that it forces industries to consider the full opportunity costs of their productive activity. It's too bad that they aren't required to consider the full cost of their political activity.

¹See Arthur Denzau, "American Steel: Responding to Foreign Competition," Center for the Study of American Business, Washington University, St. Louis, Mo., February 1985.

Social Welfare

The Political Economy of Educational Vouchers

July 1, 1986

Public financing of education means political control.

The crisis in public education is real. As judged by any reasonable measure, the quality of public education is declining as the cost of public education is increasing. The desire for reform in public education is genuine. Parents want a good education for their children, and taxpayers want an honest return for their dollars. Unfortunately, a realistic appraisal of why meaningful reform in public education is so badly needed also points to why meaningful reform is so unlikely to occur.

The underlying problem with public education is, quite simply, that it is public. As long as education is provided publicly, it will be controlled by, and for the benefit of, public education professionals. The reason for this is straightforward.

As opposed to market decisions where each consumer exerts direct and decisive control over the services he chooses to purchase, no one individual has decisive control over the political decisions which determine the publicly provided services all consumers are required to "purchase." Seeing no advantage in becoming informed and active in pursuit of objectives over which he has no direct control, the typical citizen-consumer quite rationally devotes little effort to influence public education policy. In contrast, suppliers of public education have significant political influence over public education policy by virtue of the fact that they are organized through professional associations, have a concentrated interest in decisions affecting public education, and are widely perceived as education experts. The political dominance of supplier interests over consumer interests gives public education professionals the opportunity to control the policy of the public schools. The special interests that comprise the public school lobby have taken full advantage of this opportunity to promote their private purposes while neglecting the public's desire for the efficient provision of quality education.

The implication here appears to be clear. Achieving genuine educational reform would seem to require a policy which shifted control of education from suppliers of education to consumers of education. It is this view of the crisis in public education that has motivated the call for educational vouchers.¹ The idea behind educational vouchers is straightforward. Instead of government financing education by actually supplying educational services, publicly funded vouchers would be given to the parents of school-age children to spend at the school of their choice (as long as the choice is approved by government). As envisioned by its proponents, this voucher system would transfer control to the consumers of education. Educators would be forced to compete for the consumers' educational vouchers and therefore cater to the consumers' educational demands. Only those schools providing quality education, as determined by the consumer, at low cost would survive. It is also predicted that the variety of educational approaches would increase to reflect the range of educational preferences among the public. Also, with diversity replacing uniformity in education, market choice would replace political combat as the means of expressing educational preferences.²

Educational Vouchers and Political Realism

This case for educational vouchers would be sound if it were indeed true that the root of the problem lay in the control of public school policy by professional educators. But this is not the case. Educator control of public education policy is a symptom of a more fundamental problem: the public funding of education. The flaw with the voucher system is that it attacks the symptom of the problem without addressing the source of the problem. Under the voucher system public education remains public education, and nothing fundamental has changed.

Proponents of educational vouchers have assumed a benign political setting for their proposal—one which if it indeed existed would largely eliminate the need for vouchers in the first place. Once vouchers were issued by government, consumers would supposedly be in complete control, as the public school lobby would somehow have been politically neutered. The only political influence that would be in evidence is the restriction that vouchers be used to purchase education only from approved schools. And presumably this influence would be exercised in a politically impartial way. The political arena would suddenly become a setting in which the education consumer is in control; the public school lobby is dormant; and quality education is provided efficiently because it is in the public interest to do so. Obviously in such a political setting educational vouchers would perform as advertised.

The prognosis for vouchers is completely different, however, when a realistic view of politics is accepted. As long as education is funded publicly, decisions on educational policy will be made politically. As long as decisions on ed-

¹For the purpose of this paper there is no advantage in distinguishing between educational vouchers and educational tax credits, and henceforth we will refer only to vouchers.

²Milton Friedman, the leading proponent of educational vouchers, first made the case for vouchers in "The Role of Government in Education," in Robert Solow, ed. *Education and the Public Interest*, New Brunswick: Rutgers University Press, 1955.

educational policy are made politically, the interests of consumers will remain diffused and unorganized, and dominated by the focused and organized interests of the public school professionals. Given this fact of political life there are only two possibilities for educational vouchers. The first possibility is that educational vouchers will be benign because they never will be considered seriously. The second possibility is that educational vouchers will become politically acceptable—in which case they will be no better, and probably worse, than the educational approach they replace.

Consider a voucher proposal which, if enacted, would indeed be in the best interest of the public as consumers of education. In other words, the voucher proposal would accomplish exactly what proponents of educational vouchers envision: the transfer of control over education to consumers from suppliers. One does not have to be clairvoyant to predict how the public school lobby would respond to such a proposal. They would oppose it for the obvious reason that their power and privileges would be undermined by a voucher system which worked the way it is supposed to work. This opposition is sure to be effective for the same reason that lies behind the case being made for vouchers—the ability of education professionals to control education policy when that policy is determined through the political process. What the voucher proponents have not yet recognized is that they are confronted with a Catch-22. They want an effective voucher system for the very reason that it is impossible to have one.

Unfortunately, this is not the end of the story. If it were, the idea of educational vouchers would be a rather harmless one. The problem is that there is a real danger that educational vouchers will become politically acceptable.

How will vouchers become politically acceptable if they pose such a threat to the professional educators who control the political agenda on educational policy? It has to be recognized that the public school lobby faces a second threat. That threat is public education's inferiority to the private education alternative, but this is a threat that the public school lobby can neutralize with the creative use of educational vouchers.

Compelling evidence of the inferiority of the public schools is found in the fact that private schools, charging full price for their services, are competing successfully against the fully subsidized public schools. And the number of parents who remove their children from the public school system is likely to increase. The public schools are surely not going to get better, and are very likely to get worse. The recent call for "reform" and the political rhetoric about "excellence in education" will do nothing to improve public education. Indeed, the pre tense of reform has satisfied the political demand that something be done while leaving such educationally destructive forces as the National Education Association with more control than ever. On the other hand, the private demand that something be done will continue to find expression in parents' rejection of public schools. This rejection will surely increase as per capita incomes increase, even if the decline in the quality of public education is somehow arrested. It should not go unnoticed that increased wealth represents a major threat to the public education establishment. The wealthier parents become, the greater their demand for quality education for their children, i.e., private

education for their children. The NEA's advocacy of economic policies calling for economically stifling regulations and taxes is not completely irrational from their perspective.

The Response of the Public School Lobby

The public school lobby will respond to this threat of consumer rejection, but how? It will not, indeed cannot, respond by improving the quality of education and becoming competitive with private schools. This is not to be taken as a criticism of the individuals who teach in our public schools. Many of these individuals are competent, hard working, and personally dedicated to educational excellence. The problem is one of the flawed incentive structure that plagues the provision of all publicly financed goods and services.

If suppliers are to direct their efforts efficiently and persistently to the satisfaction of consumer demands, they require accurate information on what those demands are, and compelling motivation to respond to this information. There is only one arrangement whereby this information and motivation can be provided. That arrangement is the private market where consumers, by virtue of the fact that they are spending their own money as they see fit, communicate their preferences through changes in prices and patronage in a way that conveys wealth gains to those suppliers who respond appropriately, and imposes wealth losses on those who do not. By breaking the connection between the demand for education and the ability of consumers to control their own money in expressing that demand, public education has made it impossible for the public schools to provide quality education efficiently.

But the public school lobby does not have to concern itself with providing better education at lower costs in order to beat back the threat it faces from the private school option. If the move to purely private schools begins to accelerate, the public school lobby can, and surely will, protect its privileged position against this competition by embracing educational vouchers. As strange as it will sound to advocates of educational vouchers, if the voucher approach to education ever becomes a serious political possibility, it will be as a means of reducing competition in education, not increasing it.¹

The advantage the public school lobby will see in educational vouchers comes from the ability of vouchers to entice students back into publicly financed education. Consider the situation in which a large number of parents have taken their children out of the public schools. These parents will have the control over their children's education that can come only from private education, but they will be paying dearly for the privilege; paying for both the private education they have chosen and the public education they have rejected. Given this burden, parents of children in private schools will be susceptible to a proposal for educational vouchers. As presented by the advocates of vouchers, which will now include public school professionals, the promise will be continued freedom of choice in education without the obligation to pay

¹This point was first recognized by Gary North in his article, "Educational Vouchers: The Double Tax," *The Freeman*, (May 1976): 259-75.

twice. Such a voucher proposal will also sound appealing to the proprietors of private schools, who will mistakenly see it as a way of expanding the demand for their product by eliminating the discriminatory financial burden being placed on their customers.

Unfortunately, the reality of educational vouchers will be far different from their promise. Vouchers or no vouchers, as long as education is financed publicly, control over education will be exerted through political power, not through consumer choice. Educational vouchers may, for a time, give the appearance that consumers are exercising genuine choice. But consumer choice can, and will, be circumscribed by restrictions on the vouchers; restrictions that will reflect the interests of the politically organized public school lobby, not the interests of the politically unorganized public. One can predict with confidence that the choices educational consumers will have under any voucher system that is politically acceptable will in no way threaten the privileged position of the public school establishment.

This conclusion is based on more than just idle theorizing. We have experience with Federally funded educational vouchers at the experimental level. The Federally funded voucher experiment that ran the longest and has been deemed most successful was conducted in Alum Rock, California. As one would predict, restrictions were placed on these vouchers which minimized the competitive pressures they imposed on public school professionals, and which attempted to promote social objectives that had little to do with education. Teachers, for example, did not have to worry about loss of income if their enrollments declined. They were given priority in teaching jobs at other schools and were paid for makeshift work until such jobs became available. On the other hand, teachers who succeeded in attracting additional students were not rewarded with higher salaries. Those schools which parents preferred were not able to expand to meet the extra demand. Those students who did not get their first choice were simply assigned to other schools. A local employee certification council required that any private school had to satisfy a host of standards on such things as teacher education requirements, pay and fringe benefits, and faculty-student ratios. This control over entry was used to make it effectively impossible for any private school to enter into competition for the vouchers. The Alum Rock vouchers did nothing to threaten the suppliers of public education by passing genuine control to the consumers of education.

If educational vouchers become politically viable it will be because they can be used to reverse the expansion in genuinely private education. The public school lobby will see educational vouchers as the means to entice those who are attending private schools back into a public education system that will be no better than the one which they have rejected.

Conclusion

The special interests that comprise the public school lobby have been able to subvert educational policy to their narrow advantages with the same political influence that will be used to frustrate any reform that threatens those advantages. These special interests would be emasculated by a system of educational

vouchers that worked in the way envisioned by the advocates of vouchers. It is for this reason that we will never get a voucher system that is worth having. If educational vouchers are in our future it will be because the public school lobby will see them as the best vehicle for maintaining or enlarging their special interest advantages. Educational vouchers will never serve to increase the range of freedom in education, and may do much to restrict it.

Government Redistribution Impoverishes the Poor

March 1, 1994

Only the most ideologically blinded continue to argue that socialism can outperform capitalism in the production of wealth. Yet the assertion that government programs are required to reduce the income inequality generated by capitalism is widely accepted as revealed truth. Market competition motivates productive activity by threatening with poverty those who use resources unwisely, and carrying out this threat without mercy. So, it is argued, in the absence of compassionate government transfer programs, a large percentage of the population would be left behind, impoverished, without hope, and made all the more miserable by the audacious wealth of their more successful neighbors.

The Benefits of Failure

There is just enough truth in this view to obscure the fact that it grossly distorts reality. Market competition can be harsh. But the particular failures dispensed by market competition provide the information and motivation that are indispensable to the general economic success of any economy. When failures in the marketplace are viewed in isolation from the success they make possible, they are commonly depicted as unfair. In fact, in the marketplace failure and fairness go hand in hand. When people suffer failure in the marketplace they are making a necessary contribution to the general productivity of the economy- -a contribution that enhances the opportunities of all to produce wealth, in an economic system that distributes that wealth far more widely and equally than most people realize. Each person would, of course, prefer to be protected against failure while continuing to benefit from the contribution that the failures of others make to economic progress. The fundamental fairness of the market lies in the fact that it gives no one a free ride on the contribution of others. In the unfettered marketplace everyone has to contribute to the general prosperity by accepting the failures as well as the successes that come his way.

Yet, because the failures that result from market competition are commonly seen as unfair, arguments calling for government to help the poor find sympa-

thetic ears. Government action to help the poor is seen as the only way to overcome the perceived unfairness of the marketplace. Invariably what people have in mind when considering government help for the poor are government programs that supposedly transfer income from the rich to the poor. Seldom do those who favor such transfer programs question whether they actually reduce income inequality.

While most people recognize realistically that income is distributed in the marketplace in response to competition between people interested primarily in private advantage, they somehow believe that income is distributed in the political process in response to broad social goals such as reducing income inequality. The unstated assumption is that when people shift from market activity to political activity they experience a moral metamorphosis, overcoming considerations of private interest in order to advance the public interest. Yet, there is no convincing evidence that people in their roles as politicians, bureaucrats, members of special interests, and voters are any less driven by self-interest than they are as investors, workers, and consumers in the private sector.

A Major Unsupported Assumption

Once the importance of political competition is recognized, an important, but seldom considered, question presents itself: Why should we expect the income distribution resulting from political competition to be any more equal than the income distribution resulting from market competition? Unless one is prepared to argue that (1) the skills necessary for successful political competition are different from those necessary for successful market competition and (2) the poor possess relatively more of the politically relevant skills than the nonpoor, then there is no reason to believe that government transfer programs will help the poor.

The evidence fails to support the hope that the poor can compete successfully against the nonpoor for political largess. Little of the income distributed by government is from the rich to the poor. Studies of the distribution of after-tax/after-transfer income over the last several decades find little, if any, change in the equality of that distribution. Based on these studies, economist Robert Haveman of the Institute for Research on Poverty of the University of Wisconsin has concluded, "In spite of massive increases in federal government taxes and spending, we were about as unequal in 1988 as we were in 1950."

There are government programs, of course, that transfer income to the poor. But programs that transfer income to the poor receive political support through a process of legislative logrolling that disproportionately favors programs that transfer income to the nonpoor. The poor end up receiving no greater share of existing wealth transferred by political competition than they do of new wealth created by market competition.

There is no debate over the fact that transfer programs reduce economic growth by discouraging productivity and encouraging dependency. By reducing the overall size of the pie without increasing the share of that pie going to the poor, government transfer programs have reduced the absolute income of the

poor. The inescapable conclusion is that government transfer programs have made the poor worse off.

Free market capitalism excels at producing wealth and at distributing it widely. Even those left behind by market competition benefit from the productivity of the marketplace. It is far better to be poor in California than in Calcutta. There are those, however, who disparage the market economy on the grounds that market competition unfairly distributes income. This view has been used effectively to justify transferring more of the nation's income through governmental programs. The result has been unfortunate for the poor. Substituting negative-sum political competition for positive-sum market competition reduces the size of the economic pie without increasing the share of that pie going to the poor.

