



# Cato Handbook for Policymakers

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# 1. Introduction

It's been a long time since a U.S. election generated feelings of actual joy beyond the ranks of partisan activists. If Barack Obama hasn't yet ushered in a new "era of good feelings," all Americans can take pride in the demise of yet another glass ceiling in a nation born in the idea that all of us are created equal, entitled to the inalienable rights of life, liberty, and the pursuit of happiness.

Indeed, we can take some satisfaction in observing that something normal happened: A party that had given Americans a long war and an economic crisis, led by a strikingly unpopular president, was defeated. Republican government requires that failed parties be turned out of office. The American Founders believed firmly in the principle of rotation in office. They thought that even successful officeholders should go back home to live under the laws after a short period in office. No doubt more members of the 110th Congress would have been given that privilege were it not for the vast incumbent protection complex of laws and regulations and subsidies.

George W. Bush and the Republicans promised choice, freedom, reform, and a restrained federal government. As far back as the Contract with America in 1994, congressional Republicans pledged "the end of government that is too big, too intrusive, and too easy with the public's money." But over the past eight years they delivered massive overspending, the biggest expansion of entitlements in 40 years, centralization of education, a war that has lasted longer than World War II, an imperial presidency, civil liberties abuses, the intrusion of the federal government into social issues and personal freedoms, and finally a \$700 billion bailout of Wall Street that just kept on growing in the last month of the campaign. Voters who believe in limited government had every reason to reject that record.

At the Cato Institute we stand firmly on the principles of the Declaration of Independence and the Constitution, on the bedrock American values of individual liberty, limited government, free markets, and peace. And throughout our 32 years we have been willing to criticize officials of both

parties when they sought to take the country in another direction. We published papers critical of President Clinton's abuse of executive authority, his administration's misguided antitrust policies, his nation-building experiments, and his unwillingness to take on corporate welfare. Our analysts were among the first to point out the Bush administration's profligate spending, as well as the administration's policies on executive power, habeas corpus, privacy, expansion of entitlements, the federal marriage amendment, and the misbegotten war in Iraq.

But we have also been pleased to work with administrations of both parties when they seek to expand freedom or limit government—with the Clinton administration on free trade, welfare reform, and a few tentative steps toward Social Security reform; with the Bush administration on tax cuts, the initial response to the 9/11 attacks, health savings accounts, immigration reform, and Social Security accounts. We look forward to opportunities to work with the Obama administration when it moves to reverse the worst mistakes of the Bush years or otherwise to advance policies that would enhance peace, freedom, and prosperity.

## **The Current Crisis**

In the current economic crisis, our first task is to understand it and its causes. This was a crisis caused by regulation, subsidization, and intervention, and it won't be cured by more of the same. Christopher Hitchens had a point when he wrote, "There are many causes of the subprime and derivative horror show that has destroyed our trust in the idea of credit, but one way of defining it would be to say that everybody was promised everything, and almost everybody fell for the populist bait."

The backdrop is central banking and implicit federal guarantees for risky behavior. The Federal Reserve Board creates money and adjusts interest rates, so any notion that our financial system was an example of *laissez-faire* fails at the start. Meanwhile, Congress and regulators encouraged Fannie Mae and Freddie Mac to become a vast duopoly in the mortgage finance industry. Their debt was implicitly backed by the U.S. Treasury, and they were able to expand their debt and engage in risky transactions. As Lawrence Summers wrote, "Little wonder with gains privatized and losses socialized that the enterprises have gambled their way into financial catastrophe."

There was substantial agreement in Washington that homeownership was a good thing and that more homeownership would be even better. Thus Congress and regulators encouraged Fannie, Freddie, and mortgage

lenders to extend credit to underqualified borrowers. To generate more mortgage lending to low- and moderate-income people, the federal government loosened down-payment standards, pressured lenders to increase their percentages of “affordable” loans, and implicitly guaranteed Fannie and Freddie’s dramatic expansion. All that hard work paid off: The share of mortgages classified as nonprime soared, and the quality of those loans declined.

