CHINA’S REFORM AND OPENING-UP

A planned economy produces a society entirely based on an official hierarchy. Reform and opening-up gave legitimacy to the private possession of wealth, and material capital began to gain social power.

The shift of power from the bureaucracy to capital is a form of progress. There is no such thing as a perfect system for a society. In a “capital centered” society, you can enjoy anything you can afford, while in an “official centered” society you have to hold a bureaucratic position to access anything at all. I agree with Friedrich August Hayek, who argued that a society in which wealth is the way to social status is better than a society in which social status is the way to wealth. Wealth should not be created either in the process of attaining power, or once one has obtained power. But this is what happens in China.

—Weiying Zhang

Interview with News China (October 2014).
# Cato Journal

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History and casual observations suggest that ideas and leadership are the two most important forces in all institutional changes. However, they have been absent or downplayed in conventional economic analysis of institutional changes. Conventional economics has exclusively focused on the notion of “interest” in explaining almost everything, from consumers' choices to public choices to institutional changes. In particular, institutional changes have been modeled as a game of interests between different groups (such as the ruling and the ruled), with the assumption that there is a well-defined mapping from interests into outcomes.¹

In this article, I argue that this perspective of institutional change is fundamentally problematic because any institutional change cannot be well understood without taking into account two crucial factors: (1) ideas about the direction of the institutional change and (2) leadership under which the institutional change takes place. I will analyze China’s economic and political transition to a liberal society.
by taking these two factors into account, explaining what happened in the past 35 years of the reform and predicting what will happen in the future.

I will analyze how ideas and leadership influence institutional change by adopting a simple two-dimensional framework. Ideas can be right or wrong. Leadership can be strong or weak. Thus, there are four combinations: right ideas with a strong leadership, right ideas with a weak leadership, wrong ideas with a strong leadership, and wrong ideas with a weak leadership. To facilitate the institutional changes into the right direction, the best combination is right ideas with a strong leadership; while the worst one is wrong ideas with a strong leadership. For example, Mao Zedong was a strong leader, but had wrong ideas about China’s economic and social development, which led to a great disaster for the Chinese people during the period from 1949 to 1976. On the other hand, the success of China’s economic liberalization since 1978 could very much be attributed to the right ideas and strong leadership of Deng Xiaoping and his successor Jiang Zemin. Deng and Jiang both had a somewhat strong belief in the market mechanism and entrepreneurship. They both were strong leaders to put forward their reform programs. However, Hu Jintao’s regime from 2003 to 2012 was characterized with the combination of wrong ideas and a weak leadership. During this time, China’s reform stagnated while many serious social problems emerged.

One plausible explanation for former president Hu’s weak leadership is the path he went through in becoming president. He was the product of the Chinese political bureaucratic system, which is incapable of producing strong leadership required to embark on bold political changes. On the other hand, the new leaders of China, particularly President Xi Jinping, are not the direct products of the existing political bureaucratic system, due to their elite family backgrounds. As a result, they might be less constrained by such a system but are more entrepreneurial, having a clearer sense of mission, courage, and ability to lead. I thus believe that the next decade under President Xi’s leadership presents a unique window of opportunity for China to make important institutional changes. China must not miss that opportunity.

The future of China’s transition to a liberal society is dependent on the new leaders’ ideas and leadership. Currently, China is trapped into six wrong ideas: (1) China’s economic success in the past three decades comes from the “China model”; (2) economic success can
continue without political reform; (3) current institutions benefit vested interests and any reform would harm those interests; (4) state-owned enterprises (SOEs) are the economic cornerstone of the Chinese Communist Party; (5) “political power comes from the barrel of a gun”; and (6) the more power government holds, the stronger it will become. I will elaborate on how wrong these six ideas are and why the new leaders must get rid of them in order to sustain China’s economic success.

This article is organized as follows. In the next section, I will articulate why ideas and leadership are important in understanding institutional changes. Then, I will present a two-dimensional framework to discuss the effects of the four combinations of ideas and leadership on institutional changes. Following that, I will discuss how the ideas and leadership combinations manifested themselves in the first 25 years of the economic reform under Deng and Jiang’s regimes (from 1978 to 2002), and under Hu’s regime (from 2003 to 2012). I will then discuss the idea traps and the leadership challenges China faces today. Lastly, I will conclude by proposing how important it is to create an ideas market in advancing China’s economic progress and in transitioning China into a liberal society.

The Importance of Ideas and Leadership

More than a century ago, the British economist Francis Edgeworth (1881) claimed that “the first principle of economics is that every agent is motivated only by self-interest.” Edgeworth’s claim succinctly summarized the fundamental assumption underlying the conventional economics that is still dominant today—that is, as rational agents, individuals know their interests and attempt to maximize them. Thus, every observed behavior can be explained or justified by self-interest maximization. Based on that assumption, ideas play no role in explaining individual behavior. While economics mainly focuses on explaining equilibriums and their stability, economists do apply this assumption to explain or predict institutional changes. In so doing, they model the institutional change as a game of players with different interests, such as the ruler vs. the ruled, the politician vs. the public, the employer vs. the employee, the landlord vs. the peasant, the capitalist vs. the worker, and so on. Under such modeling, the interests of every group are well-defined and every interest group makes choices to maximize its interests.
Consequently, institutional change is nothing more than moving from the old equilibrium to a new equilibrium. Ideas and leadership are completely ignored in this model.\(^2\)

While the interest-based model of institutional change is simple and has some explanatory power regarding the stability of the institution, it hardly explains why institutions actually change. My observations suggest that many of the institutional changes that happened in human history were not because one (or new) interest surmounted another (the vested interests), but rather it was because the new ideas surmounted the old ideas—or because ideas trumped interests. For example, the success of the Chinese socialist revolution led by the Chinese Communist Party was not because the interests of the workers/peasants surmounted the interests of the capitalists/landlords, but because the Marxist-Leninist ideology won over other ideologies. Moreover, whereas revolutions and reforms are often against the groups with vested interests, the important driving force for these changes often comes from the elite groups with vested interests. For instance, the founding members of the CCP were almost exclusively from the then elite families, including landlords, rich middle-class members, warlords, and intellectuals. Why did these elites stand up for revolution? The answer is that they came to accept a new ideology—Marxism-Leninism. Similarly, the important driving force of the French Revolution in the late 18th century was the aristocracies of the old regime (see Greenfeld 1992: chap. 2). The Enlightenment was nobiliary, and many of the Enlightenment intellectuals came from the aristocracy. Interestingly, the revolution for overthrowing aristocracy was in fact partly the result of the aristocracies’ effort. Likewise, the reason why George Washington and his fellow members instituted the America’s constitutional republic, or why Deng Xiaoping launched China’s market-oriented reform, cannot be explained by their self-interest maximization, but because they adopted new ideas.

Meanwhile, history has also demonstrated the crucial role leadership plays in institutional changes. Almost all institutional changes are initiated by a small group of people, sometimes even by a single political figure. These people are missionary, visionary, passionate,

\(^2\)The exception is that when there are multi-equilibria, ideas may help to coordinate a particular equilibrium as a focal point.
risk-taking, and decisive. They have the ability and charisma to gather followers and to direct them. It is evident that without George Washington’s leadership, the American political institution might have been very different; without Mao Zedong’s leadership, China’s revolution might have failed; and without Deng Xiaoping’s leadership, China might have taken a very different road after Mao’s death in 1976.

So why do ideas matter? It is because people are rational beings. As rational beings, we think, reason, and analyze before taking actions, and we act with a clear purpose. Every volitional action needs to be justified, and these justifications must be based on values and ideas. Human beings are different from other animals because we use values and ideas to guide our behaviors. As we all know, rationality is also the core assumption of economics. However, the rationality in conventional economics is often too narrowly defined as “instrumental rationality.” In other words, rationality plays no role in choosing the ends. However, as Kant argued convincingly, the primary meaning of rationality is the selection of ends. Rationality should be the master, not slave, of passion. As people are social animals, we have various appetites, desires, and inclinations. As rational beings, however, we cannot just satisfy these appetites, desires, and inclinations regardless of the potential negative consequences. We must choose the ends (e.g., what desires to pursue) according to social norms and ethical principles. These norms and principles are constructed by ideologies. That is why philosophical and religious ideas are so powerful.

Rational people do pursue their interests. Nevertheless, the interests that govern their actions are the perceived interests. That is, people understand and perceive their interests through ideas. What is good and what is bad for them largely depend on what ideas and beliefs they hold (see Lukes 1974, 2005; Geuss 1981; and Hay 2011). As David Hume (1742] 1987: Part I, Essay VII) pointed out more than 200 years ago, “though men be much governed by interest; yet even interest itself, and all human affairs, are entirely governed by opinion.” For instance, about 60 years ago, when Chinese workers and peasants were told by the CCP that their interests conflict with those of capitalists and landlords, they stood up to join the socialist revolution by seizing the latter’s properties. However, it proved afterward that their true interests were not fulfilled by, but in fact suffered from, this seizure of private property.
In other words, the concept of interests in conventional economics is flawed. Particularly, when economists assume that people maximize their utilities, these utilities are often understood as satisfaction of tangible or material interests. In fact, people’s interests are much more than tangible and material interests. There are many non-material interests people care about. As social animals, people increase their happiness through relationships with others and are concerned with how others view them. One person’s state of mind can affect another person’s happiness or utility. We aspire to be respected by others, to have a good reputation, and to establish social esteem. For this reason, we must act justly and meet others’ expectations. Our ideas of justice and fairness naturally affect our choice of actions. Therefore, intangible or nonmaterial interests are more likely to be influenced by ideas than are tangible or material interests. This is also a powerful reason why people are willing to initiate institutional changes even at the expense of their material interests. In this case, individuals make changes not to gain material benefits but to earn a good reputation, to get others’ respect, and to leave a legacy.

Even if preferences are given, people’s best choices depend on their understanding of how the world works and of what strategies are available to them, both of which depend on the ideas they accept and hold.\(^3\) No doubt, Mao Zedong and Deng Xiaoping each wanted to be a great man in history. Because they had different ideas of economic development, however, they chose different roads for China. Ronald Reagan and Margaret Thatcher promoted economic liberalization in the United States and Britain because they accepted the idea that the world works better under the free market than government intervention—ideas developed by Friedrich Hayek and Milton Friedman. Those who believe in Keynesianism would certainly act differently.

Leadership is important in the process of institutional change because there is a great deal of uncertainty concerning the consequences of reform.\(^4\) In an uncertain world, institutional changes can be viewed as venture investments. It is almost impossible to calculate the costs and benefits of a particular change in terms of probability.

\(^3\)See Dani Rodrik (2013) for more analysis of how ideas of the world and strategies affect the actions to be chosen.

\(^4\)It should be pointed out that the basic reason why the role of ideas cannot be reduced to interests is because of uncertainty (see Blyth 2011).
The Power of Ideas

Only a very small group of visionaries have the ability to see the opportunities for change, to grasp the opportunity, and to have the willpower and courage to alter existing institutions. These visionaries can be called “institutional entrepreneurs” or “political entrepreneurs” as they are the ones who either initiate ideas or first adopt new ideas and find ways to implement them through institutional changes such as developing reform policies. The success or failure of any institutional change, to a large extent, will depend on their decisiveness, persistence, and political skills. These visionaries differ from average people in that they care less about material interests than about respect, reputation, social esteem, and legacy. To serve the society and to do the right thing are the main motives for them to lead changes. Without their leadership, new ideas cannot be instituted, and no real changes can happen.

Given how important both ideas and leadership are in the process of institutional change, it is rather strange that they have been ignored by economists for so long. Denying the importance of ideas is equivalent to denying the value of economics itself. In my view, the purpose of economics (and other social sciences) is to develop new ideas or defend established ideas. If people’s actions are not affected by ideas, and if rational choices are totally independent of what economics says, as assumed by conventional economics, then economics would be totally useless, and doing economics is totally a waste of social resources. Similarly, ignoring leadership in the analysis of institutional change is like ignoring entrepreneurship in the analysis of the market. I therefore claim that conventional economics is fundamentally flawed in its basic assumptions. It is time for economists to rethink the current paradigm of equilibrium economics.

A Two-Dimensional Analytical Framework

The power of ideas and leadership is well demonstrated by the planned economic system that was once implemented in the countries that possess over one-third of the world population, including the former Soviet Union, Eastern European countries,

There have been exceptions—such as Keynes, Mises, and Hayek—and more recently some economists have begun to incorporate the role of ideas and institutional entrepreneurship in their analysis of institutional change (see Leighton and Lopez 2013, Rodrik 2013, Coase and Wang 2013). Political scientists started this new research agenda earlier than economists (see Beland and Cox 2011).
People's Republic of China, and other developing economies. It is not convincing to say that those who once promoted this system did so for their own self-interests. It is more likely that they did so “for the interests of all the people.” It was a winning of an idea. The idea came first from Marxism and was consolidated after the Great Depression in the 1930s. According to Marxist economics, the free-market economy is a chaotic and anarchic economy. The pursuit of profits by capitalists inevitably leads to successive economic crises and the waste of scarce resources. The solution to these problems is to have a central planning agent who has the authority to make an overall plan about what to produce and how to organize production, and then to implement the plan from the top-down. It was assumed that when resources are allocated according to the central plan for the “social good,” economic crises and all other shortcomings of the capitalist market economy would be mitigated. For this purpose, all of the production materials must be controlled by the central government.

The idea of a planned economy seemed to make good sense when the capitalist countries experienced the Great Depression in the 1930s while the Soviet Union's economy performed strongly during the same period. Not surprisingly, the planned economic system was even endorsed by some mainstream neoclassical economists such as Oskar Lange. Mises and Hayek, the two leading Austrian School economists who strongly opposed the socialist planning economy, were assumed to have lost the battle. Thus, many developing and newly independent countries after the Second World War implemented Soviet-style central planning. It should be noted that the political leaders who led the implementation of the planning system in their countries were all strong leaders with great visions for their countries. Without their strong leadership, the implementation of the socialist economic system would not have been possible.

While the ideal sounds beautiful, the result of the planned economy has proved a disaster. Today we see that all of the socialist planned economies suffered from inefficiency of resource allocation, stagnation of technologies, and low living standards, compared with their capitalist counterparts. The Hungarian economist János Kornai (1980) coined “the shortage economy” to describe the

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6For the history of the debate on socialist calculation, see De Soto (2010).
planned economy, meaning that everything was in short supply in the planned economy. Not only did all people lose their freedom and properties, millions of them lost their lives. For instance, in China, more than 30 million people died of starvation between 1960 and 1962 alone. It was the failure of the central economic planning that changed the ideas of the people in power, which in turn incentivized communist countries to make the transition to a market economy.

The story of the planned economies shows that ideas matter, whether they are right or wrong. John Maynard Keynes was absolutely right when he said, “The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. . . . Soon or late, it is ideas, not vested interests, which are dangerous for good or evil” (Keynes 1936: 400).

Now let me present an analytical framework. As this article analyzes the transitional scenarios of institutional changes, I shall focus on the ideas of political leaders because it is these figures who initiate and lead changes. The ideas of ordinary people are often influenced or even instilled by political leaders. Having ideas is part of leadership. When we say someone is a good leader, we also imply that he has ideas we agree with. However, for ease of analysis, I will separate ideas from leadership and treat them as two distinct dimensions. I therefore propose a two-dimensional framework.