The Perversity of Doing Good at Others' Expense

September 1, 1997

Assume your 45-year-old friend is critically ill and will die by tomorrow morning unless something extraordinary is done. Miraculously, it becomes possible for you to save your friend. But to do so you have to shorten the lives of all other Americans by a small amount. By taking away ten seconds of life from someone else, you can extend the life of your friend by five seconds. When this transfer is made from all 260 million Americans, he will receive approximately an additional 41 years and four months of life, thus achieving an enviable life span of over 86 years.

Will you use your power to save your friend? Almost surely the answer is yes. Will saving your friend be an act of virtue? The answer to this question is more complicated. Saving your friend's life will be widely perceived as a virtuous act, but a strong case can be made that it would be a harmful act of callous self-interest. The sharp contrast between perception and reality in this fabricated example is unfortunately relevant to the world of politics, and explains why organized interest groups can capture small private gains at great social costs through political actions widely seen as virtuous.

I readily admit that if a good friend of mine were desperately ill, I would save him by shortening the life of everyone in the general population by a few seconds if I had the power to do so. Although the gain in life for him would be less than the total loss of life for others, the gain would be dramatically visible, greatly appreciated, and easily associated with my act of "kindness," while the loss would be so diffused that it would go completely unnoticed. Even if the others were aware of their cost for saving my friend, a large majority of them would probably vote in favor of making their individual sacrifice (and obligating others to do the same) to extend his life, since that sacrifice was so low. We could all feel the warm glow of compassion over our virtuous sacrifice for the good of another.

There is a problem here, however. If it is so noble to save my friend's life by transferring a few seconds from everyone else, then it must also be equally noble

to extend this benefit to others. But consider the destructive consequences of each of us having the power to add years to our best friend's life (which in most cases would be our own) by reducing the life of everyone else by a few seconds (but with the total life lost being twice that gained). With everyone trying to lengthen his or her life at the expense of others, the result would be an early death for everyone. Generalizing the earlier example of a two-second loss for a one-second gain, if everyone attempted to capture 41 years of additional life by transferring seconds from others, everyone would have his or her life shortened by 41 years. For someone my age this would, at best, mean instant death, and more likely a retroactive one.

So if the ability to extend one person's life by shortening the lives of others were immediately generalized to everyone, the consequences would be quickly recognized as disastrous. But if only a few had this ability initially, and it was expanded to more people very gradually, it would take a while for the harmful consequences to be noticed.¹ And probably people would be unaware of the connection between the reduced life expectancy of most and the longer life span of the few, the result being a clamor to expand the method prolonging the lives of the few. Even when the connection between the expanded transfer process and the ever-shortening life expectancy began to be recognized, no one would willingly cease attempting to benefit from the transfers. The person who unilaterally refused to transfer years from others to himself would lose twice the life expectancy as before, as others continued to transfer life from him to themselves. Of course, there might be a movement to stop the transfer process if anyone were left alive to initiate it.

But what if the destructive effect of the transfer process were masked by medical advances that caused a slight increase in life expectancy? Then the life lost because of the transfers might go largely unnoticed. Some would understand the harm being imposed by the transfers, but they would find it difficult to get people exercised by the loss of what they never had, which exists only in a counterfactual setting with which they are not familiar. Also, any attempt to get people to oppose the transfers faces a serious free-rider problem. Why should an individual incur a private cost in an effort that, even if successful, provides general benefits to everyone regardless of his or her contribution to the effort? For each person the advantage is in devoting the effort necessary to benefit from transfers, an effort that concentrates a benefit entirely on him or her, rather than in making the far less decisive effort to achieve benefits for the general public.

Real-World Transfers

Of course, my example of extending the lives of some by reducing the lives of others is fortunately a fanciful one. Unfortunately, it describes all too well the type of transfer that increasingly dominates the political process. The coercive power of the federal government to perform its few legitimate functions has always been a source of temptation for those who see the possibility of solving

¹I assume here that there is a strict limit on how much life can be transferred from others.

their problems through transfers from others. The case for yielding to this temptation is superficially appealing because government transfers could create concentrated and visible benefits for politically organized and appreciative groups while spreading the costs so widely that they go largely unnoticed.

Fortunately, for approximately the first 100 years after the ratification of the U.S. Constitution, the prevailing understanding was that the role of government was a limited one. Government was not intended to solve the problems of individuals; rather it was to establish a setting in which they could best solve their own problems in productive cooperation with each other. That view was exemplified by Grover Cleveland's 1887 veto of a bill passed by Congress to provide \$10,000 to drought-stricken farmers in Texas. In his veto message Cleveland stated, "A prevalent tendency to disregard the limited mission of [the government's] power and duty should be steadfastly resisted, to the end that the lesson should be constantly enforced that, though the people support the Government, the Government should not support the people."¹

Unfortunately, as Cleveland was vetoing seed bills, U.S. Supreme Court decisions began opening the door for increased government regulation of the economy.² Regulation, supposedly aimed at protecting the general public against abuse by business and other organized interests, is invariably controlled by those interests to reduce the competition they face. That amounts to a transfer from the general public to those being regulated, in the form of higher prices and a less productive economy. The growth of such transfers began rather modestly. Resistance to it was well entrenched, but the concentrated benefits appeared larger than the diffused (but actually larger) costs. As the number of beneficiaries increased with little apparent cost, the case for including more beneficiaries seemed compelling. Even when the costs of government transfers were noticed, they were seldom associated with the transfers that caused them. Indeed, the costs created by the transfers were commonly cited as problems that justified government solutions in the form of yet further transfers. The most egregious example of hoping the cause can be the cure was the expansion of government control in response to the depression of the 1930s, a depression prolonged, if not caused entirely, by a combination of federal tariff increases and Federal Reserve mismanagement of the money supply.

Soon government transfers were going beyond protective regulation and increasingly taking the form of direct payments and subsidies. In 1900 the entire federal budget amounted to only about 3 percent of the nation's GDP, with little of it devoted to transfers. By 1962 federal transfers to individuals (not including interest payments) amounted to 27 percent of federal outlays and to 5.2 percent of GDP. By 1993 federal payments to individuals had increased to 56 percent of federal outlays (85 percent when interest payments and national

¹Quoted in Robert Higgs, *Crisis and Leviathan: Critical Episodes in the Growth of American Government* (New York: Oxford University Press, 1987), p. 84.

²Higgs discusses many of these decisions and their consequences in *ibid.* Also see Terry Anderson and Peter J. Hill, *The Birth of a Transfer Society* (New York: University Press of America, 1989).

defense are excluded) and to 10.5 percent of the GDP.¹

Noble Objectives

These budgetary transfers are almost always rationalized in the name of some noble public objective—helping the poor, protecting American jobs, saving the family farm, making the American economy more competitive. The reality is that the benefits from these transfers are concentrated primarily on organized interest groups and do little to achieve the noble objectives. Indeed, progress toward the goal is invariably retarded as the costs of transfers spread inefficiencies throughout the economy. Poverty programs have increased the number and dependency of the poor, trade restrictions and export subsidies have destroyed more productive jobs to save less productive ones, farm subsidies have done more to help large corporate farms than small family farms, and corporate welfare has hindered American competitiveness by subsidizing failure.

Those failures are rooted in the fact that, just as in my life-extending example, government transfers add less value than they destroy. Government transfers systematically reduce the productivity of the economy, productivity essential for solving the social problems the government claims to be addressing. The wastefulness of government transfers is inherent in the very process that explains them. Because the benefits of transfers are concentrated, they are magnified by the political process, while the dispersed costs are devalued. The result is that the political benefit-cost comparison continues to show gains from transfers long after the social benefit-cost comparison is decisively negative. The ratio of losses to gains from many political transfers is far larger than the 2-to-1 ratio assumed in the example of life-expectancy transfers. For example, in California taxpayers are paying for water-diversion projects that provide water at \$212 per acre-foot to farmers who pay for it at a rate of \$3.50 per acre-foot.² Or consider amendments to the Clean Air Act that protected Eastern coal producers against competition from Western coal by imposing scrubber requirements on electric generating plants to remove sulphur even if they burn low-sulphur Western coal. It has been estimated that this requirement costs electricity consumers approximately one dollar for every nickel it transfers to coal producers, not to mention the resulting reduction in environmental quality.³

Yet, attempts to point out the failure of an ever-expanding government role in the economy are typically met with complacency and often hostility. Again, as with the example of transferring life expectancy, it is easy to see the concentrated benefits from government transfers. It's even easier to ignore the generalized costs and see them as unrelated to the benefits. The economy, after all, has continued to grow. It would be difficult for anyone to know just how

¹These figures come from Herbert Stein and Murray Foss, *The New Illustrated Guide to the American Economy* (Washington, D.C.: The AEI Press, 1995), p. 212.

²See Dennis C. Mueller, *Constitutional Democracy* (New York: Oxford University Press, 1996), p. 11.

³See George Daly and Thomas Mayor, "Equity, Efficiency and Environmental Quality," *Public Choice*, vol. 51, no. 2 (1986): 141-59.

much greater that growth could have been, and most people are unaware of how costly even a slight reduction in economic growth is over time.¹ And even if people were aware of the general costs of government transfers, no individual would see the advantage in opposing them in general since the private advantage lies in getting more transfers for your group. Those who do suggest cutting back on transfers will encounter hostility from the beneficiaries, who realize that the amount they have to pay for the transfers to others is independent of whether or not they continue to receive theirs. Even many of those paying for a benefit going to others often respond negatively to advocates of reducing, or eliminating, that benefit because of its visible virtue and the lack of a detectable cost to any individual.²

The dynamic of government transfers is an insidious one that invariably leads to the disastrous situation Bastiat predicted: the state becomes “that great fictitious entity by which everyone seeks to live at the expense of everyone else.”³

Both the fanciful possibility of helping some people with transfers of life from others, and the factual possibility of helping some people with government wealth transfers from others, illustrate the perversities that result when people attempt to do good at others’ expense. Such attempts always give the appearance of promoting virtue while destroying the discipline and accountability that make real virtue possible.

¹It should be noted that the larger government involvement in the economy, the more the official national income statistics overstate the national income. The growth in the private sector is determined by the amount people voluntarily pay for goods and services. Since there is generally no market for government-provided services, they enter into the national income accounts at the cost of providing them, which is almost always greater than their value. So GDP can, and often is, increased by government transfers that reduce the total value of economic output. To bring my example of transferring life expectancy in line with government transfers, the additional life one received from a transfer would have to be counted for more than it actually is.

²Because the influence of any individual voter on a political decision to make a transfer is effectively zero, the opportunity cost of favoring a transfer is also effectively zero, even if the transfer is known to be individually costly. Therefore, if a person has been led to believe that a transfer is virtuous and he places even a modest value on the sense of virtue that comes from supporting the transfer, he will vote for it regardless of the personal cost if it passes. See Geoffrey Brennan and Loren Lomasky, *Democracy and Decision: The Pure Theory of Electoral Preference* (Cambridge: Cambridge University Press, 1993).

³Quoted in George Roche, *Free Market, Free Men: Frederic Bastiat, 1801-1850* (Hillsdale: Hillsdale College Press and The Foundation for Economic Education, 1993), p. 150.

Social Cooperation and the Marketplace

July 1, 1998

The primary insights of economics come from explaining how individuals pursuing their own interests make choices that best enable others to pursue their interests as well. This social cooperation is not inevitable. It requires rules that motivate people to consider the concerns of others. The rules that accomplish this amazing feat define the free-market economy.¹

Free-market economies vary in their particulars owing to cultural variations. But the fundamental rules can be stated in terms of private property. Property is owned privately, and private owners have the right, within broad limits, to use their property as they see fit; rights to property are transferable on any mutually agreed-on terms. Before considering how these rules motivate social cooperation, let's see how remarkable that achievement is.²

Sounds Impossible

Full social cooperation would require that every person have information about the preferences of everyone affected by his decisions and on the constantly changing conditions that alter the relative scarcity of resources. For example, everyone considering using cotton products would have to be informed if a fad has Brazilian teenagers increasing their desire for denim clothing, or if the supply of cotton needed to produce denim is reduced by poor weather in Mississippi, or if new evidence suggests that respiratory problems may result from working in cotton fields. People would have to know literally millions of things that affect the consumption and production of thousands upon thousands of products to know enough to adjust their decisions in mutually accommodating

¹ Adam Smith famously discussed social cooperation in terms of his “invisible hand.” See *The Wealth of Nations* (New York, Modern Library, 1937 [1776]), p. 423.

² Readers are encouraged to reinforce the discussion in this section by reading F.A. Hayek, “The Use of Knowledge in Society,” in his *Individualism and Economic Order* (Chicago: University of Chicago Press, 1980 [1948]). In my opinion, this is one of the most important economics articles ever written.

ways. One might throw his hands up at this point and consider that requirement impossible to satisfy.

Transmitting information is only part of the problem. Even if it is communicated, people would still have to be motivated to act on it appropriately, to respond as though they were as concerned with everyone else's well-being as they were with their own.

But before concluding that social cooperation requires an information network far superior to anything even remotely available, and a level of compassion seldom practiced by ordinary mortals, consider that every day we benefit from exactly that type of social cooperation. Indeed, it is so common that most people take it for granted.

How Does It Happen?

What harmonizes the pursuits of billions of individuals who have little direct information about, or interest in, one another's circumstances? The answer is found in the information and incentives that emerge when people pursue their objectives in accordance with the marketplace rules of private property and voluntary exchange.

When property is privately owned and transfers are voluntary, the prices that emerge from the interaction of buyers and sellers communicate a tremendous amount of information. The price you observe for a product reflects how much value other consumers place on an additional unit of it. If the value that Brazilian teenagers place on denim clothing increases, their additional purchases will communicate this information throughout the world in the form of slightly higher prices for cotton products. Everyone who is considering buying these products will be immediately aware of their increased value to others. Prices also indicate the relative availability of different products, and the cost of producing more of them.

Market prices motivate people to respond as if they are as concerned with the interests of others as they are with their own. Consumers will respond to the higher prices caused by Brazilian teenagers as if the consumers are thinking, "Teenagers in Brazil tell us they value additional cotton in denim clothing by a little bit more than we value it in the cotton products we use; so we will reduce our consumption so Brazilians can increase theirs." Or in the case of evidence of health damage to cotton workers, consumers will respond to the higher prices as if they are thinking, "We will reduce our consumption of cotton products to reduce the number of people exposed to the risk in the cotton fields, and we will pay a little more to compensate those willing to take that risk."