Federal Reserve credit expansion helped to make all of this lending possible. As Lawrence H. White writes in a Cato study,

In the recession of 2001, the Federal Reserve System, under Chairman Alan Greenspan, began aggressively expanding the U.S. money supply. Year-over-year growth in the M2 monetary aggregate rose briefly above 10 percent, and remained above 8 percent entering the second half of 2003. The expansion was accompanied by the Fed repeatedly lowering its target for the federal funds (interbank short-term) interest rate. The federal funds rate began 2001 at 6.25 percent and ended the year at 1.75 percent. It was reduced further in 2002 and 2003 and by mid-2003 it reached a record low of 1 percent, where it stayed for a year. The *real* Fed funds rate was negative—meaning that nominal rates were lower than the contemporary rate of inflation—for two and a half years. In purchasing-power terms, during that period a borrower was not paying but rather gaining in proportion to what he borrowed. Economist Steve Hanke has summarized the result: “This set off the mother of all liquidity cycles and yet another massive demand bubble.”

“Everybody was promised everything”—cheap money, easy lending, and rising home prices. All that money and all those buyers pushed housing prices up sharply. But all good things—at least all good things based on unsustainable policies—must come to an end. When housing prices started to fall, many borrowers ran into trouble. Financial companies threatened to fall like dominos, and an ever-expanding series of bailouts began issuing from the Federal Reserve and the Treasury department. And instead of the usual response to businesses that make bad decisions—let them go into bankruptcy or reorganization and let their workers and assets go to more effective companies—the federal government stepped in to keep every existing enterprise operating.

At this point it is important that the recent emergency measures be recognized as just that: emergency—if not panic—measures and not long-term policy. Congress should turn its attention to extricating the government from financial firms and basing long-term policies on a clear diagnosis

of what went wrong. As William Niskanen writes in Chapter 36, Congress should repeal the Community Reinvestment Act and stop pressuring lenders to make loans to underqualified borrowers. The Treasury should use its authority as conservator to liquidate Fannie Mae and Freddie Mac. The federal government should refrain from using its equity investments in companies to exercise power over their operations and should move with all deliberate speed to withdraw from corporate ownership.

One lesson of the credit crisis is that politicians prefer to “promise everybody everything”—low interest rates, affordable mortgages, higher housing prices, lower gas prices, a chicken in every pot. That’s why it’s important to keep politics out of such matters.

## **The End of Libertarianism—or a New Beginning?**

Various pundits and public figures have claimed that the credit crisis means “the end of libertarianism” or even more dramatically “the end of American capitalism.” As noted above, the crisis can hardly be considered a failure of laissez-faire, deregulation, libertarianism, or capitalism, since it was caused by multiple misguided government interventions into the workings of the financial system. It was and is precisely a failure of interventionism.

But could capitalism or libertarianism come to an end despite the facts? After all, the Great Depression was primarily caused by poor Federal Reserve policy and high tariffs. But a false impression that it was somehow caused by laissez-faire led to New Deal policies (pursued first by Herbert Hoover and then by Franklin D. Roosevelt) that turned a contraction into the Great Depression. What policies? Restrictive banking regulations, increases in top marginal tax rates, interventions to keep wages and prices from adjusting, and government rhetoric and activism that created (in the words of historian Robert Higgs) “pervasive uncertainty among investors about the security of their property rights in their capital and its prospective returns.” That set of policies lengthened the Great Depression by eight years or more and is uncomfortably similar to recent and proposed policy responses to the 2008 credit crisis.

Jacob Weisberg of *Slate* declares “the end of libertarianism” in the wake of the financial crisis. But it was in fact “progressive” interventionism that caused the crisis—just the economic philosophy that Weisberg supports. So if one big failure can kill an ideology, then let’s hear it for “the end of interventionism.”

If this crisis leads us to question “American-style capitalism”—the kind in which a central monetary authority manipulates money and credit, the central government taxes and redistributes \$3 trillion a year, huge government-sponsored enterprises create a taxpayer-backed duopoly in the mortgage business, tax laws encourage excessive use of debt financing, and government pressures banks to make bad loans—well, it might be a good thing to reconsider *that* “American-style capitalism.” Or indeed, as a *Washington Post* editorial put it in October, “Government-sponsored, upside-only capitalism is the kind that’s in crisis today, and we say: Good riddance.”

Libertarianism calls for freedom and responsibility, free markets and civil liberties, a minimal government that stays out of both boardrooms and bedrooms. Obviously libertarianism wasn’t in the driver’s seat in either the Clinton or the Bush administration.

Even if there are misperceptions about the causes of the crisis, both the system of capitalism and the idea of libertarianism are going to have more staying power than pundits like Weisberg would like. There was a time when half the world rejected capitalism, and leading intellectuals in the “free world” worried that the centrally planned economies would obviously outcompete the capitalist countries and that “convergence” on some sort of half-capitalist, half-socialist model was the wave of the future. But after the world got a look at the results of the two systems in East and West Germany, North and South Korea, Hong Kong and Taiwan and China, the United States and the Soviet Union, it became clear that socialism is a clumsy, backward-looking prescription for stagnation at best and tyranny at worst.