In the dimension of ideas, we can classify ideas into “right” and “wrong” categories. Here, of course, right and wrong make sense ex ante only in the eyes of the observers. For the holder of any particular idea, that idea is certainly right ex ante; otherwise he would not hold it. However, the same idea can be wrong for both its holders and observers ex post. People change their ideas only when they recognize that previously held ideas are wrong. Furthermore, the rightness or wrongness of ideas is not absolute; it is a matter of degree. So I treat them as two ends of a continuum.

Leadership can be classified into “weak” and “strong” categories. By “strong leaders,” I mean politicians who are missionary, visionary,
and passionate, as well as decisive, courageous, persistent, venturesome, and able to skillfully orchestrate resources and motivate supporters. Those who are short of the above characteristics are “weak leaders.” Strong and weak leadership are also treated as two ends of a continuum.

Figure 1 displays the two-dimensional framework regarding ideas and leadership. The best combination is right ideas with strong leadership in the first quadrant. The political leaders located in this quadrant are the best for institutional change because they have the capability to lead the society to establish better institutions. The worst combination is in the fourth quadrant. Political leaders located in this quadrant have strong leadership to implement their reform agenda, but their ideas are wrong. This combination will hurt society in the end. The second quadrant is the second best combination. The political leaders located in this quadrant have the right ideas but lack the leadership skills to implement them. The third quadrant is the second worst combination. The political leaders located in this quadrant have the wrong ideas, but fortunately do not have the leadership skills to fully implement them.

FIGURE 1
THE TWO-DIMENSIONAL FRAMEWORK

Right Ideas

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<td>The best combination</td>
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Wrong Ideas

<table>
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<th>III</th>
<th>IV</th>
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<tbody>
<tr>
<td>The second-worst combination</td>
<td>The worst combination</td>
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The Power of Ideas

The institutional changes China has gone through since the Communist Party took power in 1949 can be well represented by the above framework. Mao Zedong ruled China from 1949 to 1976. His regime was located in the fourth quadrant. Mao was a very strong political leader; few people in Chinese history could be compared with him in leadership. He could accomplish almost everything he wanted to do, even the “Great Leap Forward,” which led to the death of millions of people. However, his ideas were completely wrong. He believed in the central planning system and political dictatorship. With his wrong ideas and strong leadership, he revolutionized the country politically, economically, socially, and culturally. As a result, the whole country suffered disastrously. By the time of his death in 1976, China was not only at the edge of economic bankruptcy, but also at the edge of political disorder.

Deng Xiaoping was located in the first quadrant. He ruled China de facto from 1978 until his death in 1997.8 He was also a strong political leader, but his ideas were very different from Mao’s. When Deng took power after the Cultural Revolution, he had little confidence in the central planning system, and came to believe in the market mechanism, grass root initiatives, entrepreneurship, and decentralization in economic development. He launched the market-oriented economic reform, and implemented most of his ideas before his death. His economic reform proved a success in terms of China’s economic growth and improvement of the living standard of ordinary people. Deng Xiaoping is often criticized for not initiating political reform. However, it is not clear whether he had wrong ideas about the political system or he had no time to implement what he had in mind but not yet articulated.

Deng’s successor Jiang Zemin (Party general secretary from 1989 to 2002) and Zhu Rongji (vice prime minister from 1992 to 1997, and prime minister from 1997 to 2003) are arguably located in the first quadrant. They both were strong leaders, though not as strong as Deng. They shared most of Deng’s economic ideas and continued his economic reforms. Under their leadership, China further liberalized its economic system, particularly the ownership structure. Privatization of state-owned enterprises and the expansion of

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8Deng was no longer politically active after 1993. However, his leadership authority remained until his death in 1997.
foreign-invested firms mainly took place during the Jiang-Zhu era. By 2002 when Jiang and Zhu stepped down from the leadership role of the Communist Party, the nonstate sector contributed more than 60 percent to China’s gross national product. China was also moving forward on the road to a rule-of-law country.

Jiang’s successor Hu Jintao (Party general secretary from 2002 to 2012) and Zhu’s successor Wen Jiabao (prime minister from 2003 to 2013) are arguably located in the third quadrant, although close to the origin of Figure 1. Hu and Wen were more conservative in their economic policies and political changes than their predecessors. They favored government intervention and the state sector over the free market and the private sector. As a result, economic reform during the Hu-Wen regime (2003 to 2012) was stagnant and even fell backward in some aspects. By 2012, the government became more powerful, and the state sector became stronger and more aggressive than in 2002. The transition to the rule-of-law society was also reversed.

Figure 2 summarizes the above analysis and discussion about the four regimes.

Ideas and Leadership during 1978–2002

In the first 25 years of the economic reform (from 1978 to 2002), China’s leaders had the right ideas and strong leadership. Deng Xiaoping was no doubt a key person from 1978 to 1992. His reformist colleagues Hu Yaobang (general secretary of the CCP from 1980 to 1987), Zhao Ziyang (prime minister from 1980 to 1987, and general secretary from 1987 to 1989), and Wan Li (vice prime minister from 1980 to 1988, and chairman of the National People’s Congress from 1988 to 1993) supported his reform program and shared many of his ideas. From 1992 to 2002, General Secretary Jiang Zemin and Prime Minister Zhu Rongji followed Deng’s reform agenda. Their ideas and leadership trumped the conservatives and the vested interests, and led to the success of the economic reform of that period.

9Wen seems less conservative than Hu in political reform. He quite often argued for political reform. However, many people think he was doing a publicity stunt.
10Lardy (2014) disagrees with the judgment of the resurgence of the state sector during the Hu-Wen era. His arguments are misleading because he does not pay enough attention to changes in the political attitude toward private firms, enhanced restrictions on market access, discriminatory industrial policies, and local government conduct during the Hu-Wen Era.
Due to space limitations, I cannot present a full story of this period. Instead, I shall give a few examples to show how the reforms of this period relied on right ideas and strong leadership.

**The Rural Reform**

China implemented the people’s commune system in rural areas in 1958. Under this system, all land and production materials were collectively owned and all agricultural productions were conducted collectively. Because peasants did not own any land and output, they had little incentive to work. As a result, China suffered from food shortages for a long time under the commune system. The agricultural reform was a matter of survival for the Chinese people after the Cultural Revolution. However, when the reform started, the newly proposed “household responsibility system” (baocchan dao hui), which would allow agricultural production decisions to be contracted down to individual households, faced strong resistance even in some poor rural areas. The resistance mainly came from the vested interests of the then cadres of the commune and production brigades, and some top leaders with the old Marxist ideology. For example, Chen
Yonggui, the then vice premier in charge of agriculture, strongly opposed the reform. Chen was supported by the then Party chairman Hua Guofeng. Chen reached this top position through successive promotions only because his brigade (Dazhai Village) was established as a role model of the collective production. The reform was no doubt a denial of his political legitimacy.

Despite these fierce oppositions, the agricultural reform took place and spread quickly nationwide. The success of this reform could be attributed to the ideas and leadership of Zhao Ziyang and Wan Li, supported by Deng Xiaoping.11 Wan was then the Party secretary of Anhui Province. He recognized that the commune system was not working, and that the only way for peasants to have motivation to work hard was to privatize agricultural production. When some villagers in Anhui Province adopted the household responsibility system, he gave his full support. Conservatives at the central government organized various conferences and used official media to attack the household responsibility system, even accusing Wan of “going on the capitalist road” and “undermining socialism.” When Chen Yonggui criticized him in November 1978, he told him bluntly: “You say you are speaking from the Dazhai experience; I say Dazhai is an ultra-leftist model. . . . You go your way and I’ll go mine. . . . Don’t impose your views on me and I won’t impose mine on you. As for who is right and who is wrong, let’s see which way works best” (Vogel 2011: 438). The debate on agricultural reform diminished only when the reform proved a success in solving the food shortage problem. In 1983, the National People’s Congress passed the new constitution that officially dismantled the commune system. By 1984, China’s grain became oversupplied.

**Openness and Reform in Guangdong Province**

The openness policy was an important part of Deng Xiaoping’s reform program. It started in Guangdong and Fujian Provinces. During the age of the planned economy, these two provinces were designated as the “first front line” for possible war against the

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11 When Zhao was Party Secretary of Sichuan Province, the household responsibility system occurred with Zhao’s permission. Sichuan Province’s initial rural change did not draw public attention, however, since Zhao kept it secret. For an excellent description of the rural reform story, see Vogel (2011; chap. 15).
Nationalist Party–Controlled Taiwan. The government had little investment in them. By the end of the Cultural Revolution, these two provinces were among the most underdeveloped. However, they had great potential in economic development because of their geographical links to Hong Kong and also as homelands of hundreds and thousands of overseas Chinese who have a great deal of business experience. For this reason, Deng Xiaoping chose the two provinces as pilot areas for the openness policy.

At the beginning, the openness policy and reform in Guangdong and Fujian also met a lot of resistance from both the vested interests and old ideology. The vested interests were mainly from the central administrative agencies whose power was seriously challenged by trade liberalization and decentralization. Without the right ideas and strong leadership, it would have been impossible for the openness policy to succeed. Just as Wan Li's ideas and leadership played an important role in the agricultural reform, it was Ren Zhongyi's ideas and leadership that made the difference in Guangdong. Ren was appointed as the Party secretary of Guangdong in November 1980. He completely identified with Deng's ideas. However, with the increasing trade liberalization and overseas investment (mainly from Hong Kong), two new phenomena occurred, which presented a big political challenge for Deng's openness policy. One was corruption, and the other was smuggling. It was easy for the rich Hong Kong businesspeople to bribe poor Guangdong officials. Given the big price gap between Hong Kong and Guangdong, it was very profitable for people to smuggle. These two phenomena were often used as reasons by the conservatives to oppose the openness policy. The local conservatives repeatedly reported to the central conservatives that corruption and smuggling spread unchecked in Guangdong. Ren Zhongyi was under tremendous pressure and was frequently recalled to Beijing by the Central Disciplinary Committee of the CCP led by conservative Chen Yun (a major political rival of Deng Xiaoping) to do self criticism. In one case in 1982, Ren was charged of supporting capitalism and breaking socialism in Guangdong. With such high political pressure, Ren had to acknowledge his responsibility against his will. But he worried about how to tell his Guangdong colleagues and subordinates when he returned to his office. Ren was a loyal Party member. According to the CCP's discipline, he must tell the true story. However, he knew that once the true story was revealed, his colleagues and subordinates would think that the openness policy...
was reversed and would lose their confidence. He decided to go to see Hu Yaobang (the Party secretary) for advice before returning to Guangdong. Hu smiled and said to him: “You can tell them whatever you like.” With Hu’s tacit support, Ren didn’t tell the true story of the criticism of him and continued to push for openness. For Ren, while corruption and smuggling should be checked and restrained, openness and reform should not be given up. Meanwhile, Deng Xiaoping took every opportunity to give his support to what Ren did in Guangdong. With Ren’s leadership and support from Deng Xiaoping, Hu Yaobang, and Zhao Ziyang, Guangdong pioneered many reforms, including price liberalization. By 1985 when Ren was retiring at the age of 70, Guangdong had been recognized as a role model of openness and reform for other provinces (see Vogel 2011: chap. 14).12

Development of the Private Sector

China did not have any private firms under the centrally planned economy. Private businesses started in rural areas when agricultural production was liberalized. In the urban areas, private businesses were permitted initially only for pragmatic reasons. When more than 20 million “educated youths” who were sent to the countryside during the Cultural Revolution returned, the state sector was unable to accommodate them. To avoid social unrest, the government allowed jobless returnees to be self-employed. Interestingly, business has its own logic. When the self-employed people did well in their businesses, they started expanding them by hiring other people. This outcome presented a conflict with the Marxist ideology. According to orthodox Marxism, hiring other people to work for your business is exploitation and is inconsistent with socialism. To solve this dilemma, a few Chinese Marxist economists appealed to Marx’s Das Kapital. Based on the detailed analyses of Marx’s arguments, they concluded that employing fewer than eight employees was not exploitation. This provided an official legitimacy for small businesses. Nevertheless, more and more successful private businesses broke the ceiling of eight employees and some even hired hundreds of employees.

12Xia Nan, the Party secretary of Fujian Province, was also a strong reformer. He was dismissed in 1986 under pressure of conservatives after a faked medicine case in Fujian.
Policemen asked if these big employers were criminals and should be arrested.

Deng Xiaoping was very smart in solving this problem. The well-known story is as follows. Nian Guangjiu, a private businessman in Wuhu City, Anhui Province, started his melon seed roasting business as a self-employed person. His products were well received by consumers, so his business expanded cross-regionally. He made considerable profits. In the end, the number of his employees reached several hundred. Local government officials thought that he should be arrested for the crime of exploitation. However, they didn’t dare to make a decision. They reported the case to higher-level government officials. Nevertheless, even higher-level officials didn’t dare to make a decision. The case eventually arrived at Deng’s desk for a final decision. Deng reviewed the case and said: “Don’t arrest him. One person like Nian cannot shake socialism.” That was Deng Xiaoping! He didn’t say that employing hundreds was not exploitation. He just said that socialism should not be afraid of the development of private businesses, no matter how big they grew. By so saying, he sent an important message to the Chinese people that private businesses were welcomed in China.

Because of the legal and ideological constraints, the development of the private sector was not going smoothly in the early stages of reform. During that time, we often heard that some private businesspeople were arrested and sentenced as economic criminals when conservatives were in a dominant position in political and ideological struggles. Deng Xiaoping had to make a concession in unfavorable situations. However, with his right ideas and strong leadership, he eventually won the battle. In October 1987, the 13th Congress of the CCP officially recognized private enterprises as a “supplement” to the “socialist economy.” In April 1988, the Constitution amended by the 7th National People’s Congress eventually gave private enterprises legal status.13

**Toward a Socialist Market Economy**

Deng’s economic reform experienced a setback after the Tiananmen Massacre in 1989. This incident provided an unusual opportunity for the conservatives to fight back. They blamed the

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13For rich stories of debate on private businesses, see Yang (1998).
market-oriented economic reform and liberalization for being the cause of the incident. Many of Deng’s reform ideas were criticized in the official media. Many previously implemented reform measures were reversed. Private enterprises and even township and village enterprises (TVEs) faced a crackdown. Some liberalized prices were re-regulated. Deng tried to stop this anti-reform current but was not successful for a while. His reform-centered speeches in Shanghai in the spring of 1990 and 1991 could not even be published in conservative controlled central media.

This conservative aggression worried Deng a great deal. He realized that if the trend continued, his economic reform would end halfway and Chinese socialism would have no future. Thus, three years after the Tiananmen incident, Deng launched his final fight to rescue his reform program. In January and February 1992, the 88-year-old Deng Xiaoping made his famous tour of Southern China with his family. The tour was claimed to be a vacation, but actually it was a well-planned political tour. During his first stop in Wuhan, the capital of Hubei Province, he told the accompanying local senior officials: speed up reform; whoever is not committed to reform should step down. In Shenzhen and Zhuhai, the two special economic zones in Guangdong, Deng visited a few modern manufacturing companies and reaffirmed the achievements of the special economic zones. He told the accompanying local officials that planning is not equal to socialism, and the market is not equal to capitalism; capitalism has plans, and socialism has markets; and poverty is not socialism. He criticized conservatives who were trying to reverse his reform policies.