Of course, it is primarily self-interest that motivates consumers to respond that way, rather than concern for people they will never meet. Indeed, higher prices tell consumers nothing about why cotton products have become more valuable. (Important information, of course, is also communicated through lower prices.) Market prices are efficient precisely because they do not overload consumers with irrelevant information.

Prices also motivate suppliers to respond to the interests of others. Obviously, higher prices tell suppliers that consumers want more of a product.

Suppliers are strongly motivated to respond appropriately. But consumers also communicate information disagreeable to suppliers when they decide they want less of a product.

Consumers communicate to suppliers indirectly through the prices for labor, land, machinery, semi-finished goods, and raw materials (inputs). The prices textile producers, for example, pay for inputs reflect the value consumers place on other products that could be produced with those inputs. If those other products become more valuable to consumers, textile producers will receive this information through higher prices for their inputs, which are bid away by the other industries. Textile production will be reduced, and some textile manufacturers may go bankrupt. When a supplier reduces his output, or goes bankrupt, it is as though he is saying, "Consumers are telling me that the resources I am using are more valuable in other employments, so I will use fewer of them so others can put them to better use."

Blaming the Market for Its Success

The social cooperation that results from the information and incentives communicated through the market is not perfect. But no other economic system comes remotely close to the market in allowing people to achieve their objectives in productive cooperation with each other. The market is criticized mostly for its success rather than for its failure. It is commonly blamed for delivering news about scarcity. No one likes scarcity, but it is not caused by markets. Indeed, the wonder of markets is that they call to action those in the best position to respond. Blaming scarcity on markets makes no more sense than blaming fires on fire alarms.

The problem of scarcity will always be with us. But the social cooperation that is realized only through the marketplace permits us to push the limits of scarcity back farther than is possible under any other system.

Creating Jobs vs. Creating Wealth

January 1, 2000

Government policies are commonly evaluated in terms of how many jobs they create. Restricting imports is seen as a way to protect and create domestic jobs. Tax preferences and loopholes are commonly justified as ways of increasing employment in the favored activity. Presidents point with pride to the number of jobs created in the economy during their administrations. Supposedly the more jobs created the more successful the administration. There probably has never been a government spending program whose advocates failed to mention that it creates jobs. Even wars are seen as coming with the silver lining of job creation.

Now there is nothing wrong with job creation. Working in jobs is an important way people create wealth. So the emphasis on job creation is an understandable one. But it is easy for people to forget that creating more wealth is what we really want to accomplish, and jobs are merely a means to that end. When that elementary fact is forgotten, people are easily duped by arguments that elevate creation of jobs to an end in itself. While these arguments may sound plausible, they are used to support policies that destroy wealth rather than create it. I shall consider a few of the depressingly many examples in this column and the next.

Creating Jobs Is Not the Problem

The purpose of all economic activity is to produce as much value as possible with the scarce resources (including human effort) available. But no matter how far we push back the limits of scarcity, those limits are never vanquished. Scarcity will forever prevent us from securing all the things we desire. There will always be jobs to do far more than can ever be done. So creating jobs is not the problem. The problem is creating jobs in which people produce the most value. This is the point of the apocryphal story of an engineer who, while visiting China, came across a large crew of men building a dam with picks and shovels. When the engineer pointed out to the supervisor that the job could

be completed in a few days, rather than many months, if the men were given motorized earthmoving equipment, the supervisor said that such equipment would destroy many jobs. “Oh,” the engineer responded, “I thought you were interested in building a dam. If it’s more jobs you want, why don’t you have your men use spoons instead of shovels.”

As I tell my students at the University of Georgia, I will employ every person in our college town of Athens if they’ll only work for me cheaply enough, say a nickel a month. Lower the wage a bit more and I’ll hire everyone in the entire state of Georgia. If I hired workers at those wages, I could make a profit having them build dams with spoons. Of course, the students recognize that my offer is silly since they can make far more working for other employers, which reflects the more important reason my offer is silly: concentrating on the number of jobs ignores the value being created, or not created. More value will be produced in the higher-paying jobs my students can get than in the ones I am offering. A big advantage realized from the wages that emerge in open labor markets is that they attract people into not just any employment, but into their highest-valued employment.

Another advantage of market wages is that they force employers to consider the opportunity cost of hiring workers their value in alternative jobs and to remain constantly alert for ways to eliminate jobs by creating the same value with fewer workers. All economic progress results from being able to provide the same, or improved, goods and services with fewer workers, thus eliminating some jobs and freeing up labor to increase production in new, more productive jobs. The failure to understand this source of increasing prosperity explains the widespread sympathy with destructive public policies.

Dynamiting Our Way to More Jobs

In the 1840s a French politician seriously advocated blowing up the tracks at Bordeaux on the railroad from Paris to Spain to create more jobs in Bordeaux. Freight would have to be moved from one train to another and passengers would require hotels, all of which would mean more jobs. (This proposal was discussed and demolished by the nineteenth-century economist and essayist Frederic Bastiat in *Economic Sophisms*, pp. 94-95, available from FEE.)

This proposal is even more absurd than my offer to hire people for a nickel a month. At least I would employ workers to produce something of value, rather than to partially undo damage that is inflicted needlessly. Unfortunately, absurdity does not prevent economically destructive policies from being proposed and implemented. Using the jobs-creation justification, politicians commonly enact legislation that increases the effort required to produce a given amount of value.

One of the arguments for restricting imports is that it will create (or protect) domestic jobs. True, it will create some domestic jobs, just as destroying a section of a rail line will create domestic jobs. But also like a break in a rail line, import restrictions make it more costly to obtain valuable products. The only reason a country imports products is that it is the cheapest way to acquire them; it takes fewer workers to obtain the imported products through foreign

trade than by producing them directly. In this way trade is like a technological advance, freeing up workers and allowing them to increase the production of goods and services available for consumption. Import restrictions create jobs in the same way dynamiting our railroads, bombing our factories, and requiring that workers use shovels instead of modern earth-moving equipment would create jobs. Always keep in mind that creating jobs is a means to the ultimate end of economic activity, which is creating wealth.

Creating Government Jobs

Because people tend to think of jobs as ends rather than means, they are easily fooled into supporting government programs on grounds that jobs will be created. We have all heard people argue in favor of military bases, highway construction, and environmental regulations on business on these grounds. To justify spending, government agencies commonly perform benefit/cost studies in which the jobs created are counted as benefits. This is like counting the hours you work to earn enough money to buy a car as one of the car's benefits. The jobs created by a government project represent a cost of the project: the opportunity cost. The workers employed in government activities could be producing value doing something else. The relevant question is not whether a government project creates jobs, but whether the workers in those jobs will create more wealth than they would in other jobs. This is a question advocates of government programs don't want asked. If it were, there would be far fewer low-productivity government jobs and far more high-productivity private-sector jobs.

Spreading the Work to Create More Jobs

February 1, 2000

Last month I emphasized that job creation is not a sensible objective for economic policy. The purpose of economic activity is not to do work for its own sake. What's the point of creating jobs to produce goods or services that consumers don't want as much as other things that could have been produced? Yet there is a widespread view that having government create more jobs is the best way to promote economic progress. Wrong. Relying on government to create jobs invariably retards economic progress.

Productive jobs are created when people have the freedom to communicate and cooperate through markets. Consumers communicate the value they place on different jobs by how much they are willing to pay for products. Anytime a firm employs workers to produce a more valuable good than workers are producing at other firms, consumer purchases tell that firm: "We will make it profitable for you to expand output by offering higher wages and bidding workers away from less valuable jobs." Workers end up cooperating with consumers by moving into the production of more desirable products until all gains from such a move are exhausted.

Similarly, firms communicate how much it costs to produce different products (including the cost of hiring workers) by how little they are willing to charge for those products. When firms can lower production costs by making more valuable use of workers, they communicate that fact to consumers through lower prices. This motivates consumers to buy more of the industry's product and motivates the industry to hire more workers. Again, workers cooperate with consumers by moving into those jobs where they produce what consumers are most eager to have.

When government tries to create jobs it always interferes with market cooperation between workers and consumers. So even when jobs are created, people are directed into jobs in which they are producing less value for consumers than they could be producing. Government attempts to create domestic jobs by restricting imports is an example of undermining the market cooperation that

creates the most productive jobs. By preventing people from buying products from the most efficient producers, import restrictions prevent the cooperation that guides workers into those jobs in which they have a comparative advantage; that is, where they produce the most wealth. Unfortunately, there are many other examples of how government job creation destroys wealth by distorting market interaction between consumers and workers. Consider one way that government attempts to expand employment.

Spreading the Work

France is currently attempting to reduce its high unemployment rate by making it illegal for any employee to work for more than an average 35 hours a week. That policy would make sense only if there existed a fixed amount of work and it was being done by fewer than the available workers; in that case, more workers could be hired only if the amount of work done by each were limited. If this is true in France, then it has pulled off an amazing feat. The French must have all the goods and services they want, with work and toil being the only scarce things remaining. But if work rather than desirable goods is what the French lack, there is a better way of taking care of the problem than restricting the hours of work. They could simply destroy a percentage of everything produced. This would create more jobs for people to replace the destroyed output, plus additional jobs to do the destroying.

Unfortunately, neither the French nor anyone else has overcome the problem of scarcity. If more of the things people value are produced, people will be anxious to consume them as long as market communication is undistorted by government restrictions. Imagine a technological breakthrough that allows one person to produce everything currently being produced in a country. Does anyone believe that the country would be worse off or that everyone but the one person would be unable to find work? Of course not. The country would become incredibly wealthy as millions of workers were freed up to produce additional products that consumers had been doing without. And in the absence of market distortions, the extra output would be consumed since it would result from consumers' communicating their desire and willingness to purchase it.

Interestingly, it was the nineteenth-century French economist Jean-Baptiste Say who explained why expanding output should be no problem. Say's explanation is often distorted as meaning that "supply creates its own demand," which has become known as Say's Law. But this is a straw man. Neither Say nor any other sensible economist believes that the production of any particular product, or bundle of products, will create the demand for it. Producing something that no one wants will not create a demand for it. What Say explained is that when market prices are free to respond to changing production costs and consumer preferences, then the decisions of suppliers and consumers are coordinated and there is no need to worry about unemployment caused by gluts of unwanted goods.

Drilling More Holes

Trying to reduce unemployment with government restrictions on the number of hours that people are allowed to work is like trying to sober up with more drinking. Such restrictions add to existing government policies (such as minimum-wage laws, regulations on dismissal, and mandated benefits) that are already reducing cooperation between consumers and workers. Also, enforcing these restrictions employs workers, who could be responding to consumer desires, to make sure that other workers don't respond to those desires. For example, the French government hires "work police" to enforce the work restrictions. They do such useful things as note how long cars are parked outside businesses. This snooping is not merely a total waste of time. It is worse than that, having led to the detection of renegade executives who have committed the crime of working the extra hours required to negotiate complex deals that, if culminated, would lead to more productive jobs.

The more distortions governments impose on market communication and cooperation, the more problems they create—problems they can use to justify more distortions. It is as if you are on your boat and a government official comes aboard, announces he is there to help, and drills a hole in the bottom. But don't worry. As your boat takes on water and starts to sink, the official reassures you that he is going to drill some more holes so the water can run out.

Government's attempt to create jobs is almost always the economic equivalent of drilling holes in the bottom of a boat. The problem is that the costs are greater than we realize and commonly disguised as benefits.

Sacrificing Lives for Profits

Nov 1, 2000

pointed out in my last column that despite what people commonly say about how human life is priceless, they put a price on their lives every day with their actions. People take chances that shorten their life expectancies to do things that are fun, and for the convenience and savings of not taking every precaution possible. When people willingly accept risks to acquire things they value, they are putting a price on their lives—telling us with their actions that the marginal value of their lives is less than the often quite low value they realize from overeating, not exercising, driving too fast, and so on.

Unfortunately, when people take chances they sometimes have regrettable accidents. Nothing is more natural than feeling sorry for those who have suffered serious injury or death because they exposed themselves to risk. But our sympathy for them should not blind us to the fact that we would not be doing adults a favor by interfering with their ability to take risks that, given their preferences and circumstances, make sense to them. Yet such policies are condoned and encouraged every day by well-meaning people who (1) fail to recognize that, at the margin, human life is not priceless and (2) don't understand how prices and profits empower people to communicate effectively their desires to business firms. These are people who are quick to express moral outrage when they hear the charge that corporations sacrifice lives to increase their profits by making unsafe products.

People are accidentally injured and killed every day because products are not as safe as they could be. More than ever before, the prevailing legal environment encourages those harmed in these accidents to sue manufacturers of "unsafe" products to compensate for their pain and suffering. An obvious inducement for these suits is that the payoff to plaintiffs and their lawyers can be high, occasionally outrageously high. For example, in 1999 a \$4.9 billion judgment against General Motors was awarded to six people severely burned when their 1979 Malibu caught fire after being hit by a drunk driver going between

50 and 70 miles per hour.¹ The charge that sways juries and offends public sensitivities, and helps explain the large awards, is that greedy corporations sacrifice human lives to increase their profits.

Is this charge true? Of course it is. But this isn't a criticism of corporations; rather it is a reflection of the proper functioning of a market economy. Corporations routinely sacrifice the lives of some of their customers to increase profits, and we are all better off because they do. That's right, we are lucky to live in an economy that allows corporations to increase profits by intentionally selling products less safe than could be produced. The desirability of sacrificing lives for profits may not be as comforting as milk, cookies, and a bedtime story, but it follows directly from a reality we cannot wish away.

The reality is scarcity. There are limits to the desirable things that can be produced. If we want more of one thing, we have to do with less of other things. Those expressing outrage that safety is sacrificed for profit ignore this obvious point. For example, traffic fatalities could be reduced if cars were built like Sherman tanks. But the extra safety would come at the sacrifice of gas mileage, comfort, speed, and parking convenience, not to mention all the things you couldn't buy after paying the extraordinarily high price of a Tankmobile. Long before we increased automotive safety to that of a Tankmobile, the marginal value of the additional life expectancy would be far less than the marginal value of what would be given up. It simply makes no sense to reduce traffic deaths as much as possible by making automobiles as safe as possible.

Communicating with Profits

But how much safety is the right amount? The answer varies among individuals. Some people get so much enjoyment out of riding motorcycles, for example, that they do so even though the chances of surviving an accident are 17 times greater in a car. People typically purchase more safety as their incomes increase and when more people are dependent on them. When I was in graduate school, I drove a battered Volkswagen Bug with a door that wouldn't close completely. I chose more education at the cost of less safety. Now that I have a family and more income, I am willing to pay for more safety, so I drive a Suburban—not quite a Sherman tank, but close.

How do people communicate their demand for safety to automobile manufacturers? Through the prices they are willing to pay for different types of cars and the profits generated by these prices. There would be no profit in making a car as safe as a Sherman tank because nobody would buy it. Car companies make more profit as they get closer to incorporating the inevitable tradeoffs in automobile designs to the liking of consumers. So when car manufacturers compromise on safety to increase profits, they are doing what we want them to do—responding to our preferences.