Meanwhile, the half-planned economies of the West—Great Britain, New Zealand, the United States, and more—developed a milder version of economic sclerosis. Starting in the 1970s many of those countries began eliminating price controls, removing restrictions on market competition, opening up the economy, cutting tax rates, and reducing trade barriers. It came to be widely recognized—eventually on both sides of the Iron Curtain—that private property and markets are indispensable in organizing a modern economy. A nearly simultaneous cultural revolution opened up society. Women, racial minorities, and gays and lesbians entered the mainstream of society throughout the Western world. Art, literature, and lifestyles became more diverse and more individualized. The Sixties and the Eighties both led us to what Brink Lindsey in *The Age of Abundance* called “the implicit libertarian synthesis” of the United States today.

Some people see a future of ever more powerful government. Others see a future of greater freedom. *Reason* editors Nick Gillespie and Matt Welch write, “We are in fact living at the cusp of what should be called the Libertarian Moment, the dawning of . . . a time of increasingly hyper-individualized, hyper-expanded choice over every aspect of our lives. . . . This is now a world where it’s more possible than ever to live your life on your own terms; it’s an early rough draft version of the libertarian philosopher Robert Nozick’s ‘utopia of utopias.’ . . . This new century of the individual, which makes the Me Decade look positively communitarian in comparison, will have far-reaching implications wherever individuals swarm together in commerce, culture, or politics.”

Is it possible that Congress will choose to pursue policies—tax increases, yet higher spending, continued subsidies for risky decisions, intrusion into corporate decision making—that would slow down U.S. economic growth, perhaps make us more like France, with its supposedly kinder, gentler capitalism and its GDP per capita of about 75 percent of ours? Yes, it’s possible, and clearly there are proposals for such policies. But if we want economic growth—which means better health care, scientific advance, better pharmaceuticals, more leisure opportunities, a cleaner environment, better technology; in short, more wellbeing for more people—there is no alternative to market capitalism. And if we want more growth, for more people, with wider scope for personal choice and decisionmaking, libertarian policy prescriptions are the roadmap.

## **Liberty Is More than Economics**

The economic crisis grabbed the headlines last fall, and advocates of liberty and limited government can find much to criticize in the economic agenda advanced by President Obama and other Democrats on the campaign trail. But there is more to liberty than economic policy. In some of President Obama’s other positions we find much to admire and many opportunities for cooperation.

President Obama first found favor on the campaign trail for his early and firm opposition to the war in Iraq. He spoke out against the war in 2002, as did Cato Institute analysts. We encourage him to move promptly to extricate American troops from Iraq and begin a process of military disengagement from the Middle East. In Chapter 49, Ted Galen Carpenter recommends that as we withdraw our troops we convene a regional conference to encourage a stable peace. We may hope that the experience with the Iraq war has led to a greater skepticism about military force, and

Chapters 46 on strategy and 50 on Iran offer further thoughts in that direction.

We see the potential for common ground in other areas as well:

- **Executive power.** During his campaign President Obama promised to reverse the sweeping claims of executive authority made by the Bush-Cheney administration. He said, for instance, “The President does not have power under the Constitution to unilaterally authorize a military attack in a situation that does not involve stopping an actual or imminent threat to the nation. . . . I will not assert a constitutional authority to deploy troops in a manner contrary to an express limit imposed by Congress and adopted into law. . . . I will not use signing statements to nullify or undermine congressional instructions as enacted into law. . . . I reject the Bush Administration’s claim that the President has plenary authority under the Constitution to detain U.S. citizens without charges as unlawful enemy combatants. . . . The President is not above the law, and the Commander-in-Chief power does not entitle him to use techniques that Congress has specifically banned as torture.” Campaigning in the Mountain West, he declared that libertarians and even conservatives would support him on the basis of concerns about such policies as warrantless wiretaps. We welcome his commitment on these issues. In Chapter 10, Gene Healy discusses the excesses of presidential war powers.
- **Immigration.** Immigrants are a source of economic and social vitality for the United States, as they have been throughout our history. But it will take real political skills to find a path forward to secure borders, legalization of people already living and working here, and a workable system for continued labor flows amid the political furor over illegal immigration. However, with the economy slowing and media attention focused elsewhere, the vocal hostility to immigration seems to have ebbed. This might be an opportunity for thoughtful debate in Congress on finding a sensible policy, and Dan Griswold offers some useful advice in Chapter 60.
- **Guantanamo.** In Chapter 27, Timothy Lynch calls on Congress to restore habeas corpus, close the Guantanamo prison, and repeal the Military Commissions Act. Congress and the new administration should repudiate the claim that America is a battlefield. Congress should abolish “national security letters” and require federal agents to conduct their searches within the American constitutional framework.