As Deng’s speeches on his Southern Tour spread unofficially through Hong Kong based media, the atmosphere began to change. With Deng’s political influence among local officials and military officers, the conservatives turned from offense to defense. The Party general secretary Jiang Zemin sensed that Deng won the battle against conservatives and quickly expressed his support for Deng’s call for reform. Other senior leaders followed suit. Official newspapers also began to publish editorials to call for reform. In March 1992, the politburo endorsed Deng’s speeches and the revised speeches were circulated as an official document to all Party members and taken as a guideline for future reform.

Deng Xiaoping’s Southern Tour was a turning point in China’s reform process. The 14th Congress of the CCP, which was held in
October 1992, re-endorsed Deng’s reform policy, and set “building a socialist market economy” as an official reform goal, which was a breakthrough of the original economic reform goal. More reform-minded people were selected into leadership positions. In November 1993, the Third Plenary Session of the 14th Congress made “the decision of building a socialist market economic system” and laid out a detailed reform agenda. Under Jiang Zemin’s leadership, China’s reform began a new chapter.14

Privatization of the State-Owned Enterprises

The reform of state-owned enterprises (SOEs) had been the core part of the whole economic reform program in China up to 2003. The major idea shift of this reform occurred in 1993. Before 1992, the SOE reform was discussed under the premise of maintaining state ownership. Assuming that SOEs could be managed well, the question was how to manage them well. This way of thinking had both ideological and cognitive reasons. The ideological reason was that the state ownership was the foundation of the socialist economy. The cognitive reason was that SOEs could be made as efficient as private enterprises by imitating the management and incentive systems of private enterprises in the West. Thus, two major measures were implemented in the early days to improve the SOEs’ performance. The first was to expand management autonomy; and the second was to implement profit sharing and bonus systems. By 1986, these two policies had evolved into the “management responsibility system” under which the government and enterprises entered into contracts, and when the contracts were completed the profits were shared according to the terms specified in the contracts. There are many ways to share profits, but the premise of all measures was to maintain state ownership.

However, by 1992, it was clear that there was no way to resolve the problems with the SOEs under the constraints of state ownership. After more than 10 years of trying to separate administration from enterprises, as well as trying to implement profit and loss responsibility, those goals could not be realized under the existing institutions. In particular, with the development of the nonstate sector (including

14For details of Deng’s Southern Tour and the subsequent reform agenda, see Vogel (2011: chap. 23).
TVEs and joint venture companies) and the intensification of inter-regional competition, the survival of SOEs was in question. SOEs had long been the pillar of the national economy and the main source of government revenue. However, they now became a burden to local governments. In 1992, the total loss of the industrial SOEs exceeded their total profits. Therefore, the fundamental thinking regarding SOEs began to change, and new thinking about privatizing them took root.

At the Third Plenary Session of the 14th National Congress in 1993, four principles of a systemic reform were established: “clearly established ownership, well-defined power and responsibility, separation of enterprise and administration, and scientific management.” Many localities began the process of denationalization. The official mottos were “building a modern enterprise system,” “transformation of the joint-stock system,” “corporatization,” and “property rights diversification.” Large-scale systemic reforms of ownership started for enterprises controlled by local governments, especially those controlled by county and lower level governments (including rural enterprises and other forms of collective enterprises). In 1995, General Secretary Jiang Zemin proposed to “invigorate large enterprises and loosen control over the small.” A very famous story of that time is from Zhucheng City, Shandong Province, where 50 SOEs under the control of the city’s government were sold. The Party secretary of the municipal committee, Chen Guang, got the nickname “Chen Maignuang” (“Completely Sold Out”).

By the middle of 1990s, the central government-controlled enterprises had also become burdens to the central government. The huge nonperforming loans of SOEs were threatening the banking system. After the 1997 Asian financial crisis, state-owned banks stopped providing SOEs with “stability and unity loans.” Central enterprises had no option but to start the denationalization reform. The mottos at the time were “structural reorganization,” “decrease staff and increase efficiency,” and “overcome difficulties.” Under these guidelines, a large number of enterprises, especially small- and medium-sized enterprises, were cast off. At the same time, the government initiated the formation of joint-stock ownership for large-scale SOEs. Turning SOEs into joint-stock companies, and then reorganizing them with high-quality assets to go public, was an extraordinary measure. As the continuation of Jiang Zemin and Zhu Rongji’s reform, in 2003, “technically
insolvent” large-scale state-owned banks also started to transform into joint-stock companies. They brought in foreign strategic investors, and then went public on domestic stock exchanges.\textsuperscript{15}

While the SOE crisis was a driving force for changes in people’s thinking in the 1990s, I believe the ideas and leadership of Jiang Zemin and Zhu Rongji played a crucial role in transforming management reform into ownership reform. For ideological reasons, interestingly, the then Chinese leaders and the official documents avoided the word “privatization,” even though what China did with SOEs under the Jiang-Zhu regime was nothing but a kind of privatization. They did so because they believed that changing ownership was important and necessary for solving the SOE problem and building a market economy. With the constraints of old ideology and the political and social pressures, strong leadership was absolutely needed to implement Jiang and Zhu’s ideas. In 1998 alone, about 20 million state employees were laid off when the state sector was restructured. Without Jiang and Zhu’s decisiveness and courage that task would have been impossible.

**China’s Entry into the World Trade Organization**

One of the most important reforms China made during the Jiang-Zhu regime was to enter the World Trade Organization in 2001. Joining the WTO played a crucial role in fostering China’s double-digit growth as exports became a major driving force for industrialization and urbanization. Huge foreign investments flowed into China. Most of the Fortune 500 multinational companies started their manufacturing businesses in China. China quickly became a hub of world manufacturing. With favorable global markets, China’s exports grew even faster than imports. As a result, China accumulated a huge amount of foreign reserves, now accounting for one third of the world reserves.

Entry into the WTO also played an important role in driving China’s domestic economic reforms. To meet the requirements of the WTO, China launched the deregulation campaign a few years before 2001, which removed many administrative controls over economic activities. China also abolished many regulations affecting

\textsuperscript{15}For privatization of state sectors, see Li, Li, and Zhang (2000), and Zhang (2015: chap. 11).
trade and investment, and reduced tariff rates dramatically after the entry into WTO. As a result, the Chinese market is more open and China is more like a global player. The competitiveness of Chinese companies has also improved considerably. Without entry into the WTO, both the institutions and the business culture of China would have been very different.

While the benefits of China’s entry into the WTO became clear afterward, there were interest groups who opposed membership. The debate on the pros and cons of joining the WTO was heated before 2001. Opposition came from those who had wrong ideas or vested interests. Some thought that entry into the WTO was against China’s national interests and would undermine manufacturing. Because of the weak competitiveness of Chinese firms, it was feared that WTO membership would cause many Chinese firms to collapse and destroy jobs. Vested interests mainly were two types: (1) SOEs that were long protected by high tariffs and quotas and enjoyed monopoly positions in domestic markets, and (2) government officials who had administrative power to set and implement rules, and therefore had rent-seeking opportunities.

These vested interests not only voiced their opinions but also took actions to block necessary concessions China should make. They even accused Premier Zhu Rongji and the head of WTO negotiation delegation Long Yongtu of being “traitors.” However, Jiang and Zhu were determined to get China to join the WTO. They strongly believed that the entry into the WTO would provide plenty of opportunities to China, and being an equal member of the WTO family would be important for China to rise internationally. They were willing to make all necessary concessions to meet the WTO rules, even in the face of strong opposition. With such determination, China was able to reach all bilateral agreements and eventually entered the WTO in November 2001. It is evident that without Jiang and Zhu’s decisiveness, China would not have entered the WTO as early as in 2001.

In summary, the above six stories show that the right ideas and strong leadership of Deng Xiaoping, Hu Yaobang, Zhao Ziyang, Wan Li, Jiang Zemin, and Zhu Rongji, among others, in the first 25 years since the inception of reform were crucially important for China’s economic reform and openness. Without their right ideas and strong leadership, China would not have achieved such success in its transition to a market economy.
The Power of Ideas

Ideas and Leadership, 2003–2012

As Hu Jintao succeeded Jiang Zemin as the Party general secretary in November 2002 and Wen Jiabao succeeded Zhu Rongji as the prime minister in March 2003, China entered the Hu-Wen decade until late 2012. While the economic growth was strong due to the accumulated dividends from the first 25 years of reform, the Hu-Wen decade can be called a “lost decade” in terms of economic reform. Not only did China not move forward in its institutional changes, but actually its reform momentum was reversed. Many conservative policies against market-orientation were implemented. The government became more interventionist, the state sector became more dominant, and the rule of law was seriously damaged. By the end of the Hu-Wen decade, the Chinese society had become much less harmonious than a decade ago. It seemed that many people were dissatisfied, regardless of whether they were rich or poor, officials or common folks, or an employer or employee.

One explanation for this setback was that Hu Jintao and Wen Jiabao had wrong ideas about reform; they were also weak leaders. They believed in the government more than the market, state ownership more than private ownership, and the rule of the Party more than the rule of law. Hu and Wen behaved more like bureaucrats than visionary leaders, and it seemed that reform was losing its legitimacy. Moreover, even though “continuing reform” was still their open and official slogan, what they did was in fact very different from what they said. As such, with the passage of time, few people really cared about what they were saying. Because of their weak leadership, much of the reform operations were left in the hands of the bureaucracy of vested interests. These bureaucrats made the best use of their discretionary power to manipulate reform programs and consolidate their own status and personal interests, rather than push the economic system in the direction of the market. As a result, corruption and rent-seeking at all government levels became prevalent, and more and more businesspeople lost confidence in the Hu-Wen regime and chose to move abroad. Below I identify four major setbacks.

From Market Orientation to Government Intervention

As I mentioned earlier, China had taken a long time to build its trust in the market. It was only in 1992 that “building a socialist
market economy” was taken as an overall goal of the reform by the 14th National Congress of the CCP. Nevertheless, after a decade of efforts to build a market economy under the Jiang-Zhu regime, the direction began to change under the Hu-Wen regime. During this time, the market was regarded as a problem and government as a solution, just the opposite of the 1990s. Faith in governmental intervention was further strengthened after the global financial crisis in 2008–09. With the reversal of ideas, many planning-type measures were kept or reintroduced under the Hu-Wen regime, of course in the name of “perfecting the market” and “curing market failures.” So-called industrial policy became an umbrella for the various government interventions, including restraints on market access, resource distribution, taxation and subsidies, and compulsory reorganization of enterprises. During the planned economy, the State Planning Commission was the most powerful government agency. In some sense, the essence of the economic reform was to diminish the power of the Planning Commission. China indeed did that during the first 25 years of reform. However, under the Hu-Wen regime, this commission, renamed in 2003 as the National Development and Reform Commission (NDRC), fought back very aggressively and reestablished its dominant position on investment decisions and resource allocation. Now the NDRC is more like a second State Council. Almost every investment project needs to be examined and approved by the NDRC (or its local equivalent) through various administrative procedures. Without its approval, enterprises cannot do anything new. The NDRC also controlled tremendous government investment funds of the various industries. Its officials have the discretion to allocate funds to whoever they deem worthy. Because they are so powerful, even the governors of provinces must kowtow to the NDRC division heads. Without a good relationship with NDRC officials, it is almost impossible for local governments to go forward with their development projects.

Ironically, while the industrial policies attempted to solve the overcapacity problems and investment wastes “resulting from the market competition,” they actually made the situation worse. In 2009, the government launched a “plan of re-energizing the 10 big industries” in the face of the challenges from the global financial crisis. Two or three years later, however, all these 10 industries were found to be in trouble because of the production overcapacity. The solar energy industry was a typical example. This is a new industry,
and the Chinese private businesses did it well initially. However, it suffered a disaster because of the industrial policy. When the government designated this industry as a “strategic industry for future development,” a tremendous amount of financial resources were injected in it and many local governments competed fiercely to attract investors through cheap land, financial subsidies, tax holidays, and other favorable treatments. As a result, the solar energy industry spread quickly and developed overcapacity. With prices in a freefall, all of the producers suffered losses and some leading companies (e.g., Suntech Corporation) declared bankruptcy.

From State-Out and Private-In to Private-Out and State-In

During the Jiang-Zhu regime, state-owned enterprises were often criticized for their inefficiency and unprofitability. Through the various forms of restructuring and ownership reform, SOEs retreated from most of the competitive sectors and private enterprises took over. This process was referred to as “state-out and private-in” or “state-sector retreat and private-sector forward” (guotui minjin). However, during the Hu-Wen regime, SOEs were appreciated for their contributions to the national economy and to the ruling of the Communist Party. State-out and private-in was replaced by “state-in and private-out” or “state-sector forward and private sector retreat” (guojin mintui). The state-owned enterprises became more aggressive in every major industry and reentered a few already retreating competitive sectors. Through administrative measures, the SOEs took over private enterprises. This was particularly evident in the energy and steel industries, and private enterprises were more discriminated against in market access, financing, and taxation. Many owners of the privatized enterprises were arrested and sentenced in the name of “stealing state assets.”

The original purpose of establishing the State Asset Supervision and Administrative Commission (SASAC) was to reform the state-owned enterprises. Nevertheless, soon after SASAC was established in 2003, it claimed that its function was to make SOEs bigger and stronger. This was done by monopolizing market access, reorganizing through mergers and acquisitions, and bully private enterprises.

This charge was frequently used for the government to confiscate enterprises that were sold to private owners during the 1990s.
Cato Journal

Li Rongrong, head of the SASAC from 2003 to 2010, once said that “the state-owned enterprise is the oldest son of the People’s Republic,” meaning that SOEs are entitled to privileges—for example, by excluding private enterprises. After the global financial crisis, a large amount of stimulus funds and loans were injected into SOEs, which made them more dominant. These policies of the central government also changed the mindset of local government officials. For instance, Zhejiang Province had long promoted the private sector, and Guangdong Province had long promoted foreign invested enterprises. However, in the late first decade of the 21st century, both provinces implemented various preferential policies to attract large SOEs controlled by the central government to invest in their provinces.

From Wealth Creation to Income Distribution

During the first 25 years of reform, Chinese leaders made economic development a top priority and viewed economic reform as the only way to advance economically. Deng Xiaoping realized that China’s poverty problem could be solved only by making the entire pie bigger. He persistently emphasized that “economic development trumps everything” and Jiang Zemin followed him. However, Hu Jintao had different ideas. For him, pie distribution was more important than pie-making. He downplayed the priority of development and emphasized “social harmony,” the true meaning of which in his mind was that income should be redistributed more equally through government’s administrative measures. He promised the ordinary people to increase their income by governmental intervention (such as minimum wages, collective bargaining, and income taxation), and introduced various welfare systems. Under his regime, entrepreneurs were defamed for greed and exploitation.

While income distribution in China needs to be addressed seriously, I argue that to deal with this issue, we first need to understand where an unfair income gap comes from. My observation suggests that the true issue related to China’s income distribution is unfairness, not inequality. The main explanation for unfair distribution is related to the fact that some people were given privileges in doing business. Furthermore, the reason that some people were given privileges but others were not was due to the overregulation and tight government control over many resources. Under such a system, the few got rich not because of their productivity and entrepreneurship,
but because of their special connections with the government. That is why ordinary people are dissatisfied with the income gap. What China needs to do is to level the playing field and create equal opportunity, not equal outcomes.