¹The actual settlement will be less, though still much higher than justified by how much people value the marginal safety involved in the case. As of March 2000 the plaintiffs have offered to settle for \$400 million, but General Motors has refused so it can continue appealing the case.

This is not to say that mistakes aren't made. Prices and profits don't allow consumers to communicate every aspect of their preferences for cars with surgical precision. But the advantage of profits in motivating auto safety is that when a car company doesn't give consumers what they want, profit opportunities increase for car companies that do. And although this market process doesn't work perfectly, it works better than any other process.

Unfortunately, with any reasonable level of product safety, people will be killed and injured in accidents. The cost and carnage of these accidents are easily seen, as is the fact that the damage would have been less if only more safety had been built into the product being used. Not as easily seen are the advantages millions of people realize from not having to pay for more safety than they want—advantages like more money to spend on education, medicine, clothing, and housing. And more education, better medicines, and improvements in the clothing and housing available are all associated with longer life expectancies. Those whose lives are cut short by accidents are obviously identifiable, while we will never know who avoided a premature death because of the prosperity generated by an economic system guided by market prices and profits. But there can be no doubt that the latter far outnumber the former.

The Cure Can Be Worse than the Disease

March 1, 2002

Last month I discussed the prisoners' dilemma, in which everyone is motivated to behave in a way that leaves everyone worse off. One can appreciate market exchange by understanding how private property and voluntary exchange eliminate a destructive prisoners' dilemma—one in which the best choice for everyone is to try to live at everyone else's expense. The result is general poverty, coupled with the loss of freedom to a repressive state justified in the name of overcoming the prisoners' dilemma.

But even when a country has a well-functioning market system, some government action is commonly justified as necessary to overcome serious prisoners' dilemmas. For example, making sure that people obey the rules of the market (respecting the property rights of others and abiding by contractual agreements) can be thought of as overcoming a prisoners' dilemma. If everyone else obeys the rules of the market, the economy will be extremely productive, but an individual can do better by stealing and defrauding others (without sanctions against this behavior) than by being productive. As a few violate the rules of the market, obeying the rule becomes less beneficial to others, and a few more will begin to violate the rules, which can lead to an unraveling as increasing numbers steal and defraud. Engaging in productive effort becomes foolish. The only way out of this prisoners' dilemma is by imposing sufficiently severe penalties on theft and fraud so that they pay less than productive effort. Most people believe that only government can effectively impose such sanctions.

Government is also widely believed necessary for overcoming the prisoners' dilemma in providing what economists call public goods—goods that, once provided to one person in a community, are available to all. Flood prevention is the standard example. The benefit you receive from preventing a flood does nothing to reduce the benefit your neighbors receive. With most goods, the same unit cannot be consumed by more than one person—the apple you eat is one that I cannot eat; the clothes you wear are clothes that I cannot wear, at least not at the same time. These goods are called private goods.

One might think that public goods are great—just provide enough for one person and you have provided enough for all. But public goods present a serious problem when, as is sometimes true, it is difficult to exclude people from benefiting from the good once it is provided. Again, flood prevention comes to mind. If my neighbor is protected against a flood, so am I. The problem is that it is difficult to get people to voluntarily pay for a non-excludable public good because each person can hope to free-ride from the payments of others. In other words, a non-excludable public good puts people in a prisoners' dilemma.

To pick a simple example, assume that 100 people live in a flood plain and each would realize \$500 worth of benefit from building a levee along the nearby river at a cost of \$250 for each person. Clearly everyone would be better off contributing the \$250 to build the levee. But no matter what each person believes others will do, he is better off not contributing. If enough others contribute, the levee will be built and he receives the benefits for nothing, but it would be useless for him to contribute if few others do. With everyone responding to the same incentives, no one contributes and everyone is worse off than they could be.

Supposedly, by being able to force people to pay taxes, government makes everyone better off by eliminating the prisoners' dilemma we would otherwise face. By requiring that everyone either pay \$250 in taxes or go to jail, the prisoners' dilemma has been eliminated—and assuming the government uses the revenue to build the levee, everyone comes out ahead—the value they receive is greater than the taxes they pay.

Few Public Goods

However, there are far fewer public goods than claimed that really justify taxation and wealth transfers. There is hardly an organized interest group in existence that hasn't argued that its activities are vital to national defense and therefore the government should take wealth from others for its benefits: wool subsidies (soldiers wear clothes), agricultural subsidies (soldiers eat), import restrictions on shoes (soldiers wear shoes), special tax breaks for mining (provides raw material for weapon production), programs for storing feathers (to insure the availability of down for jackets if we are involved in an arctic war), and the list can be continued. None of these things are public goods, and even if important to national defense, they are best provided in markets undistorted by government subsidies and transfers.

Also, even when a good is a public good, it is often possible to exclude nonpayers and provide it more efficiently through private markets than through government. For years economists have used the lighthouse to illustrate a public good—the benefit that one ship received from the beacon did not reduce the benefits other ships could receive. But in 1974 the Nobel prize-winning economist Ronald Coase¹ pointed out that many lighthouses were privately provided in eighteenth-century England, with owners collecting payment from

¹Ronald Coase, "The Lighthouse in Economics," *Journal of Law and Economics*, October 1974, pp. 357-76.

ships as they docked at nearby ports. A television program, once it has been broadcast, is a public good, but it can be (and generally is) privately provided by getting viewers to pay either indirectly by watching commercials or directly through pay-TV arrangements.

Arguments are often made for government expansion to solve problems that aren't problems at all ¹. Of course, some interest is always served by government "solutions" to nonproblems, and not surprisingly government often steps in when it is not needed with actions that create real problems, which—surprise—are used to justify yet more government action. Even when a prisoners' dilemma prevents the private market from working with textbook perfection and it is theoretically possible for government action to improve things, it is seldom justified. Government action is invariably poorly informed, guided by motivations that have little to do with solving genuine problems, and almost always makes the problems it is supposed to solve worse.

One explanation for government's poor performance is that although it can sometimes solve some prisoners' dilemmas, it does so only by creating other, and commonly worse, prisoners' dilemmas. This will be the subject of next month's column.

¹Strong arguments have been made that private arrangements would arise without government coercion to establish and enforce the laws necessary for the proper functioning of markets. See Bruce Benson, *The Enterprise of Law: Justice Without the State* (San Francisco, Calif.: Pacific Research Institute for Public Policy, 1990), and David Friedman, *The Machinery of Freedom: Guide to a Radical Capitalism* (LaSalle, Ill.: Open Court, 1989), chapters 28-31.

Social Security Can Be Good for Your Health

September 1, 2005

Until recently I took every opportunity to inform my students about the financial fraud of Social Security. Given demographic realities and the Ponzi-scheme nature of Social Security, those about to enter the work force will receive an anemic return on their “investment,” assuming they receive any return at all. They would be far better off, and so would the economy, if they put the amount that will be taken from them by the Social Security Administration into a real investment, such as a broad-based mutual fund.

But I’m having second thoughts about presenting only the negative side of our national retirement program to the youth of America. I’ll be eligible to begin collecting Social Security payments in a few years, so I’ve decided to take a more positive attitude. The Social Security taxes I have already paid are sunk costs, and therefore are not costs at all. Only the future taxes and income from Social Security are relevant to my return on the program, a return that is getting better all the time. What a shame to jeopardize that return by turning the taxpayers of the future against the Social Security program, which can also be there for them some day if only they consider the bright side of the financial mugging heading their way. In the hope that the young people of today can be encouraged to stay the course with their Social Security “contributions,” I am writing them an open letter telling them the rest of the story. You see, Social Security is about more noble objectives than achieving financial success.

—DRL

Dear Young People,

There simply is no better feeling in the world than sacrificing for the benefit of others. That is particularly true when your sacrifice benefits me. I want you young college students to keep that in mind the next time you hear someone criticizing the Social Security system. I will be retiring about the time you

are paying large sums into Social Security, and your tax payments, I mean contributions, will be sent directly to my buddies and me so we can afford to drive enormous motor homes to the local shuffleboard courts. None of it will be invested into your own personal account for your retirement.

Some of you may be asking, but then what kind of financial return can I expect from Social Security? That is the type of question we have to expect from those who, because of the damaging effects of natural selection, insist on thinking of themselves first. But let me consider the return a college graduate about to enter the work force can expect from Social Security. The news is better than some of you believe, especially those of you who believe an invasion by the space aliens who kidnapped Elvis Presley is more likely than Social Security being solvent when you retire. Let me give you my unwritten, but completely unenforceable, guarantee: you will receive Social Security checks when you retire. That is assuming you live past age 67, which you probably will because of a wonderful incentive built into the Social Security program for your benefit. Because of this incentive, your rate of return can be far better than the experts are now predicting. Let me explain.

Assume you work from age 22 to 67 and make only the median family income during your career. In this case your Social Security contribution will be about \$3,000 a year, recognizing that you will generously help your employer with his contributions to your Social Security by accepting wages lower than you would otherwise have received. These contributions will make you eligible for Social Security payments at age 67. How much will you get? The maximum you can receive (as I write this) is \$23,868, which assumes that your spouse is still alive, or at least appears to be, and also 67 or older. When you are 67, 45 years from now, the payments will be higher, assuming they keep up with inflation (your Social Security contributions will also increase with inflation, but let's ignore that minor inconvenience). Let's be optimistic and assume they will. Assuming a 3.1 percent inflation rate (the average over the last 70 years), then your annual income from Social Security will be \$91,453 at age 67. And you thought Social Security was a lousy deal.

I'm tempted to rest my case right here, except someone is probably asking, "But how better off would I be if, instead of contributing to Social Security, I put the \$3,000 a year into the stock market for the next 45 years? At the risk of encouraging people to think of Social Security only in crass financial terms, I will answer this question.

Over the last 70 years the stock market (as measured by the Standard & Poor's 500 index) has grown at an average annual rate of 10.9 percent. At that return, your \$3,000 a year will be worth \$3,182,779 when you are 67. With that amount of money, you could buy a lifetime annuity that pays over \$356,000 a year. So a cynical, but completely accurate, conclusion is that the Social Security system will bamboozle you out of over \$264,547 a year (the difference between \$356,000 and \$91,453) during your retirement.

But why be so negative? After 45 years of 3.1 percent annual inflation, \$264,547 will be worth only about \$69,000 in today's dollars. Also, think of the incentive Social Security gives you to take good care of yourself. You can make

Social Security pay if you live long enough. The present value of your Social Security income will be worth the \$3,182,779 your private investment would have provided, if you simply refuse to die until you are 125 years old. (This assumes that your annual Social Security income of \$91,453 grows at 3 percent a year—good luck—and you discount the future value of that income stream by 5 percent—ask your favorite finance professor why discount is necessary.)

So Social Security is right up there with conferences on global warming as a way of promoting long life. I'm certainly keeping myself in peak condition in anticipation of benefiting as long as possible from your Social Security contributions. I don't want to go face down in my oatmeal until you young folks retire.

Sincerely,

Dwight R. Lee
Ramsey Professor of Economics

Libertarian Paternalism: A Test

July 1, 2007

Behavioral economics is a growing subfield of economics based on the finding that people are not as rational as economic models have traditionally assumed. Numerous experiments have shown that people's choices are systematically altered in response to changes in how those choices are framed, even though the framing is irrelevant to the consequences of those choices.

Some behavioral economists now seem intent on bringing their own rationality into question by advocating what appears to be a loopy idea—giving government more power over our decisions to make us better off, and doing so in the name of libertarianism. This “libertarian paternalism” sounds like an oxymoron, but two of its leading advocates—Cass Sunstein and Richard Thaler—assure us it is not. (Their 2003 University of Chicago Law Review article is titled “Libertarian Paternalism Is Not an Oxymoron.”)

Their argument is superficially plausible. But on closer examination it becomes clear that a big leap of faith in the integrity of the political process is required to embrace libertarian paternalism as a reasonable proposal. Fortunately there is a test of the compatibility of the political process with libertarian paternalism. I shall argue that this test should be given, and must be passed, before taking libertarian paternalism seriously. But, first, let's consider what it means and the arguments for it.

The case for libertarian paternalism begins with a finding by behavioral economists of what can be described as the default bias. In many circumstances, most people will accept a default option rather than choose another even when the stakes are high and the other options seem far better. A commonly mentioned example is a matching, tax-deferred 401(k) plan at work. When employees have to explicitly decide to join, typically more than half accept the default of not participating even though signing up is easy and, with the employer's contributions, assures an attractive return. On the other hand, studies show that if employees are automatically signed up unless they opt out, most remain in the program.

The next step in the case for libertarian paternalism gets us to the paternalism. Since in every choice there is a default option, it is a good idea, say advocates of the principle, to make it the option that is best for most people. And fortunately it is often possible for impartial experts with training in behavioral economics to know what the best option is. Therefore, if government frames the choice by requiring that the “best” option be made the default option, then the default bias would result in most people accepting this choice. But the libertarian part of the argument acknowledges that what is best for most people is not best for all, so anyone may choose something other than the default.

For example, an employee who is independently wealthy, or who isn’t expected to live long enough to retire, or who just doesn’t want to start a savings program can choose to have her name removed from the 401(k) plan. No one is forced to bend to the will of an authoritarian paternalist. The government experts, under the guidance of libertarian paternalists, will behave like libertarians by leaving the ultimate decision to the individual, but they will also be paternalists by exploiting the default bias and framing the decision in a way that makes people better off (in their view).

The obvious leaps of faith behind this proposal are in believing 1) that the political power required to implement libertarian paternalism would be limited to setting default options when the best default for most people is known and 2) that the choice of default will be guided only by the interest of the people whose choices are being affected. Without this faith in the political process the case for libertarian paternalism is wholly unconvincing. Can we actually expect that the political process will know what option is really best for most people in different situations and how a different default would affect decisions? Maybe behavioral economists are convinced that they know when they cannot pick a better default than already exists and what the best default is when they can. But even if this is true, behavioral economists will not be doing the picking. They may be brought in as advisers to the politicians and bureaucrats in charge of designing and implementing libertarian paternalism, but their advice will not always be taken. Others with more political influence and more narrowly focused interests than behavioral economists will also be giving advice—and will be doing so aggressively.

For example, if the authority to set the default on 401(k) plans is transferred to government, the financial industry will quickly recognize the potential profits in influencing how that authority is exercised. Indeed, the legislation giving that authority to government will be drafted with help from the financial industry. And there are ways to put some devil in the details of such legislation. The legislation could cover workers who, because they are young, part-time, and receive low pay, would not normally be offered 401(k) plans. Opting out could be made to require more effort than the libertarian paternalists have in mind. The type of investment people are put in if they accept the default option would be subject to political influences that have little to do with what is best for the employee. And, assuming the behavioral economists are correct and most people stay with the default, the political clout of financial

firms (likely with the help of political restrictions on competition) could result in higher financial fees. (Concern over high financial fees was one argument used by those who successfully opposed President Bush's attempts to partially privatize Social Security.)