The Founders knew that habeas corpus, the “Great Writ,” is one of the primary safeguards of individual liberty.

- Drug policy reform. It is long past time that we recognized the failure of drug prohibition. Voters are ahead of elected officials on this issue. In more than a dozen states, most recently in Michigan and Massachusetts, the people have voted to allow the use of marijuana for medical purposes or even to decriminalize marijuana. Those initiatives have usually won by a larger percentage than the winning presidential candidate in the state. Congress and the administration should stop federal interference with state marijuana law initiatives, stop treating pain doctors as drug dealers, and reform or better yet repeal mandatory minimum sentences. Beyond that, Sen. Barack Obama was not the only member of the 110th Congress who had acknowledged youthful drug use. Presumably neither he nor his colleagues thought that their lives or their communities would have been improved had they been incarcerated. Could we not now have a thoughtful debate on whether prohibition is working? Perhaps both liberals and conservatives could begin by agreeing that in a federalist system drug law should be a matter for the states and the federal Controlled Substances Act should be repealed, as recommended in Chapter 33.

Private property, free markets, and fiscal restraint are important foundations for liberty, and the party that claims to uphold those values has done a poor job of it lately. But there are restrictions on liberty beyond the realm of taxes and regulations. We hope that elected officials of both parties will recognize the dangers of censorship, drug prohibition, entanglement of church and state, warrantless wiretapping, indefinite detention, government interference with lifestyle and end-of-life choices, and other such policies. Americans declared in 1776 that life, liberty, and the pursuit of happiness are inalienable rights, and in 1787 they wrote a Constitution that empowers a limited government to protect those rights.

## Conclusion

As this *Handbook* demonstrates, there are many more issues that demand the attention of Congress than we’ve been able to touch on here. Fiscal reform, for instance. Federal spending increased by more than a trillion dollars during the Bush years, or more than 70 percent (even before the budget-busting bailout and stimulus packages). The national debt rose even more sharply, from \$5.727 trillion to more than \$10.6 trillion, or an

increase of more than 85 percent. The 2009 budget deficit may approach \$1 trillion. Trends like this are unsustainable, yet elected officials continue to promise more spending on everything from new weaponry to college tuitions. Congress and the administration must find a way to rein in this profligacy. There are budget-cutting ideas throughout this *Handbook*, most notably in Chapter 4.

The current rates of spending don't yet reflect the acceleration of entitlement spending as the baby boomers start retiring. Entitlements are already about 40 percent of the federal budget. In 20 years they may double as a share of national income. The unfunded liability of Social Security and Medicare is now over \$100 trillion, an unfathomably large number. Within barely a decade, the two programs will require more than 25 percent of income tax revenues, in addition to the payroll taxes that currently fund them. Congress needs to think seriously about this problem. Are members prepared to impose the tax burden necessary to fund such levels of transfer payments? Do we want that many Americans dependent on a check from the federal government? Eventually, the projected level of entitlements will not be feasible. It would be best to start now to make changes rationally rather than in a panic a few years from now. Chapters 12 through 17 discuss health care and Social Security reform.

Fidelity to our founding principles of respect for civil liberties and limited government may be easy when times are easy. The true test of our faith in those principles comes when we are beset by diabolical assaults from without and economic turmoil within, when public anxiety may temporarily make it seem expedient to put those principles aside. The importance of paying scrupulous deference to the Constitution's limits on federal power, of respecting its careful system of checks and balances, is greatest precisely when the temptation to flout them is strongest.

For those who go into government to improve the lives of their fellow citizens, the hardest lesson to accept may be that Congress should often do nothing about a problem—such as education, crime, or the cost of prescription drugs. Critics will object, “Do you want the government to just stand there and do nothing while this problem continues?” Sometimes that is exactly what Congress should do. Remember the ancient wisdom imparted to physicians: First, do no harm. And have confidence that free people, left to their own devices, will address issues of concern to them more effectively outside a political environment.

### **Suggested Readings**

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