The right way to deal with the issue of income distribution is to further the marketization of the economy through deregulation, privatization, and implementation of the rule of law. However, the Hu-Wen regime thought very differently. They were confused about the differences between inequality and unfairness, but accepted the idea that the observed inequality was a natural result of the market. Therefore, they thought that the only way to solve the problem is through government’s redistribution policy. Unfortunately, the result proves the opposite. After the decade of “building a harmonious society” under the Hu-Wen regime, the Chinese society had become much less harmonious than a decade ago. The corruption-related unfair income gap is also more serious than ever before. Once again, when ideas are wrong and leadership is weak, the outcome is often not as intended.

From Rule of Law to Rule of the Party

In Mao’s era, China was lawless and Mao himself was the only law for the country to follow. Mao’s rule of man resulted in a series of social and political movements and eventually led to the disastrous Cultural Revolution. Deng Xiaoping learned from Mao’s mistakes and realized that ruling by law would be crucial for China’s stability and development. Thus, once he took power, he proposed to institute legal and democratic reforms in China. During the Jiang-Zhu regime, the Communist Party officially set “building a rule-of-law state” as the goal of China’s political reform and made tremendous efforts to achieve that goal. Under the leadership of Deng and Jiang, China made considerable progress on the road to the rule of law. However, the rule-of-law process was reversed during the Hu-Wen regime. For Hu Jintao, the top principle was “maintaining stability” rather than the rule of law. The rule of law became an empty slogan rather than a real ideal for society. Instead, the law was put aside and political measures dominated the resolution of social conflicts. The CCP’s political and legal committees became much more powerful than ever before and interfered at will with judicial decisions. As a result, many legal cases evolved
into political events that could only be solved through political processes, and basic human rights and private property could not be respected and protected.\footnote{For the reversal of the rule of law during the Hu-Wen regime, see Jiang (2010). Jiang Ping is a leading legal scholar in China and was heavily involved in lawmaking during the 1980s and 1990s.}

Bo Xilai’s Chongqing presented a typical example of the setback in the rule of law. When Bo was the Party secretary of Chongqing Municipality from October 2007 to March 2012, he launched a campaign called the “Sing Red and Strike Black” (namely, sing revolutionary songs and crack down on organized criminals).\footnote{Bo was dismissed on March 15, 2012, and sentenced to life for corruption and misfeasance on September 23, 2013.} During this campaign, the court, the prosecutor, and the police were all put under Bo’s control and made decisions jointly, little different from the Cultural Revolution. Anyone could be arrested at Bo’s discretion. Indeed, many innocent businesspeople and even police were arrested and even sentenced to death, and their properties were confiscated. A few lawyers who defended their clients were arrested and sentenced. It was evident that if there had been adherence to the rule of law, Bo would not have been able to behave the way he did.

It should be noted that the setback of the reform during the Hu-Wen regime was influenced by two schools of wrong ideas. The first can be called the “Reform Failure School,” which emerged in 2004 and 2005. This school attributed income inequality, shortage of medical care, underprovision of education, pollution, and regional inequality to neoliberal economic reforms and marketization. The solution proposed by this school was to strengthen government invention and reverse marketization. Under the influence of this school, from 2004 on, the SOE reform halted, and other related economic reforms were also interrupted. Marketization lost its legitimacy, and the government exercised greater control over the economy. During the global financial crisis in 2008 and 2009, when the Chinese economy was still growing, Beijing became overconfident. Consequently, the “China Model School” emerged. The core tenants of that model were single-Party rule, powerful government control, and dominance of SOEs. The China Model School claimed that the success of the Chinese economy was due to the fact that
leaders did not follow the “Washington Consensus”—that is, they did not accept the ideas of liberalization and privatization.

Although, on the surface, the first school says the reforms failed and the second that they succeeded, the essence of the two schools is the same—namely, the denial of market-oriented reform. The Reform Failure School negated the marketization that took place during the first 25 years under the leadership of Deng and Jiang, while the China Model School rejected any further marketization and privatization. The Reform Failure School provided the legitimacy for the anti-marketization policies after 2004, while the China Model School provided the legitimacy for the large-scale stimulus policy and the government dominance of investments after 2009. However, both of these schools are wrong in their analyses and conclusions.19

The Challenges for Ideas and Leadership in the Next Decade

China has made considerable progress in the past three and half decades in its transition to a market economy, even with the stagnation during the Hu-Wen regime. However, it still has a long way to go to become a democratic/liberal society. The key to transitioning China into a liberal society is whether China can succeed in its political reform. The last three and half decades have been dominated by economic reform. Now a fundamental political reform is urgently needed. Establishing a rule of law and a democratic system should be the major targets of political reform. It may take another three decades, but the next decade under General Secretary Xi Jinping’s regime will be crucial to start political reform. Whether or not China can succeed in its political reform also depends on ideas and leadership. In my judgment, China is now bound by some wrong ideas and the bureaucratization of leadership.

Six Traps of Wrong Ideas

I identify six traps of wrong ideas. If China cannot get out of these six idea traps, political reform will be impossible.

19For a detailed analysis of the two schools, see Zhang (2012a).
Trap One: China’s Economic Success Comes from the China Model. The argument embedded in the China Model School is that China has succeeded in the past three decades because it has created its own unique governance system, and it is this unique system that drove China’s achieving in just three decades what it took the West 200 years to achieve. Therefore, China should continue its own model rather than follow the West’s model. As I mentioned earlier, the idea of the China Model School is wrong. The fast economic development in the past three and half decades was because China enjoyed a “late-comer advantage,” which is common to all other late-comers. Using the terminology of Hayek, the Chinese economy is a parasitic economy (Hayek 1960: 47). The West constructed the road; China just followed it. That China walked faster does not mean that its institutions are superior. As Hayek argued convincingly, the sciences, technologies, and managerial skills developed in free societies can be borrowed by unfree societies to support economic development. As such, the latter can even have faster growth rates for a limited period of time.

Just looking at most of the technologies Chinese companies use and the new products they massively produce, including computer, mobile phone, car, airplane, Internet, and so on, most of them are innovations of the Western free societies; they are not China’s innovation. As the late-comer’s advantages are diminishing over time, China’s future development will crucially depend on its homemade innovation. Without the fundamental changes in its political institution, the late-comer’s advantages would eventually turn out to be a curse.20

Trap Two: Economic Liberalization Can Continue without Political Reform. The second prevalent wrong idea is that China’s economic success in the past three decades shows that even without political democratization, economic liberalization and high growth are possible. This idea is wrong for two major reasons.

First, while economic liberalization alone can provide considerable incentives for business activities and therefore economic growth in the early stage when the growth is mainly driven by the reallocation of the existing resources directed by arbitraging, as people have wealth to protect and innovation becomes crucial for growth, the rule

20This point was first raised by Xiaokai Yang in his lecture notes.
of law becomes a necessity. Without the rule of law, property rights are always at risk of confiscation, and entrepreneurs would not have enough incentive to innovate because innovation takes much longer than arbitraging activities. The massive immigration of Chinese entrepreneurs into foreign countries in the past decade signals the serious need of property rights protection, which can be met only under a system based on the rule of law.

Second, the Chinese government needs new legitimacy for ruling the country. The rule of the CCP was originally from its winning the blood revolution. For a long time, the Chinese people have accepted this traditional legitimacy. However, this is no longer sufficient. According to Chinese tradition, the legitimacy of the ruling regime also depends on the living conditions of ordinary people under the regime. Deng Xiaoping realized that the Communist Party could sustain its rule only when it let people achieve good living standards. So, he launched the reform. In some sense he succeeded, as the Chinese Communist Party is still in power long after the Soviet Union and the communist regimes in Eastern Europe collapsed. Nevertheless, as the survival problem has been solved in China, the Chinese people are and will no longer be satisfied with a comfortable material life. They need dignity, freedom, and self-expression. If the government cannot protect people’s basic human rights, including the freedom of speech, press, and religion, its legitimacy will be seriously challenged. Even within the Communist Party, without some form of democracy, the legitimacy of its leaders would be questioned. This calls for political reform to build the rule of law and democracy. Only through such political reform, can the Chinese government gain its new and urgently needed legitimacy.

Trap Three: The Status Quo Is Good for the Vested Interests. A dominant idea among the ordinary people as well as among the elite is that the status quo benefits the vested interests groups at the expense of others. This idea seems to be reasonable on the surface. There are conflicts between the vested interests and others. But a deep analysis shows that this idea is not right. The existing system actually turns out to be good for nobody, even the vested interests. While the vested interests enjoy privileges, they lack the basic human

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21 Based on data of the World Value Survey, Inglehart and Welzel (2005) provide a very convincing argument for democratization as the survival value is overtaken by the self-expression value.
rights such as free speech and personal security, just like other ordinary people. Even though privileges give them better opportunities to be wealthy and powerful for the time being, the lack of human rights implies that they are always at political risk—neither their personal freedom nor their property is secure. Under the current system, anyone can be arrested without going through a legal procedure, regardless of seniority. The interesting thing is that the conflicts of interests among the ruling elites are actually much greater than those between the rulers and the ruled. Anyone can become the victim of the political power struggle. As a result, the vested interests are living in anxious situations. Not only those who are judicially sentenced for corruption or for political reasons have lost their freedom, even those senior officials who did not commit any financial fraud feel like they are living under house arrest. For instance, a retired minister could not even go abroad to visit his children and relatives. So why would the vested interests think the current system is good for them but institutional reform would hurt them? The answer is that they are too ignorant. Once the vested interests realize where their true interests reside, they would more likely support, or at least less likely resist, political reform, even if they still want to retain their power. In the long run, the rule-of-law system is better than the rule-of-man system even for the elite, as demonstrated by British history (North, Wallis, and Weingast 2009).

Trap Four: State-Owned Enterprises Are the Cornerstone of the CCP’s Ruling Power. One of the ideological barriers to privatization of the state-owned enterprises is that they are regarded as the economic cornerstone of CCP’s ruling power. This idea is also wrong. Historically, the Chinese Communist Party took power before it built its state sector, not the other way around. If it had relied on its control of a large state sector, it would never have had the opportunity to rule the country. The CCP won the war against the Nationalist Party not because of its assets but because of its ideas. Even 100 percent state ownership of the economy cannot guarantee the rule of the Communist Party. The Soviet Union is a typical example. It collapsed when the state owned the whole economy.

22The Chinese Communist Party has the “shuanggui system” under which any Party member can be arrested by the CCP Discipline and Investigation Committee long before being legally sued.
CCP still holds its ruling power not because of the state economy but because of the rapid development of the private economy and the partial privatization of the SOEs in the 1990s. Today, because of the inefficiency and corruption of the state sector, SOEs have become a negative asset for the government. If the remaining part of the state sector can be privatized, the better economic performance might earn the CCP more public support.

*Trap Five: Power Comes from the Barrel of a Gun.* Mao Zedong once said that “power comes from the barrel of a gun.” This idea has become a deep belief of the Communist Party. The absolute control of the military is regarded as the essence of the CCP’s ruling authority, so any proposal to nationalize the military is strongly opposed. However, if this idea were true, no political regime could have been overthrown, because the military forces were initially always in the hands of the ruling authority. Even the CCP could not have taken over power because in the 1940s the Nationalist Party’s military force was much stronger than the Communist Party’s. The Communist Party won not because of its gun power but because of the power of its ideas. Guns followed ideas. When ideas change, guns change hands. Many Chinese intellectuals turned to the Communist Party during the civil war after the anti-Japanese War, because they were dissatisfied with the dictatorship of the Nationalist Party and believed that the Communist Party would give them more freedom and democracy. The leaders of the Communist Party must realize that honoring its promise on freedom and democracy is more important than controlling the army.

*Trap Six: An Unlimited Government Is Stronger than a Limited Government.* The sixth wrong idea is that an unlimited government is stronger than a limited government. This idea has been a doctrine of the Chinese government for a long time, and China’s quick response to the global financial crisis seems to provide new support to it. The idea actually confuses authority with strength, and confuses strength with power. History has shown that a strong government is not an unlimited government, but a limited one. The reason is that a government can be strong only if it is trusted by its people. This can be well exemplified by the history of Great Britain (see Weingast

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23 According to the CCP’s doctrine, the army should be controlled by the Party, not the state. Thus, the Chinese army is the Party’s army, not the nation’s.
Before the Glorious Revolution in 1688, the king’s government was almost unlimited. For example, the king decided whether or not to repay the government debts on time. As a result, it was very difficult for the government to issue bonds to the public. After the Glorious Revolution, the British government changed into a limited government under the constitutional monarchy. With higher credibility of the bond contracts, the capacity for the government to raise funds through bond issuing dramatically increased. A truly strong government is one under the rule of law, rather than under the rule of man. Limited government and democracy are like the commitment made by the government to its people. With these commitments, people can then trust the government, and the government becomes a strong one as a result. If the Chinese government cannot transform itself into a limited government, then it cannot become a truly strong government.

The Dangers Hidden in the Bureaucratization of Leadership

Apart from idea traps, China is facing a leadership problem. The principle of CCP’s rule can be understood as that the 1.3 billion Chinese people contract the governance of the country to the Communist Party. The best way forward for the CCP is to find the best qualified “chairman of the board,” “general manager,” and management team to run the country (“company”).

However, China has reached a point where its politicians are drawn exclusively from the political bureaucracy, whereas leadership and bureaucracy are very different. The top leaders are called “civil servants”—and ranked highest in the administrative order—and judges and justices are also defined as “civil servants.” This is an absurd predicament. The bureaucracy follows carefully prescribed rules to ensure that mistakes are avoided, and therefore people who climbed up through this system are cautious and risk averse. Great leaders should care about the nation’s destiny and future, and they must have extraordinary abilities to take risks and withstand the hardships of open political competition. It is very unlikely great leadership could emerge from the bureaucratic training process.

In China, the Party secretary is the head at all levels of governments, and the promotion ladder is strictly bottom-up hierarchical. Imagine that you were somehow appointed to a deputy head of a county government in China. How many steps away from becoming the county Party secretary would you be? Five! Each step takes at
least two years to complete. If you were lucky, in 10 years you could become the Party’s county secretary. Once you hold this position, you become the true boss and might be able to undertake important things with full authority. But if you still want to progress up the political ladder, your next position should be a deputy mayor of a municipal government. Suppose you now become the deputy mayor and are still five levels away from being the city Party secretary, which would require another 10 years. Reaching provincial Party secretary from deputy governor of a province will take another 10 years. You can become a top national leader only after you hold the provincial Party secretary position for a few years.

At the end of this 40-plus-1 year process, those with courage and principles will probably have been knocked out, while those who chose to adapt themselves will have become thoroughly bureaucratized. At the end, we are left with a nation of bureaucratized leaders.

That is why Hu Jintao and Wen Jiabao were so weak in their leadership. It was the first time in the history of the Chinese Communist Party that the top leaders came completely from the bureaucracy. It is understandable that they lacked a sense of mission, vision, and courage.

The system as it now stands is incapable of producing great leaders at precisely the time when China needs great leaders for transitioning China into a constitutional and democratic system. With the case of Taiwan, before his death in 1988, Chiang Ching-kuo recognized the importance of democratic institutions and began Taiwan’s political transformation. The first generation of the Mainland Chinese revolutionaries had the power to create a similar transformation, but failed to do so. Even Deng Xiaoping missed his opportunity to become mainland China’s Chiang Ching-kuo. After more than 60 years, China is still waiting.