Placement of Food

Libertarian paternalists use examples other than savings plans to illustrate what they have in mind. They often mention the placement of food in cafeterias, buffets, and grocery stores. Again they argue that the food items have to be placed somewhere, and behavioral economics has apparently shown that choices of what to eat are influenced by where food is placed. So food encountered sooner in cafeterias and most conveniently located in grocery stores can be thought of as default options—it is still possible, of course, for people to choose other options. As far as I know, no advocate of libertarian paternalism has yet recommended that government regulate the location of food in cafeterias and grocery stores. But if the principle achieves political traction, there are sure to be pressures in that direction—though maybe cautious and subtle at first. Who would have thought not long ago that governments would soon be imposing restrictions on where and how cigarettes are displayed in stores or what type of fat is permitted in fast food?

If government began moving toward using libertarian paternalism to encourage people to choose healthier diets, political competition among suppliers of grocery-store products would intensify. The fruit and vegetable suppliers, along with the organic-food farmers, would lobby regulators to have their products moved to the front of the store. The producers of soft drinks, candy, chips, bean dip, and a host of other processed foods would use their significant political influence to maintain their locations. Even the magazine publishers would join the fray. No one knows how this political competition would play out. But don't expect that fruit, vegetables, tofu bars, and maybe cigarettes made with organically grown tobacco would soon dominate the shelves at the checkouts, with the candy and gum there now being moved as close as possible to the loading dock. Or that you would find serious reading material such as *The Economist*, *Barron's*, *The Nation*, *National Review*, and *The Chronicle of Higher Education* in the checkout racks, with the magazines on dieting, fashion tips, and the latest activities of Hollywood celebrities relegated to where the tofu used to be.

Of course, a move in this direction cannot be ruled out. What we can be confident of is that more resources that could have been used to produce goods and services valued by consumers would be devoted to influencing political decisions. The financial well-being of government regulators and lobbyists would certainly be improved more than the dietary well-being of the public.

Some may think that this depiction of an overreaching political process powered more by organized interest than by the public interest is overstated. And perhaps even if the political process does possess the special-interest tendencies just discussed, an idea like libertarian paternalism has so much potential to serve the public interest that the ability of narrowly focused interests to sabo-

tage it will be severely limited. If libertarian paternalists believe this, then they should not object to a test of the political process's affinity for implementing libertarian paternalism primarily to benefit the public. There is such a test, and libertarian paternalists should require the political process to pass it as a prerequisite for their continued advocacy.

The Test

The test requires considering the many paternalistic regulations that governments now enforce in unlibertarian ways and recognizing that they could be made consistent with libertarian paternalism. A political process compatible with new regulations in the spirit of libertarian paternalism should be able to pass the test by modifying existing regulations to make them consistent with that spirit. Several examples of existing regulations and policies that can be used in this test come to mind.

First, the Bush administration's plan to partially privatize Social Security would be a move in the direction of libertarian paternalism. The current Social Security system would remain the default option, but workers could reduce their payroll tax up to some specified amount that would increase over time by an amount equal to each dollar they put in a private savings program—with restrictions on accessing the savings before a certain age. There are obviously transitional issues involved in such a policy shift, but if libertarian paternalists and others cannot convince the federal government to establish even a limited private option to Social Security, it will not be an encouraging sign for the political feasibility of libertarian paternalism.

Second, taxpayers are now required to help the poor by having a certain percentage of their tax dollars transferred to them (a smaller percentage than most people believe) by various levels of government. Instead of requiring that those transfers be made through governments, we could make government transfers the default option, but with taxpayers allowed to reduce their tax payments by some significant percentage of the money they donate to private charities dedicated to helping the poor. This libertarian-paternalism approach has real potential for improving the way the poor are helped, since private charities are better than government agencies at assisting the poor without inducing dependency. But this potential depends on government's being willing to accept competition from private organizations by allowing people to reject the default option. If governments reject this shift to a libertarian-paternalism approach, it would have to be seen as a failure on the test of governments' willingness to properly implement libertarian-paternalism policies.

Third, smoking regulations suggest another way of testing governments' willingness to exercise the tolerance for alternative approaches required of libertarian paternalism. An increasing number of state and local governments have outlawed smoking in privately owned establishments that serve the public. The purpose is to protect people against being involuntarily subjected to secondhand smoke. Of course, many people who frequent restaurants, bars, pool halls, bowling alleys, and other establishments enjoy their experience more if they can smoke, with secondhand smoke being an unobjectionable and triv-

ial supplement to firsthand smoke. The preferences of these people are largely, if not completely, ignored by existing antismoking regulations. This situation would be improved by the libertarian paternalism approach. No-smoking could be the default policy, but the owner of a restaurant, for example, could opt out of that policy by making it clear to potential patrons that smoking is allowed. Plenty of options would remain for people to dine out in nonsmoking restaurants, but there would also be options for those who enjoyed smoking while dining, drinking, shooting pool, or bowling. If governments are sufficiently libertarian to offer this alternative to the default policy of no-smoking, it would be an encouraging sign for libertarian-paternalist policy. If governments resist options that let people enjoy smoking while in the company of other smokers and those who don't mind secondhand smoke, it has to be considered a failure on the test.

Fourth, regulations against insider trading are another area where libertarian paternalists should be able to get government to liberalize its approach if their principle is in harmony with political incentives. The purpose of insider-trading prohibitions is to prevent outsider investors in corporate stock from being harmed by the trading of those with inside information. The objective is a good one, but prohibiting insider trading may not be the best way to achieve it in all cases. For example, regulation against half the perceived problem is unenforceable, since prohibitions against using insider information to decide not to trade cannot be enforced. Also, the price information created by insider trading can be useful to outsiders and can increase the general efficiency of financial markets. Instead of an outright prohibition, no trading on insider information could be the default policy for corporations, but they could opt out in favor of a policy allowing insider trading by making that policy clearly and widely known. This libertarian-paternalism approach would allow corporations and investors greater choice in how they operate and invest. In particular, outside investors could protect themselves against any harmful effects they perceived from insider trading by not investing in the firms that allowed it. And to the extent that investors did perceive harmful effects from insider trading, the relative price of stocks would compensate for those effects. How willing the Securities and Exchange Commission is to move to this approach would give useful information on how appropriately libertarian-paternalist policies in general would be implemented by government.

Organ Sales

A final example of a political libertarian-paternalism test (out of the many that could be considered) involves increasing the supply of organs for transplant. Currently in the United States people can choose to donate their organs on their death by indicating a willingness to do so, usually when they obtain or renew their driver's licenses. Not making the "donate" choice means that a person has automatically chosen the default option not to donate. As behavioral economists predict, most people choose the default option. Libertarian paternalists don't think this is the best choice for most Americans, and so they want to switch the default option to "donate." Being the libertarians they are,

however, libertarian paternalists would allow people to opt out by explicitly choosing not to donate.

As evidence from other countries suggests, this would significantly increase the number of Americans who choose to donate their organs. But one would think that real libertarians would want to allow people to sell their organs as another nondefault choice. This is more libertarian (indeed a policy restricting our choices to either keeping our organs or giving them away is not even remotely libertarian) and would probably increase the number of organs available to those who need them. Another advantage libertarian paternalists should see in adding the selling choice is that it would provide another measure of how much the political process could be trusted not to sabotage the other applications of the principle they are recommending.

None of these libertarian-paternalist alterations would bring perfect policies. But how good would they have to be to be better than what they replaced? And certainly they would result in policies more in the spirit of libertarian paternalism. If anything, libertarian paternalists should want to change some of the defaults from what is required by existing policies to options that would be paternalistically superior. But this is a test, and leaving the defaults where existing policies have placed them surely makes it easier for government to pass.

If those recommending libertarian paternalism really want to improve public policy, they should be anxious to subject governments to this and other libertarian-paternalism tests. If the governments pass, existing policy will be improved by bringing them more in line with libertarian paternalism. On the other hand, if governments consistently fail, this will provide libertarian paternalists with important information. Governments unwilling to alter existing regulations and programs so they conform to libertarian paternalism are unlikely to create new ones that satisfy the principle's requirements. Far more likely is that the rhetoric of libertarian paternalism will be used to justify the expansion in government's authoritarian paternalism.

Of course those claiming to be libertarian paternalists may object to the test because they think the existing regulations are acceptable as they are. But this would suggest that they are really authoritarian paternalists trying to pass themselves off as libertarian paternalists. So my test is not only a test of the political process's compatibility with libertarian paternalism. It is also a test of the libertarian paternalists' commitment to libertarianism.

Making Social Security More Harmful

October, 1 2008

Social Security is a fundamentally flawed system. If a private firm offered such a retirement system and made the same claims for it that the federal government makes for Social Security, that firm would quickly become a poster child for corporate fraud, and its managers would soon be convicted of criminal charges.

There are two fraudulent claims the federal government makes about Social Security that deserve special attention. By considering how these two claims interact with each other, it becomes clear that the politicians and pundits who defend Social Security are increasing the harm it is imposing on American workers.

Two Fraudulent Claims

Consider first that ever since Social Security was enacted in 1935 Americans have been told that their “contributions” are being deposited into their own account to pay for their retirement benefits. This claim has become more implicitly suggested than explicitly stated in recent Social Security brochures, but not in the statements of politicians when opposing any attempt to partially privatize the program. Al Gore, in his 2000 presidential campaign, assured the public that if he were elected our Social Security “contributions” would remain secure in a “lockbox” until our retirements. It was never made entirely clear whether we each had our very own lockbox or all the money was in one big lockbox.

We cannot find any serious study that estimates how many people really believe that the taxes they pay to Social Security are being saved and invested to finance their retirement, instead of being spent immediately by politicians, as is actually the case. But it is clear that many do believe that they have a personal Social Security account containing the money to fund their retirement benefits. Alan Greenspan recounts in his recent book, *The Age of Turbulence*, a story told by former House leader Tom Foley. When Foley tried to inform his

mother that there were no lockboxes containing the money to pay for Social Security, she told him, “I hope you will not be offended at how surprised and shocked I am to find that the majority leader of the House of Representatives knows nothing about Social Security.”

The other fraudulent claim made about Social Security (again, from the very beginning of the program) is that employees pay only half the cost, with employers paying the other half. This claim is widely seen as plausible because the legislation authorizing Social Security clearly stipulates that the required payments are to be split evenly between employees and employers. If this were true, then employees would now be paying 6.2 percent of their before-tax income up to \$102,000 a year; employers would match that amount.

As any good student in an economic-principles course should learn, however, the amount of a payroll tax actually paid by employees and employers has absolutely nothing to do with what politicians mandate in legislation. It is true that each worker has 6.2 percent of his after-tax income deducted from his paycheck and sent to the Social Security Administration (SSA) and his employer sends in the same amount. But by altering the wages employers pay and workers receive, these payments change the supply and demand schedules for labor—at a given nominal wage, different amounts of labor will be supplied and demanded than before. (In the lingo of economics, the supply and demand curves shift.) Until we know how wages and salaries change in response to these shifts, we cannot tell how much of the Social Security cost is paid by the employees and how much is paid by employers. For example, if a worker’s salary is reduced by exactly the same amount that the employer sends to the SSA for her, then the cost to the employer is nothing (what he pays for the worker’s Social Security is offset by the lower salary) and the worker ends up paying the entire cost.

We are not going to work out the details for determining how the Social Security cost is divided between workers and employers. But having worked this out with graphical analysis in an October 2006 article in *Economic Inquiry*, we can provide a simple verbal explanation of how those who defend Social Security are adding to the harm it inflicts on American workers.

The employer requirement to send a check to the SSA for each worker equal to 6.2 percent of salary revises downward the firm’s demand schedule for labor according to the amount of this check. This reduction in demand, considered by itself, obviously reduces the salary the firm is willing to pay each worker. Similarly, the Social Security deduction from each worker’s paycheck reduces the labor supply by revising upward the supply schedule by the amount of this deduction, assuming that there is no expected benefit from Social Security.

But this overstates the reduction in labor supply if workers believe they are going to receive some benefit from Social Security. The more benefit workers expect to realize from Social Security (in present-value terms), the less the labor supply will decline. And indeed, if they expect to receive more in Social Security benefits than the amount deducted from their checks, then labor supply will increase out from the original level.

But this means that even if workers are receiving benefits greater than the

amount being deducted from their paychecks, they are not necessarily better off. The decrease in labor demand and the increase in labor supply can result in a salary reduction greater than the amount Social Security benefits are expected to exceed paycheck deductions. In fact, as we show in our Economic Inquiry article, workers are made worse off by Social Security unless the benefits they expect and actually receive are at least equal to the total amount paid for Social Security by both the workers and their employers.

Defrauding Workers

We are now able to nail down our main point—that advocates of Social Security are defrauding American workers in two ways. First, claims which leave the impression that money paid into Social Security is being saved for our retirements lead workers to believe their benefits are more secure than they are.

Second, persistent claims that workers pay only half the Social Security tax lead them to believe their benefits cost them less than they really do.

These fraudulent claims clearly increase the political viability of Social Security by misleading workers into expecting larger benefits than they will receive. But it is worse than this. By generating exaggerated expectations of Social Security benefits, the two claims are actually reducing the net benefits workers receive by increasing the amount they are paying for them with lower wages.

It is ironic that those pundits and politicians who oppose even the most timid moves to privatize Social Security by downplaying, or denying outright, its Ponzi-scheme nature are widely seen as protectors of American workers.

Reducing Income Inequality at the Expense of the Poor

February 5, 2013

Market economies motivate positive-sum activities in which people become rich by creating more wealth for others—both in the form of higher-paying jobs and improved goods and services at lower prices. That doesn't mean everyone will earn the same, but it means improved conditions for everyone, even the least well off. It is far better, after all, to be poor in Cleveland than in Calcutta.

Yet when people talk about increasing income inequality, they almost always discuss the topic as a market failure calling for government correction. They invariably ignore the possibility that increased income inequality has resulted from things few people would want to “correct”—namely, individual freedom and the success of markets in satisfying the needs and wants of the masses.

Four such successes come to mind.

To begin with, the returns on education have increased significantly in recent years, as reflected in the increased salaries and wages that come with more education. This increased return is exactly what we should want as technological progress increases the productivity of those who acquire more knowledge and improve their abstract reasoning skills relative to those who do not.