Of course, we may not need to be so pessimistic. Owing to special historical circumstances and elite family backgrounds, China’s new leadership team may possess the appearance of great leaders who have a sense of mission, courage, and the ability to lead.24 It is because of this that I believe that the next 10 years present a rare window of opportunity to transform China. It is imperative that the new leaders do not miss this opportunity to embark on a political reform,

24However, I must confess that I am still not sure if they have right ideas. As argued earlier, strong leadership with wrong ideas would be a disaster.
as future generations of Chinese leaders are unlikely to be as capable as today’s without political reform.

Conclusion: China Needs a Free Market for Ideas

In this article, I argue that ideas and leadership play a crucial role in institutional changes. In particular, I propose a two-dimensional framework of ideas and leadership to analyze China’s economic and political transition to a liberal society. I have demonstrated that the major progress in China was made during the first 25 years when the ideas were right and leadership was strong under Deng Xiaoping and Jiang Zemin. In contrast, the reform was stagnant and even had setbacks under the leadership of Hu Jintao and Wen Jiabao because they had wrong ideas. The future of China’s reform will depend on the kind of ideas and leadership the new leaders, particularly General Secretary Xi Jinping, have. To succeed in a peaceful transition to a liberal society, China must get rid of the wrong ideas. Bureaucratization of the politicians is a big obstacle to the production of high-quality leaders. The future of China’s transition is therefore uncertain and difficult to predict.

Can China say goodbye to revolution? The answer to that question will depend on luck. If China has good luck, then reform will bring us a constitutional government and democracy. If its luck is poor, then China might have another revolution, and no one knows what the consequences of that would be.

The question I have not yet discussed is: Where do the new and right ideas come from? A direct answer is to create a marketplace for ideas. It is the free competition in the academic market and the debate of different opinions, beliefs, theories, and ideologies that produce new and right ideas. I am not saying that the right ideas would necessarily win competition in the idea market. But if we want to produce right ideas and get rid of wrong ideas, the idea market might be the only mechanism we can rely on (see Dorn 2014).

The idea market in China is underdeveloped and heavily restricted because of the monopoly of the Communist ideologies. Nevertheless, Chinese economists and scholars in other social sciences have played important roles in the production of new ideas for the reform movement. This was particularly true during the first 25 years of the reform. The “debate on the truth’s criterion” and the
"thought liberalization movement" were well-known for their breakthrough contributions to the startup of Deng Xiaoping’s reform (see Yang 1998: chap 3). In the 1980s and 1990s, almost every reform program was debated in academia before it became an official policy for implementation. The basic process works like the following: first, a few researchers proposed a new idea for reform that provoked heated debate; then it was accepted with modification by the reform-minded leaders; and finally it was integrated into the new policy and law. Without intensified academic debating, “the socialist commodity economy” would not have been written into the communique of the Third Plenum of the 12th National Congress of the CCP in 1984; private enterprises would not have been legalized by constitutional amendment in 1988; “the socialist market economy” would not have been recognized as the goal of the reform by the 14th National Congress of the CCP in 1992; and “the rule by law” would not have been replaced by “the rule of law” by the 15th National Congress in 1998.

My personal experience with the price reform may be a convincing example of how the idea market influenced the reform. By 1984, the urgency of price reform had already been well recognized by the top leaders. However, the dominant idea at the time was that major product prices must be set by the government, and that the government has the capability to set the right prices so long as it respects “the value principles.” With this idea in mind, price reform was treated as how to adjust prices administratively. The top leaders were waiting for the State Council’s Price Research Center to calculate the right prices. In an article I wrote in 1984, I argued that the right prices could never be set by the government and that the only way to solve the price problem was to remove price controls gradually through a dual-track approach (Zhang 1984; for an English translation, see Zhang 2015: Appendix to chap 12). My idea provoked a hot debate in an academic meeting in September 1984.\footnote{This so-called Moganshan meeting was held in the famous resort site of Moganshan in Zhejiang Province, September 3–10, 1984. Participants at the meeting were young scholars from all over the country, selected from more than 1,000 applicants based on submission of academic papers. I was then a postgraduate of Northwest University, at age of 25, and the youngest participant at the meeting. The meeting was a start for young scholars to be involved in the discussions about economic reform.} It eventually convinced a majority of the
participants at the Moganshan meeting. Soon the idea of the dual-track pricing system was accepted by the top leaders and then became an official price reform policy in January 1985. This was a change in the way of thinking. Without changes in ideas, the price reform process of China would have been very different. If there had not been a free and open discussion at that meeting, it would not have been possible for my idea to influence policy.

The Chinese reform has also benefited from the idea market in the West. Just as China imported a great deal of technology and equipment developed in the West, it has also imported many ideas from the West. Without the ideas of Friedman, Coase, and Hayek, just to name a few, the Chinese reform would have been very different.

Ronald Coase was correct to argue that a free market for ideas is crucial for a peaceful and smooth political transition in China (Coase and Wang 2013). The Third Plenum of the 18th National Congress of the CCP produced a roadmap for reform during the next decade. Key ideas include letting “the market play the decisive role in resource allocation” and providing for “modernization of the governance structure.” However, if people are not allowed to freely debate how to reform the political system, then it will be impossible to develop the right ideas to implement this roadmap. Thus, there is every reason to be worried by the increasingly tight control of academic freedom and by the lack of publication and press freedom.

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26For a detailed analysis of China’s price reform, see Zhang (2012b).


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Political Capitalism

Randall G. Holcombe

Political capitalism is an economic and political system in which the economic and political elite cooperate for their mutual benefit. The economic elite influence the government’s economic policies to use regulation, government spending, and the design of the tax system to maintain their elite status in the economy. The political elite are then supported by the economic elite which helps the political elite maintain their status; an exchange relationship that benefits both the political and economic elite.

Political capitalism as an economic system was explicitly implemented in the fascist and corporatist economies of Germany and Italy between the World Wars, and as he was leaving office, President Eisenhower warned, in 1961, of the dangers of the military-industrial complex, a manifestation of political capitalism. The idea of the differing interests of the elites and masses has a long history in political science and sociology, but has been less recognized in economics. Economics tends to use individuals as the unit of analysis, so is oriented toward recognizing that different individuals have different interests, rather than that groups of people might work together to further their interests, and that group boundaries might be determined by social divisions. However, an examination of the academic literature in economics shows that the building blocks for a theory of political capitalism are already in place. This article draws...
together several strands in the academic literature to show how they can be woven together to understand political capitalism as a distinct economic system.

The Concept of Political Capitalism

Political capitalism is a concept introduced by Max Weber (1922) to describe the political and economic systems in ancient Rome. However, Love (1991: 4) argues that Weber did not fully develop the concept: “Whereas Weber developed the ideal type of rational capitalism to a high degree, . . . unfortunately the same cannot be said of his concept of political capitalism.” Love defines Weber’s concept as “the exploitation of opportunities for profit arising from the exercise of political power (ultimately violence).” In a more modern setting, Kolko (1963) adopted the term to describe the American political and economic systems that developed during the Progressive Era, which he dates from 1900 to 1916.

The conventional wisdom on the Progressive Era is that government imposed regulation on business to limit the ability of those with concentrated economic power from using it to the detriment of the masses. According to Higgs (1987), the Progressive Era represented a change in American ideology. Prior to the Progressive Era, Americans viewed the role of government as protecting individual rights. Progressives expanded that view and held that government should look out for people’s economic well-being in addition to protecting their rights.

Government regulation of concentrated economic power, according to the conventional wisdom, was a part of looking out for people’s economic well-being. Kolko (1963: 2–3) challenges the conventional wisdom, noting:

Progressivism was initially a movement for the political rationalization of business and industrial conditions, a movement that operated on the assumption that the general welfare of the community could be best served by satisfying the concrete needs of business. But the regulation itself was invariably controlled by leaders of the regulated industry, and directed toward ends they deemed acceptable or desirable. . . . It is business control over politics (and by ‘business’ I mean the major economic interests) rather than political regulation of the economy that is the significant phenomenon of the Progressive Era.
This is what Kolko calls political capitalism.\(^1\)

The concept of political capitalism has been recognized in political science, although not as a dominant paradigm and not under that name. It has not been as much a part of mainstream economic thought, although the building blocks for political capitalism are well-accepted by economists. Some recent work in development economics has recognized a similar concept, concluding that poor countries remain poor because the elite who control the political and economic system retain low-quality institutions for their benefit, at the expense of the general population. For example, Acemoglu and Robinson (2012) categorize political institutions of nations as inclusive or extractive, with inclusive institutions producing prosperity while extractive institutions are controlled by an elite to enrich themselves at the expense of the general population. Political capitalism recognizes that the elite design and control political institutions not only in poor countries but in rich countries, and they design those institutions for their benefit.

Political capitalism is more than just an explicit recognition that politics influences the economic system—an idea that is well-recognized in the public choice literature. Rather, it is a system in which the political and economic elite design the rules so that they can use the political system to maintain their elite positions. The idea has gained some credence in more popular analysis of the economic events of the early 21st century. Government bailouts of firms following the recession of 2008, subsidies to firms with political connections, and even Federal Reserve policy that has aided the banking industry have been called “crony capitalism.” Likewise, the Occupy Wall Street movement that began in 2011 recognized the concept of political capitalism, calling the beneficiaries of favorable government policies the “1 percent” and contrasting them with the “99 percent” who were often left to bear the costs of policies that favored the 1 percent.

Political Capitalism as an Economic System

Economics as a discipline has not explicitly recognized political capitalism as an economic system for several reasons. The issue is not the failure to use that term, but rather the failure to recognize the

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\(^1\)See Bradley (2009: ch. 5) for an analysis of political capitalism.
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concept as fitting within an analysis of comparative economic systems. Up through the 1980s, comparative economic systems was an area of inquiry within economics, mainly focused on a comparison between capitalism and socialism—that is, between a market allocation of resources and government allocation of resources. Loucks and Whitney (1973) is typical of a comparative economic systems textbook of the time: it has one part on capitalism and four parts on socialism. Adams (1955) includes fascism as an economic system in addition to capitalism and socialism. The major question was whether government planning was a better way to allocate resources than markets, with the caveat that all real-world economies have elements of both.

Comparative economic systems as an area of study fell out of favor after the collapse of the Berlin Wall in 1989 followed by the break-up of the Soviet Union in 1991. Capitalism had won the intellectual battle because of the breakdown of socialist economies, but there was still a substantial role in economic analysis for evaluating how a market economy might best be regulated for the public interest. The proof of the uniqueness and stability of general equilibrium by Arrow and Debreu (1954) demonstrated that under the right conditions markets would allocate resources optimally, but for various reasons those conditions are unlikely to exist, leading to what economists call “market failure.” A substantial literature explains how market failure can occur and derives conditions under which public policies can correct various market failures.

Capitalism, as an economic system, was depicted as a system of markets in general equilibrium, supported by government interventions designed to correct for market failures. Within that corrective framework provided by government, resources were allocated through markets in capitalism, as opposed to socialism, where resources were allocated through a government plan. No economy allocated resources only through markets or only through government planning, so a comparative systems approach could analyze the degree to which mixed economies were differing combinations of market allocation and government planning. Capitalism, in the comparative systems approach, incorporated government as an institutional feature that would stabilize markets and improve on the efficiency of resource allocation.

Comparative economic systems, as an area of economic inquiry, fell out of favor in the 1990s. Central economic planning was no
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longer given serious consideration as an alternative economic system and the focus of economic systems shifted to economies in transition—that is, formerly socialist economies that were making the transition to capitalism. The old comparative economic systems question about capitalism remained, namely, what types of government oversight are required to allow a capitalist economy to function efficiently?

Government oversight does not always work as perfectly as it is described in theory, everybody knows. In the capitalist system, there are information problems and incentive problems that lead government intervention to create rent-seeking losses, regulatory capture, and other maladies. Those problems lead to additional challenges for designing policies that can use the visible hand of government to direct resource allocation more efficiently. Still, economists depict market activity in the capitalist model as maximizing behavior on the part of private sector actors within the framework of the institutional constraints designed by government.

Political capitalism is a different economic system. As Kolko (1963) describes it, private sector actors are not merely acting within the framework given by government constraints, the “major economic interests” are designing the constraints under which they act, so that they can retain their dominant positions. The economic elite recognize that the creative destruction of capitalism described by Schumpeter (1934, 1947) works against them, as existing firms are weakened by innovative newcomers. Kolko (1963: 6) states, “In the long run, key business leaders realized, they had no vested interest in a chaotic industry and economy in which not only their profits but their very existence might be challenged.” So, they sought government regulation and oversight to preserve the status quo—that is, to stabilize the existing state of affairs and to make it difficult for those outside the elite to displace them.

If this characterization of the American economic system rang true in the Progressive Era, as Kolko claims, it surely rings more true in the 21st century, when the federal government took equity interest in a dozen major banks and two major auto manufacturers to preserve their economic status, even as it allowed hundreds of smaller banks and other firms to fail. The “too big to fail” doctrine, where government allows private firms to retain their profits but underwrites their losses, is perhaps the most obvious manifestation of political capitalism. This system of private ownership but government
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management of the economy falls under the heading of fascism in the old comparative economic systems taxonomy. Political capitalism is closer to fascism than to either capitalism or socialism.

The standard economic approach to analyzing the interaction of markets and politics is that government policies are designed to provide an institutional framework for markets that can improve their efficiency. Those policies do not always work perfectly, so the policy challenge is to design better policies that can allocate resources more efficiently. Government designs the policies and market participants are constrained by them. Political capitalism is a system in which the policies are designed by the economic elite to enable them to retain their dominant positions. This is not the market economy described by comparative economic systems, nor is it some mixture of markets and central planning. Political capitalism is a distinct economic system.

Despite not being recognized as a distinct economic system, there is a substantial amount of academic economic analysis that provides a foundation for understanding political capitalism. After examining the politics of political capitalism, one of the goals of this article is to discuss the economics literature to describe the existing academic foundation for political capitalism, and to build a framework on that foundation that more accurately depicts the operation of all advanced economies from the Progressive Era up through the beginning of the 21st century.

The Politics of Political Capitalism

Political science has done a better job of recognizing political capitalism than has economics, at least partly because economics depicts individuals voluntarily interacting, limiting the power that any one individual has over others. Even when the individual actor is a giant firm, within the framework of the market that firm can only buy its inputs, hire its labor, and sell its products if the other parties to those transactions voluntarily agree. They must reach agreement within government-designed constraints that sometimes facilitate agreement and sometimes inhibit or prevent potential transactions from taking place. Nevertheless, market transactions only take place when all parties agree. This is not true in politics, where political winners can use government to impose policies by force.
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Who are those political winners? Gilens and Page (2014) offer a straightforward taxonomy of four theories that have been recognized in the academic political science literature: majoritarian electoral democracy, economic-elite domination, majoritarian pluralism, and biased pluralism.

Majoritarian Electoral Democracy

Here political outcomes are determined by the average citizen or median voter. Gilens and Page associate this view with Downs (1957) and Black (1958), whose work was instrumental in providing a foundation for modern public choice theory, and has made some inroads into economics through that channel.

Economic-Elite Domination

This theory is consistent with political capitalism in which economic elites determine policy outcomes. Beard’s (1913) description of the U.S. Constitution as designed by the economic elite falls into this category, and they mention Mills (1956) as an important contributor to this theory. While Beard’s work has been recognized in public choice, Mills’ idea of a “power elite” remains outside the bounds of contemporary economic analysis.

Majoritarian Pluralism

This approach is an interest group theory in which the interests of all groups are balanced in the making of public policy. Gilens and Page cite Bentley (1908) and Truman (1951) as significant contributors to this view of politics, showing that it dates back to the era when the study of political economy was separated into economics and political science. This view has also been depicted in public choice through the work of Becker (1983) and Wittman (1989, 1995), to name two examples, so interest group theory has had an impact in the economic analysis of politics.

Biased Pluralism

Here the interests of corporations, business associations, and professional groups are disproportionately represented in the policymaking process. Gilens and Page offer many citations to political scientists who support this theory, but also note the contributions of two economists: Olson (1965) and Stigler (1971). While Gilens and
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Page are accurate in their assessment of Olson and Stigler, an economic (and public choice) theory of interest groups tends toward majoritarian pluralism rather than biased pluralism.

Gilens and Page use an extensive data set to empirically investigate the degree to which actual public policy outcomes conform with these four theories, and find that the economic-elite domination and biased pluralism theories fit best. Those theories are also the most consistent with political capitalism.

Elites verses Masses?

One reason economists might question the political capitalism model is that it separates people into two distinct classes: the elites and the masses, or the 1 percent and the 99 percent, to use contemporary language. Economists are more used to thinking about continuous changes rather than discrete changes. So, one might surmise that greater wealth would allow individuals to buy more political influence, but why would there be some arbitrary cut-off where, above that level a person is in the elite, but below, the person is in the masses? Shouldn’t one’s influence vary more or less continuously with the person’s level of wealth? There are several reasons why there might be, effectively, a discontinuity in the influence people have on public policy that would divide the population into elites and masses.

One reason has its foundation in the discontinuity of public policy outcomes. While there may be compromises, as depicted by Becker (1983), public policy measures are often more accurately depicted as having binary outcomes. A party either wins or loses as a measure passes or fails. Participating in the process is not inexpensive, so people who cannot afford the price of entry find themselves in the masses. In markets, people who produce low value receive low incomes, and those who produce high value receive high incomes. In politics, where issues win or lose, the outcome is not continuous, so people who enter that arena must choose to devote sufficient resources to it so they can have their share of victories. Most people realize that they can have no effective influence, so they stay out of the system and choose to be, as Downs (1957) says, “rationally ignorant.” Olson (1965) explains why it is that concentrated interest groups can organize to have political influence, while disbursed interests cannot.

A second reason, related to the first, is that for people who cannot afford to buy their way into the process (or choose not to),
transaction costs are high and they are unable to bargain. To use the terminology of Coase (1960), the elite are in the low transaction cost group while the masses are in the high transaction cost group; hence, they are unable to bargain to influence public policy. Consider the difference between citizens voting in a general election to elect their representatives and those representatives voting on issues in the legislature. There are a large number of citizens who vote in many different locations using a secret ballot, and all those factors raise transaction costs and make it difficult for citizens to bargain with one another to exchange votes. In a legislature, by contrast, there are a small number of legislators who all know one another, and their votes are a matter of public record, making it easy for them to logroll and trade votes. They are in a low-transaction-cost group.

One of the contributions of Buchanan and Tullock (1962) was to demonstrate how this logrolling and political exchange can enhance the value of political outcomes to members of the trading group. Likewise, lobbyists and other insiders are in a position to bargain with legislators, offering campaign contributions and other forms of political support, so they can enter the low-transaction-cost group. The cost of access means that some people are in the low-transaction-cost group. Those people are the power elite who make public policy, whereas others are in the high-transaction-cost group who cannot bargain to affect public policy outcomes. Those people have no access, and would have little effect on public policy outcomes if they tried. So, they remain outside the process and are part of the masses.2

This is a difference between markets and politics. A low-wage worker can put in a few extra hours of work and make a few more dollars. Someone with no political influence can put in a few extra hours and still have no political influence. Thus, people naturally separate into elites and masses.

The observation that the elite determines public policy in modern democratic capitalist societies is as old as democratic capitalism. Marx and Engels (1948: 10–11) argue,

Each step in the development of the bourgeoisie was accompanied by a corresponding political advance of that class. . . .

2A counter-argument to this view that transaction costs prevent some people from influencing political outcomes is found in Wittman (1989, 1995).
The bourgeoisie has at last, since the establishment of modern industry and of the world market, conquered for itself, in the modern representative state, exclusive political sway. The executive of the modern state is but a committee for managing the common affairs of the whole bourgeoisie.

This is the argument that Kolko (1963) was making when he characterized the Progressive reforms as political capitalism, and that argument carries forward into the 21st century.

Holcombe (2014) notes that in an interesting pair of books, Stiglitz (2012) and Stockman (2013) both argue that contemporary political and economic problems are the result of faulty government policies that are designed by the economic and political elite at the expense of the masses. Stiglitz uses the Occupy language and refers to policies created by the 1 percent at the expense of the 99 percent, and Stockman characterizes the elite as cronies and calls the system crony capitalism. Stiglitz titles one of his chapters “A Democracy in Peril,” and Stockman (p. 614) concludes that crony capitalism leads to “the destruction of any semblance of a free market economy. . . . Most importantly, it means a fatal corruption of political democracy.” Both Stiglitz and Stockman agree that government policies skewed to benefit the elite at the expense of the masses are damaging both the market economy and democratic government.

Stiglitz writes from the vantage point of the political left while Stockman writes from the vantage point of the political right. They are good choices for a comparison because of the similarities in their conclusions despite differences in their political views, but they are not alone in identifying problems caused by a political system run by and for elites. Schweizer (2013) argues that the special interest political activity that often appears as bribery—interest groups bribing legislatures for favorable outcomes—is more accurately described as extortion. Legislators threaten businesses and other interests with harmful legislation, or threaten to hold up legislation they desire, until those interests make payments to the politicians. He offers lots of examples to make his case, describing a system of cronyism that works for the benefit of the elite but imposes costs on the masses.3

3 McCchesney (1987, 1997) makes the same points as Schweizer.
Allison (2013) focuses more narrowly on the 2008 financial crisis and its aftermath, but describes policies that favor the politically connected over the general public in a manner similar to Stockman. Holcombe and Castillo (2013) look at cronyism beyond the United States dating back to the early 20th century, and Holcombe (2013) discusses a strong foundation for this line of reasoning in the literature of academic economics.

While Allison and Schweizer write from the vantage point of the political right, there is a substantial literature on the political left making the same point. Bartels (2008) calls the political privilege the elite enjoy at the expense of the masses the new gilded age, noting how the political process is skewed to benefit the 1 percent, and Hacker and Pierson (2010) and Gilens (2012) argue along with Stiglitz that the growing privilege of the 1 percent is not due to market forces but to the political power of those at the top. Gilens and Page (2014) offer a persuasive empirical analysis and conclude that government policy conforms with the preferences of the elites, and goes in the direction average citizens prefer only when their preferences correspond with those of the elites. Nader (2014) argues that this opposition to crony capitalism unites the political left and right.

A fundamental component of political capitalism is the ability of the economic elite to control public policy for their benefit. The literature in economics and public choice, while recognizing the influence of interest groups, has not depicted this kind of clear division between the elites who determine public policy and the masses who are governed by it. There is not only an argument that supports this division but also a substantial literature that documents it. The next several sections show that there is also an economic theory that lays a foundation for it, even though that foundation has not been fully integrated to develop a theory of political capitalism.

Interest Groups, Rent Seeking, and Regulatory Capture

Prior to the public choice revolution, which began in earnest in the 1960s, economists left political considerations completely out of their policy analysis. Public policy analysis consisted of finding “market failures” where markets failed to meet an ideal benchmark of perfect efficiency, and then deriving conditions under
which those market failures could, in theory, be corrected. Two articles that illustrate this paradigm well were written by Bator (1957, 1958). The first article derives the mathematical conditions for a welfare-maximizing general equilibrium, and the second illustrates mathematical conditions that show why an economy can fail to reach that equilibrium. The policy goal is then to design policies that satisfy the conditions for welfare maximization, but from the economist’s perspective, the actual process by which those policies would be designed fell under the discipline of political science, not economics.

The public choice revolution brought the analysis of political decisionmaking—and government allocation of resources—under the umbrella of economics. As Buchanan (1975a) explains, public choice uses the tools of economics to analyze political decisionmaking, so that the same tools of analysis and the same behavioral assumptions are applied whether one is looking at resource allocation through markets or through government. Looked at in this way, even if there is a “market failure,” trying to fix it through government policy could create a “government failure” that would be even worse. Although the ideas of public choice have become a part of mainstream economics, Holcombe (2012) notes that the bulk of academic economic policy analysis still ignores it and assumes that once economists have derived the theoretically optimal policy, government will implement it. Public choice is a separate subdiscipline, and its lessons are often ignored in policy analysis in other subfields in economics. This is one reason why the study of comparative economic systems has not recognized political capitalism as a distinct economic system.

Public choice has identified the fundamental components of political capitalism, so developing a theory of political capitalism does not mean starting from a clean slate. Mancur Olson has made three major contributions to the economic effects of interest-group politics. Olson (1965) has shown that concentrated interests have an advantage in organizing to get public policies that further their interests, giving an economic foundation to the division of elites versus masses in the policy arena, and Olson (1982) develops a framework to show how, over time, interest groups become more firmly entrenched into the political system so that political decisions become increasingly made for the benefit of well-connected political interests, to the detriment of a nation’s overall economic
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performance. Olson (2000) shows how governments can act as “stationary bandits” and organize the rules in such a way as to maximize the benefits to the rulers.

The importance of special interests in politics is well-recognized within public choice, but that literature has not made the distinction between majoritarian pluralism and biased pluralism, to use the division that political scientists have perceived. To push the interest group theories of politics used in public choice toward laying a foundation for political capitalism would mean accepting the biased pluralism hypothesis with regard to interest group influence. By combining Buchanan and Tullock’s (1962) analysis of logrolling for the benefit of those who are able to engage in political exchange with Coase’s (1960) notion of transaction costs, a theory can be developed in which the elite are in a low-transaction-cost group so they can engage in political exchange for their benefit, at the expense of the masses who are in the high-transaction-cost group. This happens in politics but not in markets because government is able to force people to pay for their programs regardless of whether they want to participate, whereas in markets even those with substantial economic power can obtain resources from the masses only if they voluntarily agree to participate in transactions.

Rent seeking, first identified by Tullock (1967), has become a major area of inquiry since Krueger’s (1974) article gave it that name. The concept makes it clear that some are using the power of government to receive benefits at the expense of others. As with interest group theories, the rent-seeking literature has not identified the recipients of rents as the elite, or the 1 percent. It only divides people into rent seekers, recipients of rents (perhaps a subset of all rent seekers), and the groups who have costs imposed on them as a result of the transfer of rents. It would be a small step to say that the 99 percent are not able to effectively engage in rent seeking, so the beneficiaries are the 1 percent, but the public choice literature has not looked into this issue, and it may not be true. It depends on whether rent seeking is better described as a majoritarian pluralistic activity or a biased pluralistic one.

If one applies the insights of the previous section to these public choice issues, there are arguments supporting the idea that interest group politics and rent seeking are not avenues open to average citizens, so the biased theory would have some credibility, and theories of special interest politics and rent seeking would lay a foundation for
a theory of political capitalism. At this point, however, public choice has not even looked into the issue, so these areas of inquiry do not fall into the biased or majoritarian area in the current public choice literature.

Stigler’s (1971) capture theory of regulation fits very comfortably within political capitalism. The firms that are able to capture the regulatory agencies that regulate them, so that regulation works for the benefit of the regulated firms, easily fall within anyone’s conception of the economic elite. Moreover, just as Kolko (1963) envisioned political capitalism, the elite are able to write the rules to benefit themselves, to stabilize the system, and to keep competitors from eroding their positions at the top.

The building blocks for the theory of political capitalism are already well-established in the literature on public choice, even though economists have not taken the steps to build that theory. Economic models of interest group politics, rent seeking, and regulatory capture do not consider the possibility that these opportunities to use the political system for their own gain may be open to some—the elite—but not open to others—the masses. Political science offers some assistance, because it has developed persuasive theories that depict domination by economic elites and biased pluralism that posit the domination of elites over the masses in the public policy arena.

Regulatory Capture and Transitional Gains

Political capitalism is a two-way street in which the political elite produces policies that benefit the economic elite in exchange for the economic elite’s support of the political elite. The capture theory of regulation suggests that regulatory agencies act in the interest of the firms they regulate, but the other half of the story is that the regulated firms act in the interest of those who establish and maintain those regulations. The relationship is reciprocal, to use a term Coase (1960) applied to externalities.

Tullock (1975) described what he called a “transitional gains trap.” Rent seekers are able to get government to create policies that transfer rents to them, but over time those rents are dissipated because they become capitalized into the assets that are required to receive the rents. A clear example is the taxicab medallions that are required to drive a cab in New York City. The number of medallions
is limited, so a barrier to entry is created into the industry, creating an above-normal profit. The medallions can be sold, so anyone who wants to enter the market must buy one of the existing medallions, which have sold for more than $1 million. The transitional gain has been capitalized into the value of the medallion, so the market value of a medallion is equal to the expected present value of all the future rents that will come to the cab owner because entry has been restricted. The trap is that if one were to undo the policy and allow free entry into the market, existing owners of medallions would suffer a transitional loss of more than $1 million per medallion because the medallions would then become worthless. The value of future rents is capitalized into the value of the medallion, so current owners do not receive above-normal returns from the restriction on entry.

This example generalizes to any government program that creates rents for one group at the expense of others. Farm subsidies, for example, transfer money from taxpayers to farmers, raising farmers’ incomes. To get the subsidies, recipients must own farmland, so the value of the subsidy becomes capitalized into the value of the farmland. Doing away with farm subsidies, quotas, and other agricultural programs would lower the value of farmland, making the owners of farmland suffer a transitional loss.

The result is that those firms that have captured the agencies that regulate them, or that otherwise benefit from rent-creating government programs, are dependent on those who control the programs for their continued profitability. One example Tullock gives of the transitional gains trap is the now-defunct Civil Aeronautics Board. The CAB essentially cartelized the airline industry by assigning routes and setting fares. It would allow airlines to expand their routes only if they could show a need for capacity on that route, and would allow airlines to raise their fares but not lower them. This is just what a cartel does: raise prices and restrict output. The system worked well for the airlines that participated.

The transitional gain was dissipated in many ways: high salaries for unionized pilots, good service (at a high price) for customers, and excess capacity. The excess capacity was beneficial because if a competing airline wanted to enter a route already flown by an airline, the airline flying the route could point to that excess capacity, saying “we are only filling 60 percent of the seats we now have on that route, so there is no need for additional capacity.”
When the airlines were deregulated in the late 1970s and the CAB was abolished, the existing airlines suffered transitional losses and few survived. Well-established and long-standing airlines like TWA, Eastern, and Braniff disappeared, to be displaced by newcomers like Southwest and USAir. This provides a good example of the political capitalism Kolko described. The purpose of the CAB regulation was to stabilize the industry and allow the existing firms who controlled the market to maintain their dominant positions. The disbanding of the CAB is a rare case where the economic elite lost the protection of the regulatory agency they had captured, upsetting the stable market they wanted to preserve. Airfares did fall, but this creative destruction is not what the economic elite wants. This example shows that regulatory capture creates a dependence of those firms on the regulatory regime that benefits them, so they must support the political structure that maintains that regime or they will suffer transitional losses.