Second, profound social, economic, and political changes have combined to remove barriers to market access by women. Half the population now has full participation in a marketplace that had for generations been closed to them. More women than ever are taking advantage of the market's opportunities, often building on advanced degrees. Among those women, more are now majoring in fields that yield the highest returns. This choice goes a long way toward explaining why income inequality between men and women in the United States has declined in recent decades. In many fields—once factors such as differences in major, career selection, and duration of employment are controlled for—income disparities between the sexes evaporate. Despite this relatively equality between the genders, we should expect to find increasing income inequality among women as more women ascend to high-salary positions.

Third, the day has long passed in most countries when marriages were arranged without the consent of the betrothed. This freedom, along with the increased mobility people enjoy in wealthy countries, means that marriage markets in those countries are highly competitive, with each participant putting his or her looks, personalities, and prospects on offer to compete for someone who best satisfies what he or she is looking for in a partner. With more women getting advanced degrees and working alongside high-earning colleagues, marriage markets have generated more matches between individuals who each have high earning potential.

Fourth, spurts of technological progress create big winners. But the resulting technological improvements leave everyone better off by making possible what has always been required for sustainable improvements in our general living standards: the production of more value with less effort and fewer resources—all while increasing the economically relevant resource base.

For example, technological progress has recently made it possible for almost everyone in wealthy countries to enjoy the performances of the very best athletes, musicians, singers, talk-show hosts, comedians, etc., wherever they are, with visual and audio clarity that rivals and often exceeds that of live performances. Between those who entertain and those who bring the entertainment to our eyes at relatively low cost, we are bound to find high earners. In other words, technological access explains why people such as Tiger Woods, Britney Spears, and Oprah Winfrey have earned incomes that comparably skilled athletes and entertainers could not have imagined a few decades ago. Those entrepreneurs who develop ways to provide the most value to consumers at the lowest costs, such as Bill Gates, Mark Zuckerman, Michael Dell, and Jeff Bezos, also become billionaires at young ages. These achievements are consistent with other periods of rapid technological progress. One ambitious and intelligent individual, willing to take a big risk, can come up with the sorts of products and services that improve the lives of millions by offering them low-cost opportunities to be entertained, enlightened, and connected.

It is difficult to imagine how anyone interested in improving the welfare of the least advantaged would want to lessen income inequality by reversing any of the four socioeconomic trends above. The increased prosperity these trends have made possible for the most successful among us is obvious. The increased prosperity and well-being for the poor is no less real, but these gains are commonly ignored in discussions of income inequality.

Although creating more wealth is the most effective way of reducing poverty—and happens also to be a great way to become fabulously wealthy—one standard argument is that the poor would be better off if government reduced income inequality simply by transferring more money from the rich to the poor.

The serious problem with this argument is that government transfers have never been very effective at reducing income inequality or improving the conditions of the poor. Ironically, most government transfers go to those who are not poor. The two largest federal transfer programs, Social Security and Medicare, are targeted to the elderly, most of whom are not poor (medical care for the poor is provided by Medicaid). Many seniors are poorer than they would

otherwise be, though, because these programs reduce the incentives for people to save for their old age. These two transfer programs make up close to one-third of all federal spending, and there are many billions of other federal transfer dollars going to politically influential recipients who are not poor and are often quite wealthy (e.g., large agribusiness concerns, defense contractors, pharmaceutical giants, etc).

Of course, some government transfer dollars and in-kind benefits do go to the poor, but they often perpetuate poverty among the most economically disadvantaged. When the poor make an effort to improve their skills and work hard to increase their incomes, the government money and benefits they receive are reduced by a large percentage of their additional earnings. Sometimes it's more than 100 percent, leaving them with less take-home income than before. The result is that many poor people see little benefit in making the effort to earn more income, or any income at all. They are trapped in poverty by the very programs that were supposed to help them escape it. (We'll pass over the army of administrators who skim a percentage of these transfers and enjoy lavish benefits.)

Relative economic freedom, despite the income inequality that results, has done far more to help the poor than government transfer programs have ever done. Indeed, government attempts to reduce income inequality would do little to reduce inequality but a great deal to hamper economic growth and reduce economic opportunities for the poor to improve their lives with productive effort.

Environmental Policy

The Problem of Environmental Protection

April 1, 2001

A common belief is that economists don't care much about the environment because they are preoccupied with money, markets, and material wealth. And when economists do consider ways to protect the environment, they emphasize benefits and costs, trying to express all values in terms of cash. This view is angrily expressed by mountaineer-philosopher Jack Turner, who decries the economists' approach to the environment as "[reeking] of cynicism—as though having failed to persuade and woo your love you suddenly switch to cash. [Economists] think they are being rational; I think they treat Mother Nature as a whorehouse."¹ While Turner's comment is harsher than most, it is representative of many statements that can be found claiming that economists are environmentally callused.

In truth, economists are just as concerned about environmental quality as most people, maybe more so. All sensible people value the quality of the natural environment, and would like to maintain and improve that quality. Also, economists have thought a lot more than most about the source of our environmental problems and have developed important insights into the best ways to solve them. Unfortunately, it is easy for non-economists to misunderstand the economic approach to protecting the environment, causing them to underestimate the effectiveness of that approach and the genuine environmental concern that economists have.

The typical reactions to pollution are to blame it on the greed of those who put profits ahead of protecting the environment and to have someone in authority stop it. The perspective of economists is different. They do not automatically conclude that pollution is always a problem that demands a solution. When they do conclude that pollution is a problem that should be addressed, they seldom suggest having government demand that the pollution

¹See Jack Turner, "Economic Nature," in Deborah Clow and Donald Snow, eds., *Northern Lights: A Selection of New Writing from the American West* (New York, Vintage Books, 1994), p. 121.

be stopped altogether. Finally, economists see blaming pollution on self-interest as unproductive, if not downright silly.

Because of scarcity, attempting to eliminate all harm caused by pollution makes no sense. Sure, it would be nice to eliminate pollution, but reducing pollution always requires doing less of something else that is desirable, and long before we reduced pollution harm to zero, the marginal benefit would be less than the marginal cost. Of course, in many situations it is desirable to reduce pollution. While people may seldom agree on how much to reduce, they should agree that any reduction ought to be achieved as cheaply as possible—at the least possible sacrifice of value. But having a government agency command polluters to reduce pollution is the most costly way to protect the environment. And economists see no advantage in blaming self-interest for pollution because that leads to inefficient pollution reduction. Indeed, the cheapest way to reduce pollution is by taking advantage of self-interest.

In this column I shall begin a discussion of how the concepts of scarcity and marginalism provide important insights into the problem of pollution and how best to address it.

Environmental Protection versus Environmental Protection

Few things are more aggravating to those professing great concern for the environment than economists' insisting on considering the cost of reducing pollution. The environment is seen as too important to be thought of as just another commodity, so costs simply aren't relevant. Pollution harms the environment and should be reduced drastically regardless of the cost. Economists find these comments either hilarious or depressing, depending on their mood. The environment is important, but we get silly environmental policies when we ignore the costs of environmental protection. This would be true even if environmental quality were all we cared about, since protecting the environment in some ways requires sacrificing it in others. Consider some examples.

Environmentalists want to protect and expand wetlands, which are the habitat for a wide variety of flora and fauna. They are also concerned about global warming, which is supposedly resulting from the emission of greenhouse gases. But wetlands are one of the biggest sources of methane, a major greenhouse gas. So a cost of expanding wetlands is the release of more greenhouse gas. Is this a cost environmentalists think we should ignore?

Environmentalists also want to save forestland and eliminate the use of chemical pesticides and fertilizers in agriculture. Preventing starvation in poor countries without using chemical pesticides and fertilizers would require clear-cutting millions of acres of trees for agricultural use. So fewer trees are one of the costs of reducing chemical pesticides and fertilizers. Finally, and more generally, since waste products have to go somewhere, one cost of reducing water pollution is an increase in either air pollution or waste-disposal sites.

These costs are the direct result of scarcity and require facing up to some tough questions. Is protecting wetlands more important than preventing global warming? Is protecting rivers, lakes, and oceans against the runoff of chemical fertilizer more important than maintaining our forests (which absorb carbon

dioxide, another greenhouse gas)? Which is more valuable, clean air or clean water? Environmentalists like to argue that environmental concerns are more important than anything else, but they can't argue that every environmental concern is more important than every other environmental concern.

There is a way around these questions by accepting some insights from economics.

The only sensible way to determine whether clean air is more or less valuable than clean water is by making the comparison at the margin. If the water is extremely dirty (dysentery in every drop) and the air is extremely clean, then the marginal value of clean water (the value of an incremental increase in water quality) is greater than the marginal value of clean air (the value of an incremental increase in air quality). In this case, it is sensible to improve water quality even though the cost is reduced air quality. And the improvement in water quality should continue as long as the marginal value of clean water is greater than the marginal cost of dirtier air.¹

Those who read my January column will recognize this as an example of equating at the margin: doing the best we can by not doing anything as well as we possibly could. Only by accepting this marginal principle can we deal sensibly with the tradeoffs that scarcity forces us to confront. As I will discuss next month, the implications of equating at the margin for environmental policy are too sensible for some environmentalists to feel comfortable with.

¹This assumes that the only cost of improving water quality is reduced air quality. More accurately, water quality should be improved until the marginal value of doing so equals the marginal cost, where cost reflects all sacrificed value, not just the sacrificed value of air quality.

The Efficient Amount of Pollution

May 1, 2001

When environmentalists argue that the costs of protecting the environment should be ignored, they quickly find themselves in a box. The only way to protect environmental quality in some ways (say, reducing water pollution) is by harming it in other ways (say, increasing air pollution). To say that we should protect the environment without considering the cost is the same as saying that we should protect the environment without considering the damage done to the environment. When environmentalists take a break from silly rhetoric and get serious about improving environmental quality, they have to compare the value of alternative environmental goals; for example, clean air versus clean water. Doing this requires recognizing that, first, decisions are made at the margin (a little more clean water at the cost of a little less clean air), and, second, the marginal value of everything eventually begins to fall as we get more of it. Without these two insights from economics, an environmentalist can never get beyond providing comic relief for those who think seriously about environmental problems, which, I want to emphasize, includes some environmentalists.¹ But accepting the insights of marginal analysis leads to logical conclusions that many environmentalists do not like.

Once we recognize that it's marginal values that are relevant to our choices, and that the marginal value of all goods declines as we use more of them, it follows that environmental values don't always trump other values. Sure, we value environmental quality. But we also value lots of other things such as warm homes in the winter; cool homes in the summer; life-saving drugs; stylish clothes; fast food; hot showers; large, roomy vehicles; jet travel; hair spray; disposable razors, diapers, and grocery bags; fast-acting detergent; contact lens solution; chemically treated lawns; and so on. The production and consumption of all these things damage the environment, but it makes sense to increase our consumption of them as long as their marginal value is greater than the marginal environmental cost. And this means consuming trinkets, gadgets, and conveniences to the point of significantly damaging the environment if environ-

mentalists are right when claiming that maintaining environmental quality is a serious problem.

The Efficient Amount of Pollution

We can illustrate the tradeoff between environmental quality and other desirable goods with a diagram. Beginning with no pollution, the marginal value of polluting would be extremely high. Imagine not being able to discharge any bodily pollution for a few hours and think about how much satisfaction would be realized by polluting a little bit (a minute or two would be sufficient, since you discharge carbon dioxide, a greenhouse gas, with every breath). But as you increase your pollution by doing things that are less and less urgent, the marginal value of polluting declines. This decreasing marginal value of pollution is shown in the figure with the downward-sloping curve MV (the marginal value of pollution). At some point, P' in the figure, we have done all the polluting that creates value and the marginal value of pollution is zero.

Polluting is costly, of course, because it reduces environmental quality, at least beyond some point. Perhaps the assimilative capacity of the environment is so great that we can pollute a lot before there is any loss of environmental quality, in which case the marginal cost of pollution is zero over a wide range of pollution.² This situation is shown with the marginal cost of pollution curve, MC. When pollution first begins harming the environment, the marginal cost will be quite low, little more than aesthetically unpleasant. But as it increases, the marginal cost will also increase, with additional pollution beginning to harm plant and animal life. So the MC curve is upward sloping, as shown in the figure.

Given the values represented by curves MV and MC, what is the efficient amount of pollution (the amount that maximizes the total value derived from polluting)? When pollution is less than P'' , the marginal value realized from more pollution is greater than the marginal value sacrificed, or marginal cost—additional pollution adds more value than it destroys. But beyond P'' , the marginal value from more pollution is less than the marginal cost, and additional pollution destroys more value than it creates. The most net value is clearly realized when pollution is P'' . At P'' the marginal environmental damage is given in the figure by D'' , and the total environmental damage is given by the area A (the area under MC from 0 to P'').

Many environmentalists will argue that pollution is a more serious problem than suggested by the marginal cost curve MC, with the real marginal cost curve more like MC' , showing greater cost at every pollution level. If true, then the efficient amount of pollution is reduced to P^* , but the marginal environmental damage is given in the figure by D^* , and the total environmental damage is given by the area B (the area under MC' from 0 to P^*). The more vulnerable the environment to the damaging effects of human activity, the more environmental damage we are justified in doing.³

Regardless of whether the efficient amount of pollution is P' or P^* , we will increase our pollution to P' (where its marginal value is zero) without some process for making us consider the cost that our polluting activities impose on

others. Our pollution problems should make all of us, especially environmentalists, appreciate the advantages of private property and market exchange, which require us to pay prices for goods and services that reflect their marginal cost. If this were the case with polluting activities, there would be no pollution problems, since pollution would be expanded only up to the efficient level, where its marginal value equals its marginal cost.

The Efficient Amount of Pollution

June 1, 2001

*Are People Pleased with the Efficient
Amount of Pollution?*

It is clear that zero pollution is not a reasonable goal once we recognize that polluting creates benefits as well as costs. Long before we reduced pollution to zero, there would be so much environmental quality and so few manufactured goods that the marginal value gained from increasing pollution would be greater than the marginal cost. There is an efficient amount of pollution that maximizes the value realized from all the things we enjoy, of which environmental quality is but one. The efficient amount of pollution occurs where the marginal value of pollution equals the marginal cost (see my column last month).

Economists are so enthusiastic about efficiency that one might believe that if we ever got to the efficient amount of pollution, everyone would be pleased with it. This is not true. Indeed it is likely that nobody would be pleased with the efficient level of pollution—everyone would prefer a different level. But why? How can economists get so excited about the efficient amount of pollution if nobody likes it? Good question, and the answer provides important insights into why we have a pollution problem in the first place.

Most goods are like food, clothing, housing, and entertainment, which can be consumed in different quantities and qualities by people in the same community. This is not true of environmental quality.