Schweizer (2013) says that special interest politics is often depicted as bribery, but more typically it is extortion. It appears that interest groups are bribing politicians to pass legislation they favor, but Schweizer offers many examples to illustrate that the typical process is for legislators to hold up producing any favors for interest groups until they pay up in the form of campaign contributions, hiring of friends and family members, or other favors. Schweizer offers real-world examples for what McChesney (1987, 1997) has called “rent extraction.” Politicians approach interest groups and threaten to pass legislation that will impose costs on them unless they pay up to have the proposed legislation withdrawn. The political elite is able to extract payment from the economic elite because the economic elite is dependent on the political elite for the legal and regulatory environment that ensures their continued profitability and dominance.

The capture theory makes it appear that the benefits go one way, to the firms that benefit from regulation, but there is a transitional gains trap, and as those firms become dependent on that regulation for their continued profitability, the political class is able to extract benefits from the economic elite in exchange for the beneficial legal and regulatory structure they desire. The transitional gains ultimately trap the rent recipients into dependence on the system of political capitalism.
Rent-Seeking Losses

The rent-seeking model developed by Tullock (1967) makes it appear that rent-seeking losses should be much larger than the losses that can be empirically identified, an observation known as the “Tullock paradox.” While there will be winners and losers among rent seekers, on average the gains should roughly offset the losses. Otherwise, if rent seeking were on average profitable, that would be a signal for entry into rent seeking until rent seekers just earned a normal profit. Likewise, if rent seeking on average entailed losses, that would encourage exit until rent seekers earned a normal return.

The model that describes the welfare cost of rent seeking as equal to the amount of rents generated assumes free entry into rent seeking. Within the political capitalism framework, rents are limited to the elite, who write the rules so that they create a barrier to entry to those not in the elite group.

If a cartel can create a barrier to entry, it can create a continuing stream of profits for its members. By restricting rents to the elite, there is a net benefit to the rent recipients (at the expense of others), and the welfare costs of rent seeking do not equal the entire amount of rents. This explains why the welfare losses from rent seeking are not larger. Most people are barred from competing for rents because they are not a part of the elite—the low-transaction-cost group that is able to maintain a set of public policies for their benefit. Consider that if all of the rents are dissipated as welfare losses, the rent seekers gain nothing on net. By creating a barrier to entry, the political and economic elite can benefit each other. The economic elite gain the rents they are seeking at a cost lower than the rents and transfer some of the rents they gain to the political elite, allowing both the political and economic elite to gain from the rents sought and granted.

A barrier to engaging in rent seeking enhances the efficiency of the economy by lowering the welfare cost of rent seeking, which benefits everyone, but the elite maintain that barrier to entry for their own benefit. As Kolko (1963) notes, concentrated economic interests have an incentive to maintain the status quo, and an essential element of political capitalism is the elite’s maintaining their status relative to the masses. The rent seekers are a cartel, as are the rent granters, and they use barriers to entry to maintain a continuing stream of benefits to them from the masses.
The Constitutional Framework of Political Capitalism

Economic analysis examines the way people choose subject to constraints. Buchanan (1990) describes constitutional economics as a study of the choice among constraints. This constitutional framework lays the ultimate foundation for a theoretical analysis of political capitalism. Looking at the components of political capitalism that already have a solid representation in economic analysis—interest-group politics, rent seeking, regulatory capture—those components represent individuals in the private sector as facing a set of constraints in the form of government rules, regulations, and institutions, and maximizing within the constraints that they face. Within the framework of constitutional economics, the rent seekers, the regulated firms, and the interest groups are not merely reacting to the constraints government has placed in front of them; they are designing those constraints themselves, for their benefit.

Kolko (1965) and White (2011) offer a compelling case that the Progressive push to regulate the railroads in the United States was supported by the regulated railroads because regulation benefited them. FDA regulation of pharmaceuticals makes it so costly to bring new drugs to market that small firms have no hope of competing with the established companies. Physician licensure is a common example of a barrier to entry that benefits those who have the credentials, while raising costs to those who use physician services. Economic methodology, which examines people’s choices subject to constraints, looks at these individuals as responding to a given institutional environment, whereas constitutional political economy studies the choice among constraints, and opens the analysis to an examination of how it is that those members of the economic elite are able to design the constraints to their benefit. A development of a more complete theory of political capitalism therefore begins with the subdiscipline of constitutional political economy, to describe the mechanisms that allow the elite to design an institutional structure that enables them to maintain their status and to favor themselves over the masses.

Much of the work in constitutional economics, based on the pioneering work of Buchanan and Tullock (1962), Rawls (1971), and Buchanan (1975b), examines the development of constitutional rules through a process based on consensus, where those governed by the rules engage in a collective decisionmaking process to design rules
that are agreed to by those who will be governed by them. Political capitalism depicts the choice of constitutional rules as being made not by consensus of the masses, but by the elite, for the benefit of the elite.4

The Continuing History of Political Capitalism

After the fall of the Berlin Wall and the breakup of the Soviet Union, Fukuyama (1992) described liberal democratic government and the market economy as “the end of history,” in the sense that they represented the end of evolution in political and economic systems. The model of political capitalism tells a different story, because there is an inherent conflict between a market economy and a democratic government. A market economy is based on clearly defined property rights and interaction among individuals through voluntary exchange. People can obtain resources, goods, and services from others only if those others agree. Democratic government, in contrast, allows those with political power to extract resources from others without their consent. In the majoritarian democracy framework, a majority can use the political process to forcibly extract resources from a minority, but in the elite domination or biased pluralism frameworks, a minority is able to use the political process they control to extract resources from the masses.

Whether democratic government is controlled by the elites or the masses, the conflict between democracy and a market economy arises because in a market economy interpersonal interaction occurs only when all parties to those interactions agree, whereas the basis for democratic government is to allow some to use the

4 The political elite strongly encourage the political participation of the masses, as long as the masses can have no impact on political outcomes. Political participation by the masses has a strong symbolic impact, because it implies the support of the masses for the political elite, as Edelman (1964) notes. However, when people outside the political elite actually can make a difference, their participation is vilified. Note, for example, the complaints about money in politics—especially money that comes from large donors. Politicians are happy to receive donations that support their positions and help maintain their positions in the elite, but when money comes from people who challenge the elite, like the Koch brothers, they are vilified because they are challenging the ruling elites. Participation is encouraged by the political elite, unless that participation can displace members of the elite from their positions of power.
force of government to appropriate resources from some to transfer to others. There is an inherent tension between a democratic political system and a market-based economic system. A good example is found in Piketty’s (2014) analysis of capitalism, where he views a market economy as generating ever-increasing inequality, and calls for highly progressive taxes on income (up to an 80 percent marginal rate) and on capital ownership. Piketty sees the tension between a market economy and democratic government, and urges the latter to confiscate income and wealth in the former, not to produce public goods, but to reduce inequality.

This tension was also discussed by Hayek (1944), who saw government allocation of resources as the road to serfdom, and explains how, in government, where the whole purpose is to force people to abide by its rules and policies, the worst get on top. Schumpeter (1947) likewise saw this tension, noting that those who benefit most from capitalism will not stand up to support it. Holcombe (2002a) describes how this tension between capitalism and democracy has grown as government has grown. This is increasingly apparent in the 21st century, where businesses use their political clout not to support free markets, but as Kolko (1963) observed, to create policies that cement their position in the economic elite so they can avoid being the victims of the creative destruction that characterizes a market economy. Olson (1982) describes the solidifying of interest group relationships over time as the cause of the decline of nations. The institutions of democracy eventually undermine the institutions of a market economy.

Baumol (1990, 1993) depicts entrepreneurship as the engine of economic progress, but notes that when institutions are designed so that individuals can benefit from using the force of government to transfer resources from others to themselves, people’s entrepreneurial impulses turn toward predatory and destructive activities. As Holcombe (2002b) notes, there are limited opportunities for welfare-enhancing political entrepreneurship, but there is no limit to predatory political entrepreneurship, which imposes costs on some to buy the political support of others. Political capitalism undermines both liberal democracy and the market economy by designing the rules to place the control of economic resource allocation in the hands of an elite minority. In Buchanan’s (1990) framework, they design the rules so that they retain their positions in the elite.
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There appears to be a stronger argument that the end of history is political capitalism, rather than liberal democracy and a market economy.

Conclusion

Political capitalism is an economic and political system in which the economic and political elite cooperate for their mutual benefit. While the essential idea of political capitalism has a long history, it has not been recognized as a distinct economic system. In part, this is due to the 20th-century vision of economic systems as capitalist, socialist, or a mixed economy that contains elements of both capitalism and socialism. It has also been due to the frequent vision of government as an institution that acts in the public interest, corrects market failures, and controls the activities of business. Political capitalism is an economic system in which business controls government more than government controls business. One goal of this article has been to broaden the vision of economic systems to depict political capitalism as a distinct economic system. It is not some intermediate system lying between capitalism and socialism.

A second goal of this article has been to demonstrate that while political capitalism as an economic system has barely been recognized, the building blocks that form a theoretical foundation for political capitalism are firmly in place and well-accepted. In political science and sociology, the ideas of elite domination and biased pluralism are mainstream concepts that are a fundamental part of political capitalism. In economics and public choice, the concepts of rent seeking, regulatory capture, and special-interest politics are similarly mainstream concepts, although in that literature they have not been linked to the class theories found in political science and sociology. The theoretical foundation also rests on the literature in constitutional political economy, which Buchanan (1990) has depicted as studying the choice among constraints. Economic analysis, including the literatures on rent seeking, regulatory capture, and special-interest politics, has tended to view those activities in the context of economic agents maximizing subject to the rules and constraints present in the political system, whereas political capitalism recognizes that those economic agents are the ones who are designing the rules and constraints for their benefit. The
theoretical framework for political capitalism does not have to be
developed. The building blocks are already there and just need to
be assembled so that the system is recognized.

Critics from throughout the political spectrum have observed
and criticized government policies that favor insiders and cronies
at the expense of the general public. These observations come
from the political left to the political right, from libertarians to pro-
ponents of big government. A theory of political capitalism focuses
attention on political and economic problems that are widely rec-
ognized and command broad agreement. Despite this agreement
on the causes and consequences of political capitalism, there is no
widespread agreement on policies to deal with it. On the left, there
are calls for more government oversight, more government pro-
grams, and more government spending, while on the right, critics
conclude that government is the problem and that the solution is
less government. Rather than delve into those policy differences
here, this article focuses on the areas of agreement to describe
political capitalism and assemble its theoretical foundation. If the
many ideas that build the foundation of political capitalism are rec-
ognized as describing a distinct economic system, that foundation
can lead toward more productive policy discussions to address the
problems political capitalism presents.

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THINKING AHEAD OF THE NEXT BIG CRASH

George C. Bitros

In the aftermath of the unprecedented 2008 financial crisis, researchers of macroeconomics, finance, and political economy are showing renewed interest in the old but very significant question: Are central banks in large reserve currency democracies—in particular, the U.S. Federal Reserve—prone to creating asset bubbles and, if so, how is it possible to prevent the misuse of the banks’ discretionary powers?

If one searched for guidance in the relevant literature, one would come across three main strands of thinking. The oldest stems from the views classical economists held and is expressed in the following sharp criticism that David Ricardo (1809: III, 21–22) addressed to the Bank of England for the way it managed the quantity of banknotes:

By lessening the value of the property of so many persons, and that in any degree they pleased, it appeared to me that the Bank might involve many thousands in ruin. I wished, therefore, to call the attention of the public to the very dangerous power with which that body was entrusted; but I did not apprehend, any more than your correspondent, the signature of “A Friend to Bank Notes,” that the issues of the Bank would involve us in the dangers of national bankruptcy.

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George C. Bitros is Emeritus Professor of Political Economy at Athens University of Economics and Business. He thanks two anonymous referees for their helpful comments.
Ricardo was concerned that the Bank of England violated the principle of price stability and, by doing so, risked ruining many people and driving Britain to bankruptcy. Notice though that Ricardo did not appeal to experts for devising mechanisms to tame the power of the central bank, as specialized economists are doing in our times. He appealed to the public—the ultimate source of power in democracies—by stressing that if central banks are left unchecked, they have too much power and may use it with devastating consequences for the citizens and their countries.

The 2008 events in the United States affirmed once again the time-honored truth of Ricardo’s intuition that controlling the power of central banks is an issue of political economy rather than monetary engineering, and it is precisely this realization that motivates the present article.

The second strand of thinking emanates from the Austrian theory of the business cycles that Ludwig von Mises (1936) and Friedrich A. Hayek (1939) proposed. For them, there was no doubt that ruinous bubbles are always ignited and propagated by central banks. The sequence of events they envisioned starts with an increase in the quantity of money issued by the central bank. This, in turn, lowers the nominal interest rate below the rate that would be set by the time preferences of savers. Responding to the lower interest rate, entrepreneurs create a boom by reallocating investment toward long-lived and away from short-lived capital goods, because the former become more profitable than the latter. But since the time preferences of savers remain unchanged, the demand for the output of long-lived assets grows gradually short of its supply, and eventually it becomes clear that capital has been misallocated. The greater the monetary expansion, the longer the boom and the more serious the misallocation of capital becomes. Thus, there comes a time when suddenly a recession, or depression, breaks open and leads to liquidation not only of the inefficient and unprofitable businesses but also of the speculative investments in all sorts of financial stocks, bonds, and real estate. This theory explains what happened in the United States in 2008 quite well. But before looking into this issue in detail, a reference to the third strand of thinking is necessary.

1 For a concise description of this theory, see French (2009: 111–14).
This can be inferred from the analytical approach suggested by Adam Posen (2011) and presumes that it is impossible to say whether central banks create bubbles or not, because there is the following fundamental problem of knowledge. For central banks to self-control against creating bubbles, they must be able to: (1) identify precisely the relationship between the quantity of money and current prices, as well as prices that would be warranted by the fundamentals in key sectors in the economy; (2) construct reliable indicators that will warn sufficiently ahead which misalignments between these two sets of prices are dangerous; and (3) develop instruments that will permit quick and effective interventions whenever dangerous misalignments grow beyond certain safe limits. However, such knowledge does not exist at present and is unlikely to exist in the future. For this reason, central banks ought to adopt a minimalist approach to the aims they pursue and the instruments they use to achieve them.²

From the preceding it follows that the responses vary from, “yes,” central banks do create dangerous asset bubbles, to “quite likely,” depending on how they manage monetary policy and allow for the regulation of the banking industry, to “we do not know.” As a result one might get confused or even discouraged by this lack of agreement among experts. But from a methodological standpoint, it offers a significant advantage because, by confronting the economic theories underlying the three responses with the facts, we may be able to come closer to a firm conclusion as to which is valid. Adopting this approach, I initially look at what happened in the United States in 2008 and employ the findings to assess the explanatory power of the three strands of thinking. From this assessment, it emerges that the Federal Open Market Committee (henceforth, “the Fed”) created, or at least cooperated, in the creation of a real estate bubble, which, upon bursting in 2008, led the United States into a deep recession, unsettled the international financial system, and pushed weaker countries like Greece to the brink of bankruptcy.