Environmental quality is what economists call a public good. A given amount of environmental quality provided for one person in an area is simultaneously provided for everyone in that area. An additional person can benefit from a cleaner environment without reducing the benefits to others. This may sound like an ideal situation, but it creates serious problems. It is often difficult, if not impossible, to exclude people from the benefits of a public good; so some can benefit without paying. If too many people attempt to free-ride, less than the efficient amount of the good will be provided. Also, since everyone in a community has to consume the same quantity and quality of a public good, it is difficult to accommodate diverse preferences. For example, people who

enjoy outdoor activities, such as jogging, will want extremely high air quality, while those who prefer bowling in smoky bowling alleys will hardly notice a smog alert.

The only way to harmonize different preferences for a public good is by charging people different prices for the same good. For example, since the jogger values clean air more than the bowler, the only way to satisfy both with the same air quality is to require the jogger to contribute more to providing clean air than the bowler. But there is a problem in charging for a public good. Even if a charge is imposed to pay for cleaner air, say, through taxation, there is no easy way to get people to reveal their preferences honestly to determine the right charge. People will claim little desire for clean air if higher charges are imposed on those receiving higher benefits. Of course, tax burdens are not determined from surveys on preferences but by the value of property holdings, income, and the whims of legislators. The clean-air-loving jogger may be a struggling graduate student who pays no taxes and the bowler may pay very high taxes. So even if we had the efficient level of air quality, the jogger and the bowler would be unhappy with it. The jogger would want much more spent on cleaning up the air, and the bowler would want much less.

I'll Pay You Not to Pollute

Next consider a situation involving only the bowler and the jogger, with the bowler having the right to any level of air quality he wants, but with it possible for him and the jogger to negotiate an agreement over the pollution level. Before the negotiations start, the bowler wants more pollution than is efficient—an amount where the marginal cost of pollution is greater than the marginal value—since he receives little of the marginal value from reducing pollution but pays all of the marginal cost. With negotiations, however, the bowler will consider the marginal cost the jogger suffers from pollution because the jogger is willing to pay an amount equal to that marginal cost to reduce pollution. As long as the marginal cost of pollution is greater than the marginal value, the jogger is willing to pay enough to motivate the bowler to reduce pollution. When pollution is reduced to its efficient amount, the jogger is no longer willing to pay enough to compensate the bowler for more pollution reduction, and both have done as well as possible because of the exchange.

Similarly, if the jogger had the right to clean air, negotiations would still lead to the efficient level of pollution. The bowler would be willing to pay an amount equal to his gain from more pollution to the jogger for accepting more pollution. Consequently, the jogger finds it to his advantage to consider the value the bowler receives from having more pollution as well as the value he receives from less. So again, as long as the marginal value of pollution is greater than its marginal cost, both can gain through exchange that will increase pollution to its efficient level.

We see that everyone will be content with the efficient level of pollution as long as the costs of negotiating and enforcing an agreement are zero. Unfortunately, many people are typically affected by pollution, and it would be extremely costly, if not impossible, for them to reach a mutually acceptable

agreement on the pollution level and side-payments, and then enforce that agreement. This inability to cooperate on pollution decisions through exchange explains why there would be widespread dissatisfaction with environmental quality even if we achieved the efficient level of pollution. It also explains why achieving (or even determining) the efficient amount of pollution is almost impossible.

If people in the same area could consume different levels of environmental quality depending on their preferences, efficiency could be easily achieved through market exchange. Each individual would pay for the cost of improving his private environmental quality to the point where the marginal cost equaled the marginal value. There would be no free-riding, no controversy, and no pollution problems, since everyone would have the environmental quality he was willing to pay for. But even with the problems that exist because we have to consume environmental quality commonly, we can use market incentives to do a far better job than we are doing to reduce pollution. After considering what it takes to reduce pollution as cheaply as possible in my next column, I shall begin discussing the advantages of market incentives in controlling pollution.

Reducing the Cost of Reducing Pollution

July 1, 2001

As we discussed last month, the efficient amount of pollution is not likely to please many. The problem is that everyone in an area has to consume the same amount of environmental quality while the value of that quality and the price paid for it vary from person to person. Some will want less than the efficient amount of pollution; some will want more; and almost no one will want the same amount.

The efficient amount is what everyone would want if there were no cost to negotiating and each individual faced payments that honestly reflected the value he receives from pollution reduction. Unfortunately, reaching agreement on and enforcing such a payment scheme is impossible when many people are involved. The result is that we cannot determine the efficient amount of pollution or reach agreement on the desirability of any amount of pollution.

But a pollution policy requires a decision on how much pollution to reduce. And even if we cannot all agree on the desirable pollution level, we should all be able to agree on one thing: no matter what pollution level is decided on, we want to achieve it at least cost—at least sacrifice of other things we value. Equivalently, we can all agree that no matter how much cost we incur, we want to reduce as much pollution as possible.

What does it take to reduce pollution at least cost? More than it may seem. Clearly, it requires that every polluter reduce pollution as cheaply as possible. There are many ways to reduce pollution, and doing so in the least expensive way requires a lot of local information—information available only to those familiar with local conditions and circumstances—that is difficult, if not impossible, to communicate to others.

For example, there are many ways to reduce the emission of sulfur dioxide from an electric generating plant—substitute low-sulfur western coal for high-sulfur eastern coal, substitute natural gas for coal or petroleum, install a stack scrubber to filter out some of the sulfur dioxide, substitute more costly but nonpolluting pump-storage generation (see my March column) to serve peak-load demands, or shut down the plant. The costs associated with each of these

actions vary among generating plants. A plant in Kansas may find it less costly to switch to western coal, while a plant in New Jersey is more likely to find it cheaper to install a stack scrubber. The cheapest way to reduce emissions by a small inefficient generating plant that is barely covering its costs may be to shut it down, something that would be very costly for a large efficient plant that is producing electricity worth far more than it costs to generate. Or the least-cost action may be some combination of approaches, such as relying more on pump-storage generation for peak load demand and substituting natural gas for coal. The possibilities are endless for every type of polluting activity, and the only hope for choosing the least-cost reduction in demand requires the use of information known only to those closely involved in each situation.

But even if every polluting firm were reducing its pollution at least cost, pollution would not necessarily be reduced at least cost. Having everyone reduce pollution as cheaply as possible is clearly necessary for least-cost pollution control, but it is not sufficient. We also need the right pattern of pollution reduction over all polluters. Some polluters can reduce pollution at a lower cost than others. Clearly, those who can reduce pollution at low cost have to reduce by more than those who can reduce only at high cost if we are to achieve the least-cost pattern of reduction. But to determine exactly what this least-cost pattern is, we have to consider the marginal costs of pollution reduction.

Equating at the Margin

It does not tell us much to say that one firm can reduce pollution at low cost and another at high cost. If this were true at all levels of reduction, then the first firm should reduce its pollution all the way to zero before the second begins any reduction at all. But as a firm reduces more of its pollution, the marginal cost of reduction will begin to increase (it makes sense to start with the pollution easiest to reduce and then move to that which is progressively more costly), and long before the low-cost firm has reduced its pollution to zero, its marginal cost of reduction will exceed the high-cost firm's marginal cost of its first unit of reduction. Clearly, reducing another unit of pollution at minimum cost requires that it be reduced by the firm with the lowest marginal cost. But this increases that firm's marginal cost, and soon additional reduction is more cheaply done by another firm. No matter what the level of pollution reduction, it is not occurring at least cost unless the marginal cost of reduction is the same for all firms.

For example, if the marginal cost of reducing pollution is \$50 in one firm and \$25 in another, then the first firm could increase pollution by one unit (saving \$50) while the second firm reduces pollution by another unit (costing \$25). This would result in the same amount of reduction at a saving of \$25. This increase in pollution by the first firm and offsetting reduction by the second continues to reduce the cost of a given amount of pollution until the marginal cost of reduction is the same for both.

It obviously requires a lot of information to reduce pollution at least cost, and this information is widely dispersed. Each polluter knows more than anyone else about how to reduce his pollution as cheaply as possible. Even if this

information could be communicated to a central authority, it would soon be rendered obsolete by changing circumstances. There is simply no way remote government authorities can acquire the knowledge necessary to dictate to firms how each should reduce pollution and how much each should reduce to protect the environment efficiently and effectively. Furthermore, even if policymakers had all the information necessary for reducing pollution at least cost, they would have little motivation to use it appropriately.

But the current centralized command-and-control approach assumes government can do those things. I'll discuss this approach in my next column, emphasizing why it often does more to protect special interests than to protect the environment.

The Perverse Popularity of Command and Control

September 1, 2001

Most government attempts to protect the environment involve imposing detailed regulations on how, and how much, pollution must be reduced. This command-and-control approach does reduce pollution, but as I explained last month, it does so at high cost.

I now consider why the command-and-control approach is so popular politically. One possibility is that though command and control is a costly way to reduce pollution, there is no less costly way. Just because a policy is costly does not mean it is inefficient, unless there is a cheaper way of realizing the goal. So it may be that Congress and the EPA are concerned only with protecting environmental quality and have embraced this approach because, as costly as it is, it is cheaper than feasible alternatives.

We are about to see that this is not the case. The political popularity of command and control has far more to do with protecting special interests than with protecting the environment. Next month I shall discuss an alternative approach to environmental protection using market incentives, one that is resisted politically because it would do far more to protect the environment than to protect special interests.

I hope I don't sound outrageously cynical when I say that employees of the EPA are willing to sacrifice environmental quality for personal gain. I hasten to add that I am not singling out EPA employees for special criticism. They are just like the rest of us. We all do things for personal benefit that harm the environment (almost everything we do causes some environmental harm). It shouldn't be surprising that EPA employees do the same. Command-and-control policies are not the best for protecting the environment, but they are great for protecting (and expanding) EPA budgets and jobs. The EPA has more to do when it is involved in the details of pollution control than it would if decisions were shifted to those with more information on local conditions. As The Economist pointed out, "The EPA exists to regulate things, not to see the

market do the job for it.”¹

Few things are easier than convincing yourself of the social virtue of things that serve your interest, so most EPA officials are likely convinced that command-and-control policies are justified.

But even if they are motivated by civic virtue, EPA officials benefit by reducing pollution through detailed regulation. And since they are well organized and considered experts on pollution control, their views have significant influence on environmental policy.

Another political advantage for the command-and-control approach is its public appeal. If big businesses are polluting our environment, then nothing seems more appropriate than for government to step in and make them stop. Discussions about local knowledge and least-cost reduction are far too subtle to capture the attention of the public. Also, the market approach, which (as we shall see) allows people to pollute as much as they want as long as they are willing to pay a price, is easily dismissed with bumper-sticker phrases like “it’s a license to pollute.”

Don’t Throw Me in the Briar Patch

The public may believe that the command-and-control approach is the best way to get tough on big-business polluters, but businesses are among its most enthusiastic and politically influential supporters.

True, businesses often object to environmental regulations, but most of these objections are like Br’er Rabbit’s begging the fox not to throw him into the briar patch. True, businesses don’t like all environment regulations (they don’t want to be thrown just anywhere in the briar patch), but some types of regulation are just fine with them, especially big businesses.

Command-and-control regulation typically increases the costs of doing business. But those costs are often easier for a big business to handle than a small business, because large firms already have legal departments to deal with the inevitable litigation that comes with environmental regulation, and they can spread the costs of pollution control over more units of output.

Also, pollution-control regulation often reduces an industry’s output. This can increase industry profits by allowing firms to raise prices and act like a monopoly cartel, something that is normally illegal. For example, EPA regulations for reducing sulfur in gasoline have recently improved the profit outlook for refiners by causing them to shut down some plants.²

Sometimes command-and-control policies are intentionally used to protect an industry against competition at the expense of the environment. One blatant example involves air-pollution policy. The 1970 Clean Air Act established acceptable levels of several pollutants, including sulfur dioxide (SO₂), the primary pollutant of coal-fired electric generating plants. While requiring those generating plants to reduce their SO₂ emissions, the Act did not specify how. The cheapest way to reduce SO₂ emissions is often to shift from high-sulfur

¹“William Reilly’s Green Precision Weapons,” *The Economist*, March 30, 1991, p. 28.

²Peter A. McKay, “New EPA Rules May Fuel Refiners’ Profits,” *Wall Street Journal*, February 2, 2001, p. C-1.

eastern coal to low-sulfur western coal, and that is exactly what many coal-fired plants did, even some in the east. The alternative is to install stack scrubbers that remove much of the sulfur from the flue gas, but they are expensive, consume large amounts of energy, and often do less to reduce SO₂ emissions than simply burning western coal.

Unsurprisingly, the eastern coal industry and the United Mine Workers Union were unhappy about the shift to western coal. (It requires little labor to mine and the labor is not heavily unionized.) So they were prepared to lobby for the elimination of the competitive advantage of western coal when the Clean Air Act was amended in 1977, even if it meant dirtier air and higher electricity bills. They backed amendments requiring that all new (or substantially modified) power plants install the “best available control technology,” which meant scrubbers, regardless of the sulfur content of the coal used. Furthermore, they pushed through a “local coal amendment” that outlawed “importing” western coal if it threatened jobs in eastern coal-mining states.

This command-and-control policy mandating how pollution has to be reduced means that coal-fired power plants have neither the incentive nor, in many cases, the legal right to reduce pollution as cheaply as possible. This mandate had nothing to do with protecting the environment, but a whole lot with protecting an organized interest group. Because of these amendments to the Clean Air Act, the price of electricity increased in all parts of the country (power plants in the west continued to use western coal but still had to install expensive scrubbers) and the environment was actually harmed in many parts of the country.¹

¹For a more detailed discussion on the 1977 amendments to the Clean Air Act, see Peter Navarro, “The Politics of Air Pollution,” *The Public Interest*, Spring 1980, pp. 36–44.

Maximum Cooperation Means Minimum Cost

November 1, 2001

There are two big advantages to a pollution-control policy that relies on transferable pollution permits. First, firms can reduce pollution any way they choose, which will be the cheapest way possible. Second, firms will coordinate their reduction with one another so that the pollution target is achieved as efficiently as possible. In last month's column, I explained how that coordination causes firms to adjust their pollution so that the greatest possible value is created by the allowable pollution. I now emphasize the other side of the same efficiency coin—reducing pollution to the allowable level at least cost, or the least sacrifice in value.

With pollution permits any firm (or any polluter) can legally discharge a specified amount of the designated pollutant only if it owns the required permits. As long as the firm's marginal cost of pollution reduction is less than the market price of a permit it will reduce pollution rather than buy the necessary permits. As the pollutant is reduced, however, the marginal cost of reduction increases and at some point will become equal to the permit price.

Reducing pollution another unit below that point will cost more than buying a permit allowing the unit to be discharged into the environment. So the firm will reduce pollution until the marginal cost of reduction equals the permit price, with enough permits being purchased to cover the remaining pollution.

Thus the market price of pollution permits will tend toward the marginal cost of reduction. If the price is higher, firms will do more to reduce pollution so they can sell permits, driving the price down. If the price is lower than marginal reduction cost, firms will buy more permits so they can reduce less, driving the price up.

Because firms have to pay to pollute, they will be alert to cheaper ways to cut their discharges. When they are successful they will sell permits, causing their price to fall. But some firms will be facing increasing demands for their products, and they may have to pollute more to meet that demand even with better reduction techniques, which can increase their marginal cost of pollution control. These companies will be buying permits, increasing their price.

Firms communicate and cooperate through the price for pollution permits. The firm whose marginal cost of control increases communicates that information by bidding up the permit price a little bit with its purchases. Other firms respond to this information by selling a few permits. They act as if they are saying, "Another firm is telling us that its marginal cost of pollution control is higher than ours, so we will reduce our pollution a little more so it can reduce its pollution a little less."

Conversely, the firm that can lessen its marginal cost of reduction communicates that information by putting downward pressure on the permit price by selling some permits. Other firms, by buying a few more permits, will be acting as if they are saying, "Another firm is telling us that its marginal cost of pollution control is less than ours, so with it polluting a little less we can pollute a little more and still keep pollution within the allowable limit."

Since the price of permits is the same for all firms and it pays each to reduce pollution until its marginal cost of doing so equals that price, the marginal cost of control is roughly the same for all. This "equating at the margin" means that all opportunities to lower costs by reallocating pollution reduction among the firms have been exploited through a process of mutual adjustment.

The Evidence

The argument for pollution permits doesn't tell us how much the cost advantage is relative to the command-and-control approach. Numerous studies have estimated the actual cost of pollution reduction for different air pollutants and locations under current EPA policy and then compared those costs to what the same reduction would have cost with a pollution-permit approach.

Those studies all show that the permit approach is cheaper than the command-and-control approach, usually much cheaper. For example, the reduction of particulate air pollution over St. Louis is six times more costly than it needs to be; the reduction of sulfur dioxide from the air over the four corners region of Utah, New Mexico, Colorado, and Arizona is 4.25 times more costly than it needs to be; and the reduction of nitrogen dioxide air pollution over Chicago is 14.4 times more costly than it needs to be.¹ With pollution control costing tens of billions of dollars annually, the possible cost reductions would save tremendous amounts of money, with more done to reduce pollution.

Also important are the motivation and freedom that permit prices give each polluter to decrease pollution cheaply. In the few cases where permits have been experimented with the price of the permits is typically far lower than anticipated because polluters found ways to reduce pollution more cheaply than anticipated. When Wisconsin Power and Light started trading sulfur dioxide permits with Duquesne Light of Pittsburgh as part of a test case, the permits were expected to sell for \$600 to \$700 per ton of pollutant. They sold for around \$150 instead.²

¹These and similar studies are summarized in Tom Tietenberg, *Environmental Economics and Policy*, 3rd ed. (Boston: Addison Wesley, 2001), pp. 270-73.

²Gregg Easterbrook, *A Moment on the Earth* (New York: Viking Penguin Books, 1995), pp. 177-78.

Reducing Bad Taxes

If the government sells off pollution permits, it will raise lots of money: tens of billions of dollars or more. This is not necessarily desirable. Sure, if the government has more money it can do more good things. The problem is (1) the government often spends money on things that destroy rather than create wealth (for example, imposing trade restrictions, enforcing silly regulations, controlling prices, and subsidizing unproductive activities), and (2) even if the money is spent to create value, it comes out of the private sector where it would have probably produced more value.

But there will be a net gain if the government uses the revenue from permits to reduce taxes by the same amount. Most government revenue comes from taxing desirable activities, such as working, saving, and consuming. This is the reason for the dead-weight cost of taxation that I explained in my March 2000 column. Reducing this revenue by substituting revenue from a tax (the sale of permits) on an undesirable activity like polluting would reduce the dead-weight cost of taxation without reducing government revenue. The danger here is obvious: Government will take the revenue from selling permits without reducing other taxes.

Energy Production versus Conservation

December 1, 2001

One of the most important insights in economics was made by F. A. Hayek in a famous article titled “The Use of Knowledge in Society” (American Economic Review, September 1945). Hayek’s insight was simple, but powerful: the information necessary for making sensible economic choices is far too dispersed and difficult to articulate ever to be possessed by any one person or group of experts. Hayek emphasized in his article that only through market prices can people become sufficiently informed to direct resources into their most valuable uses. Eliminate market prices, or distort them with politically imposed ceilings or floors, and you systematically destroy the information that people need to avoid wasting resources.

Unfortunately, most people seem immune to Hayek’s point. This immunity is particularly strong among politicians and journalists. The prevailing view seems to be that when an economic problem arises, the solution lies in ignorance.

The most recent example of this view concerns the production-versus-conservation debate over energy policy. It is widely accepted that the decision on the right mix of production and conservation is best made by Congress after it has imposed “market-based” price caps on important energy prices. Consider an editorial comment in the May 28, 2001, *Business Week*: “No one, except for a handful of eco-extremists, believes that conservation is the only answer to the energy crisis. But few believe that conservation plays no role either. It is up to Congress to negotiate a balance in the weeks ahead.” (Emphasis added. I should point out that price controls were not recommended in this editorial.)

If politicians could only resist the urge to control energy prices, there would be no need for them to worry about “negotiating a balance” between energy production and conservation. But having yielded to the urge to control those prices, neither politicians nor anyone else can have the foggiest idea how much production and conservation is appropriate.

Every time we get worried about the availability of energy, a debate breaks out over conservation versus production. It happened in the 1970s and early

'80s in response to the export restrictions of OPEC and then again earlier this year in response to less drastic OPEC cutbacks coupled with the politically induced electricity shortages in California. One side argues that we should drive smaller cars, make more use of mass transit, buy more energy-efficient appliances, do a better job insulating our homes and offices, and keep them warmer in the summer and cooler in the winter; the list of possibilities goes on. The other side argues that we can't conserve ourselves to prosperity, so we should produce more energy by drilling for more oil, mining more coal, building more electric generating plants, and bringing more nuclear plants on line.

Of course, on both sides of the debate reasonable people acknowledge that some mix of conservation and production is necessary. But all insist that their policy recommendations will result in the right mix, or that the other side's recommendation will result in the wrong mix.

Which side is right? What is the best combination of production and conservation? The answer is, no one knows. No one! No individual or group of experts in Washington, D.C., or anywhere else, has a clue about how much energy we should conserve or produce.

But We Can Find Out

But the information necessary for determining the best balance between conservation and production does exist, partly in the form expert knowledge on the technical details of recovering energy resources, converting those resources into usable energy, and transporting it to users. This information is possessed by tens of thousands of people scattered all over the world, few of whom have direct contact with each other. Yet somehow, if energy decisions are to be sensible, it all has to be collected, given proper weight, and communicated to those who can make the best use of it.

Equally important information has nothing to do with expert knowledge and is even more widely scattered: the information that millions of people have about their circumstances and preferences, and the tradeoffs they are willing to make. Some can easily take the bus to work, while others live in areas or have jobs that make taking the bus extremely difficult. Some wouldn't mind shifting to smaller cars, while others with growing families and special needs would. Some would suffer little discomfort from a wider range of inside temperatures, while those with certain health concerns would suffer more than discomfort. Some people are simply afraid of the dark and are willing to sacrifice other things to keep the lights on at night. This information is not only more fragmented and dispersed than the expert information, it is highly subjective and impossible to articulate precisely, if at all. This information may seem rather mundane, but it is just as essential to sound energy choices as is the scientific knowledge possessed by experts.

Fortunately there is no need to collect all this information in one place so it can be run through a computer to determine the right amount of conservation and production—even if all the information were collected, no computer could process it all—and even if it could, by the time the processing was done, the information would have changed.

The only way that the information needed to make sensible energy decisions can be communicated by those who have it to those in the best position to respond appropriately to it, and communicated in a way that motivates appropriate responses, is through market prices—assuming these prices are not distorted by politically imposed caps.

Market prices allow consumers to inform producers, and one another, how much they value different energy uses, and allow producers to inform consumers how much it costs to provide different types of energy. In response consumers will decrease their energy use in ways that minimize their inconvenience when that inconvenience is less than the value of the energy saved. And producers will expand production of energy sources that provide the most value to consumers for the cost required, and will expand those sources as long as consumers value the additional energy by more than the value sacrificed to produce it. The result is a combination of conservation and production that best harmonizes the interests of us all.

Price communication doesn't work perfectly, and even without price caps it can be argued that markets don't guarantee exactly the right amount of energy conservation and production. But energy decisions made in response to the information provided by market prices are far better than those that will be made by politicians and bureaucrats in the informational vacuum they create by imposing price caps.

Thank You, Internal-Combustion Engine

October 1, 2007

*Thank You, Internal-Combustion Engine,
for Cleaning up the Environment*

The internal-combustion engine is widely believed to have been an environmental disaster. It has been accused of harming our health by reducing air quality and contributing to what is currently claimed to be the most threatening of all environmental problems, global warming. But long before carbon dioxide was declared a major pollutant, a car was smashed with sledgehammers by students in Seattle during the first Earth Day on April 22, 1970. Al Gore called for eliminating the internal-combustion engine within 25 years in his 1992 book *Earth in the Balance* (only ten years left). Others, not worried about offending voters in Detroit, are less restrained in the criticism. Someone named Royce Carlson states in an Internet posting that because of “one hundred years of gasoline and diesel internal combustion engines...our air is polluted, ...and we are destroying the environment.” A 2006 article in the *Vancouver Sun* reported that “more than half of British Columbia drivers believe that cars are destroying the environment.

In fact, everyone concerned with a clean and healthy environment—and that includes far more people than those vocally claiming to be environmentalists—should be enthusiastic fans of the internal-combustion engine because of the important contributions it has made to environmental quality. The environmental benefits we realize from the engine have long been clear to anyone who bothered to notice. And these benefits have become more obvious because of an article in *The Independent*, a respected British newspaper (<http://tinyurl.com/ys5srd>). The article was based on a study by the United Nations Food and Agriculture Organization (“Livestock’s Long Shadow—Environmental Issues and Options”), which found, quoting the newspaper, that “livestock are responsible for 18 percent of the greenhouse gases that cause global warming, more than cars, planes and all other forms of transport put together.” The problem begins in the digestive systems of livestock and ends up as flatulence.

The internal-combustion engine began improving the environment, however,

long before global warming became a concern. Consider the fact that in 1900 a large percentage of the available horsepower really was horse power, or mule power, or ox power. As the power of the internal-combustion engine began to be substituted for animal power in the early 1900s, we began to substitute the emissions coming out of the tailpipes of cars and trucks for those coming out of the tailpipes of animals. The result was that the environment started becoming far cleaner and healthier.

Consider horse manure's effect on the environment and health of New Yorkers in 1900. Robert Fogel, a Nobel Prize-winning economic historian, writes:

We complain a lot about air pollution today, but there were 200,000 horses in New York City, at the beginning of the 20th century defecating everywhere. And when you walked around in New York City, you were breathing pulverized horse manure—a much worse pollutant, than the exhausts of automobiles. Indeed in the United States, the automobile was considered the solution to the horse problem because pulverized horse manure carried a lot of deadly pathogens.

No serious person denies that photochemical smog from gas-powered vehicles is a health risk. It would be silly to do so. It would be even sillier, however, to deny Fogel's observation that the air and water pollution from horse manure was a far greater health risk than the pollution from cars and trucks. Diseases such as cholera, typhoid, typhus, yellow fever, and diphtheria were responsible for the deaths of tens of thousands of Americans in the early twentieth century. As cars and trucks began replacing horses and other beasts of burden, these deaths began to decline dramatically. Medical improvements get some of the credit, but most of the credit during the early decades of the twentieth century goes to the reduced filth in the environment from animal waste.

The environmental benefits from the internal-combustion engine have not been confined to towns and cities. Before the power of internal combustion was harnessed, beasts of burden were adding greatly to the pollution generated by meat-producing animals, such as cows, pigs, and chickens in agricultural communities. By eliminating the need for horses, mules, and oxen on farms, tractors, trucks and other types of gas-powered farm machinery limited the problem of animal waste from agriculture almost entirely to feed lots that environmentalists, with justification, still complain about. It would be nice to hear them acknowledge that they would have even more to complain about without the internal-combustion engine.

Another environmental benefit that internal combustion seldom receives credit for is that it eliminated the need to grow food for millions of farm animals. It has been estimated that in 1910 about 25 percent of U.S. acreage devoted to growing crops was being used to grow food for the farm animals that were soon replaced by motorized farm equipment. Much of that land is now forestland, with the number of trees absorbing the greenhouse gas carbon dioxide much greater than it would have been without the internal combustion engine.

Based on the animal waste and the diseases that have been eliminated by

the internal-combustion engine, plus the additional forestland it has made possible, environmentalists should be celebrating motorized vehicles on Earth Day instead of destroying them with sledgehammers. And the reason for celebrating internal combustion is even stronger now that we have evidence that by eliminating all those barnyard animals, the engine has also eliminated vast amounts of methane from animal flatulence—a gas with far more greenhouse potency than the carbon dioxide produced by gasoline engines.

No Credit Given

Yet with respect to the UN report, the mainline environmentalists are not giving the internal-combustion engine any credit for reducing greenhouse gases. Instead, they are pointing their fingers at meat eaters, with some recommending vegetarianism as the best way to combat global warming. From a report written for EarthSave International, we read, “Arguably the best way to reduce global warming in our lifetimes is to reduce or eliminate our consumption of animal products” (quoted in the February 20, 2007, *Christian Science Monitor*, <http://tinyurl.com/3997wc>). What is not mentioned is that if the vegetarian solution were taken seriously, it would increase the environmental benefits provided by the internal-combustion engine. Imagine the extra animal manure and methane that would be discharged if we had to grow all those additional vegetables without motorized farm equipment.

The internal-combustion engine is certainly not pollution free—as is always the case, there is no such thing as a free lunch. Before criticizing anything for being costly, however, one should always ask the question—compared to what? When this question is taken seriously, the environmental record of the internal-combustion engine is impressive by virtue of its being far less polluting than the animals it replaced. Furthermore, gasoline-powered engines are less polluting today than they were a few years ago, and they will be less polluting in a few years than they are today. And the less intrusive government is with yet more commands and controls in response to every problem, real or imagined, the sooner an even-less-polluting power technology will replace internal combustion. Until then, let’s give the internal-combustion engine the respect it deserves for its contribution to a cleaner and healthier environment.

WE INVITE YOU TO ADVANCE LIBERTY WITH US.



The Foundation for Economic Education is the premier source for understanding the humane values of a free society, and the economic, legal, and ethical principles that make it possible. At FEE, students and their mentors explore freedom's limitless possibilities through seminars, classroom resources, social media, daily content, and free online courses, all available at FEE.org.

FEE.ORG |

FEE