²However, central banks are moving in the opposite direction. The Bank of England, the oldest central bank in the Western World, recently decided to modify its century-old sole policy objective of controlling inflation by adopting a supplementary one. It now pursues flexible targets of inflation and unemployment. Given that the Federal Reserve and other central banks have pursued both policy objectives for many decades, the changes do not come as a surprise. As for the changes in central bank thinking, see the report of the Committee on International Economic Policy and Reform (2011).
Next, I discuss the ideas that have been proposed over the years to prevent central banks from misusing their power. Here I examine the literature on rules versus discretion in central banking, the influence it exercised in the conduct of Fed policy, and the present situation. The 2008 crash revealed that the institutional arrangements in place leave too much discretion to the Fed. Indeed, there are now high-level voices calling for the abolition of the Fed. Are such drastic proposals the solution? If not, how might institutional arrangements be overhauled to prevent the Fed from creating asset bubbles? If yes, what might be an alternative bubble neutral monetary regime? After addressing those questions, I conclude with a summary of the main findings and a few ideas for further research.

Determinants of the 2008 Crash

Before the 2008 collapse of the U.S. real estate market, there was another serious but relatively milder crisis in the 1980s, which emanated from the savings and loan (S&L) industry. In particular, toward the end of 1986, the rising rate of nonperforming loans of S&Ls was bankrupting the Federal Savings and Loan Insurance Corporation. The Reagan administration tried to secure the necessary funds to save it, but the Competitive Equality in Banking Act, which Congress passed in 1987, did not provide adequate funds and, even worse, compelled the Federal Home Loan Bank Board to continue pursuing regulatory forbearance, which implied allowing insolvent banking institutions to keep operating. The situation deteriorated rapidly. Losses in the S&L industry mounted and the collapse of the real estate market in the late 1980s exacerbated the problem.³

In 1991 Congress sought to take advantage of the lessons that had been learned from the S&L crisis by passing the Federal Deposit Insurance Corporation Improvement Act (FDICIA). Its provisions were designed to: (1) recapitalize the bank insurance fund by raising the ability of the Federal Deposit Insurance Corporation to borrow and to assess higher deposit insurance premiums until its reserves reached the level of 1.25 percent of insured deposits; (2) reform the deposit insurance and regulatory

³A concise account of the S&L crisis and how much it cost taxpayers is given in the report that the Congressional Budget Office (1992) submitted to Congress.
system so that taxpayer losses would be minimized; and (3) avoid regulatory forbearance and ensure quick action by regulators. FDICIA was in the right direction as it reduced the scope of deposit insurance, strengthened regulators to deal with too-big-to-fail banks, and compelled them to intervene and resolve insolvent banking institutions quickly and decisively. But, with regard to the housing policies, FDICIA left the status quo intact and this, in combination with many other institutional arrangements and bank practices, proved once again its undoing in the years that followed.

What Happened

Congress has subsidized home ownership for generations. After the S&L real estate debacle, Congress started in the 1990s to channel its support mainly through two government-sponsored enterprises (GSEs): Fannie Mae and Freddie Mac. In particular, these two “banks” extended low-interest loans to American households that did not meet the standard criteria for obtaining mortgages through the normal banking channels. To secure the necessary funds, Fannie and Freddie issued securities backed by the mortgages on the houses they financed and sold them to domestic and international banks, insurance companies, and other financial institutions. Based on the guarantees of the federal government to these two GSEs, the value of subprime securities reached $4 trillion. Thus, when the rate of nonperforming housing loans increased unexpectedly in 2008, the value of houses and the mortgage-backed securities declined precipitously, causing widespread domestic and international turmoil.4

The crisis broke open with the bankruptcy of the giant financial firm Lehman Brothers and continued to worsen as major banks,

4Among experts there is almost unanimous agreement on the above sequence of events. For example, Ferguson (2008, 267–69) argues that the U.S. financial crisis of 2008 resulted from the breaking of the bubble in the housing market. In his view, the bubble was created by granting loans to poor people to purchase houses they could not afford in the framework of the “Dream Downpayment Act” that was signed into law in 2003 by President George W. Bush (see also Wallis on 2010). However, looking backward, the beginning of the crisis was evident by February of 2007 when two major mortgage lenders announced losses tied to subprime lending. These were New Century Financial and HSBC Financial (the old Household Financial). The former was to fail, whereas the latter was bailed out by its parent.
insurance companies, and industrial concerns had to be saved with huge influsions of taxpayer money. Financial markets froze and banks stopped lending. Foreclosures of houses skyrocketed. Consumption decelerated as rising unemployment eroded personal incomes and consumers started to deleverage. Enterprises postponed investing as the uncertainty about the duration of the recession and the response of policymakers was heightened. In short, financial and real markets entered a recessionary spiral that gradually reversed after the Fed started to pour hundreds of billions of dollars into the economy in November 25, 2008, through consecutive rounds of quantitative easing. Since then economic growth has been restored but at a very slow pace, inflation remains subdued, and the double-digit rate of unemployment has declined to 6.2 percent. But the situation continues to be precarious because the economy is beset by many macroeconomic imbalances, especially those caused by the Fed’s policy of keeping its target interest rate (the fed funds rate) close to zero.

The effects of the U.S. crash spread quickly to Europe, the emerging economies, and the rest of the world. In the European Union (EU), recession hit early and hard because many major European banks, which had invested in the toxic subprime securities of Fannie Mae and Freddie Mac, lost significant percentages of their capital and slowed lending. Without much delay, Greece succumbed to the crisis and its potential bankruptcy threatened the stability of the European financial system and the eclipse of the euro. Shortly afterward, the crisis worsened in Ireland, which had entered the crisis in early 2008 (predating the Greek crisis), and spread gradually to Portugal, Spain, Italy, and, much more recently, to Cyprus, revealing major fiscal and structural imbalances in all Mediterranean countries. Currently, recession shows signs of a turnaround, but unemployment continues to stay at historically high levels. Through this very trying five-year period the European Central Bank (ECB) kept a moderately aggressive posture. It intervened in situations that risked major unsettling of the euro, but, unlike the Fed, it refrained from reverting to the printing press to stimulate economic growth and reduce the high rate of unemployment. The ECB has kept its lending rate low but positive and, despite all predictions, the euro has retained much of its value relative to the U.S. dollar and the other reserve currencies.
As recession in the United States and the European Union took hold and slowed down imports, the effects of the crisis spread to the rest of the world. The ripples hit emerging countries—such as Brazil, Russia, India, China, and South Africa (the BRICS)—very hard as exports of consumption goods and natural resources slumped. From these events, it became evident that government and central bank policies in the large reserve currency countries can cause international spillovers whose costs may exceed the benefits governments and central banks attempt to secure locally through their policies. By implication, this evidence introduced in the analysis a new dimension, which is too significant to be ignored.\(^5\)

**Why It Happened**

Bubbles in market-based economies pop up suddenly, but they gather strength over extended periods of time through the confluence of many usually unsuspected forces. The 2008 bursting of the real estate bubble in the United States was not an exception. It formed slowly over many years and became unsustainable due to numerous institutional arrangements and bank practices with near catastrophic consequences. The synopsis below centers on the ones identified by Charles Calomiris (2009) as more or less responsible for the formation and bursting of the latest real estate bubble.

**Government Errors of Omission.** In the banking industry a basic objective of regulation is to prevent banks from undertaking risks in excess of their capital. However, given that risks and returns are correlated positively, banks usually find ways to bypass the barriers imposed on them by the regulators in the form of capital requirements and to move to higher risk-return points. Calomiris (2009: 65–66) shows that commercial and investment banks practiced regulatory arbitrage by buying various forms of newly invented securities that were improperly priced for the risks they involved, and by booking the value of these securities off their balance sheets. In view of the widespread usage of these practices, many researchers have argued that the subprime crisis emanated from government “errors of omission” that allowed

\(^5\)According to experts on the Committee on International Economic Policy and Reform (2011), these spillovers are now of first-order importance and call for rethinking the role of central banks.
banks to avoid regulatory discipline. Calomiris (2009: 66) agrees with them by noting:

There is no doubt that the financial innovations associated with securitization and repo finance were, at least in part, motivated by regulatory arbitrage. Furthermore, there is no doubt that if on-balance sheet commercial bank capital regulations had determined the amount of equity budgeted by all subprime mortgage originators, then the leverage ratios of the banking system would not have been as large, and the liquidity risk from repo funding would have been substantially less, both of which would have contributed to reducing the magnitude of the financial crisis.

But also he goes several steps further by offering solid evidence to the effect that the errors described below were far more significant in generating the huge risks and large losses that brought down the U.S. financial system.

**Government Errors of Commission.** According to Calomiris (2009: 68–71), the undertaking by managers in large financial institutions of excessive and improperly priced risks did not result from “random mass insanity.” Rather, it resulted from specific government and Fed policies that induced and encouraged their disastrous behavior. To substantiate his arguments with regard to government policies, he cites three groups of distortions:

**Group 1**

- Political pressures from Congress on the government-sponsored enterprises Fannie Mae and Freddie Mac to promote “affordable housing” by investing in high-risk subprime mortgages.
- Lending subsidies via the Federal Home Loan Bank System to its member institutions that promoted high mortgage leverage and risk.
- Subsidization of Federal Home Associations to high mortgage leverage and risk.
- Mortgage foreclosure arrangements that were developed in the late 1990s and early 2000s to reduce the costs to borrowers who failed to meet debt service requirements on their mortgages.
- Almost unbelievable, legislation in 2006 that encouraged ratings agencies to relax their standards for measuring risk in subprime securitizations.
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Group 2

- Government restrictions limiting pension funds, mutual funds, insurance companies, and banks from holding anything but tiny stakes in any particular company. As a result, effective corporate governance within large financial institutions was rendered virtually impossible, thus giving a free hand to managers to pursue their own interests, not those of shareholders.

Group 3

- Regulators took at face value the assessment of risks by credit rating agencies and internal bank models.
- Even if regulators detected that “too-big-to-fail” financial institutions suffered large losses and that they had accumulated imprudently large risks, regulators would have found it difficult to credibly enforce effective discipline on large, complex banks.

In addition it should be noted that regulators and credit rating agencies are in an inferior position relative to the information financial institutions have regarding the quality of their assets and liabilities. By implication, the measurement of credit risks is beset inherently by major informational and methodological problems.

Federal Open Market Committee Errors. With respect to the Fed, Calomiris (2009: 67–68) argues that it erred on three counts: First, during 2002 to 2005, the Fed kept real short-term interest rates “substantially and persistently” below the levels that would have been consistent with fundamentals.\(^6\) Second, during the same period, the yield curve was flat, meaning that the Fed kept real long-term interest rates at historically low levels.\(^7\) Third, the available empirical evidence shows that, under the above conditions, banks charge less for bearing risk and even resort to alchemies that are possible “only because asset managers decide to purchase very risky assets and pretend that they are not very risky.”\(^8\)

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\(^6\)For evidence to the effect that the policy interest rate in the United States (and other advanced economies) was far below what the Taylor Rule called for between 2002 and 2005, see Taylor (2007, 2011).

\(^7\)Data and explanations as to why the yield curve was flat during the period in question are given in Backus and Wright (2007).

\(^8\)Bekaert et al. (2010) and Maddaloni and Peydro (2010) find empirical evidence according to which loose monetary policy decreases risk aversion and increases risk-taking in bank lending, both in the United States and the eurozone.
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From the preceding it follows that the formation and bursting of the 2008 real estate bubble in the United States was not exclusively the result of “animal spirits,” “crowed madness,” or “irrational exuberance.” It resulted also because of the specific policies that the government and the Fed pursued. Actually, on account of these policies, the surprise is not what happened. The surprise would have been if it had not happened. Therefore, to prevent the next big crash, which may bring down the international financial system, it is necessary to identify the primary culprit of the 2008 debacle.

Assessment

The government contributed to the formation of the real estate bubble in many ways. It induced Fannie Mae and Freddie Mac to promote “affordable housing” by investing in high-risk subprime mortgages. It encouraged financial institutions that specialize in housing loans to adopt lending policies of high mortgage leverage and risk, and it even granted incentives for the credit rating agencies to relax their standards for measuring risk in subprime securitizations. Viewed in the context of the experiences of the S&L crisis in the 1980s and the changes that globalization introduced in the world economy in the meantime, these policies in the 1990s and 2000s were at least imprudent. For, how else can such policies be characterized when their undesirable consequences in the United States and the world might have been prevented? Unfortunately, this incident is part and parcel of the crisis in representative democracy (Bitros and Karayiannis 2013). All indications are that it will be repeated, unless the Fed stays firm in the course of a prudent monetary policy, irrespective of the vicissitudes of the business cycles and the suasions, if not pressures, from politicians.

9 Contrary to central-bank-induced bubbles, those instigated by avarice, manias, animal spirits, crowed madness, and other similar traits of human nature will continue to emerge from time to time. But given that they pop up spontaneously, one can never distinguish in advance the good from the bad ones, and hence market discipline recommends that they should be left to run their course. Otherwise, as documented by French (2009) in the case of three famous episodes, quantity of money related central bank interventions risk making the situation worse.

10 The House of Representatives introduced recently the Federal Reserve Accountability and Transparency Act of 2014 in the expectation that, by strengthening the political oversight in the conduct of monetary policies, the Fed might be restrained from using its discretionary powers in ways damaging to taxpayers. However, past experiences do not bode well with this expectation because the provisions of the act very likely will result in further politicization of the Fed (see Dorn 2014).
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Can the Fed be trusted in this regard under the present state of knowledge and institutional circumstances? The monetary policies leading to the 2008 crash speak for themselves. For, if the real long-term interest rates are kept by monetary authorities “substantially and persistently” at historically low levels over several years, even without knowledge of the Austrian business cycle theory, a first-year university student of economics would expect the prices of houses and other durable assets to go into an upward spiral and their stocks to accumulate into unsustainable levels. The empirical evidence leaves no doubt that this is actually what happened in the United States. Under the housing policies pursued by the government and the shortcomings of the macro- and micro-prudential provisions of bank regulation, which were fully known to the monetary authorities, the Fed ought to have pushed real long-term interest rates to much higher levels well before the housing bubble formed in the 2002-05 period. Hence, the Fed must be held primarily responsible for the formation and bursting of the 2008 real estate bubble. Therefore, given that the reasons that lay behind Ricardo’s criticism of the Bank of England 200 years ago and convincingly reaffirmed by Mises and Hayek in the first half of the 20th century continue to hold, central banks cannot be trusted to conduct bubble-neutral monetary policies, and indeed not even if for some period they abide by a bubble-neutral monetary rule.

While this realization may be innocuous for central banks in small and peripheral economies, it is very ominous in large reserve currency countries where central banks may create bubbles, the bursting of which transmits damaging spillovers all over the world. That is why the question of how to prevent central banks from this inherent tendency, particularly in large representative democracies like the United States, is as urgent as ever.11

The Dashing of Hopes in Monetary Rules

Money in market-based economies is a great force. It facilitates transactions as no other means could do; it helps economic agents achieve superior efficiency in the intertemporal allocation of their

11The urgency of this task is amply corroborated by the fact that such high-profile economists as McCallum (2010) are in the search for alternatives to the present Fed arrangements and recommend reforms along the lines that have been suggested by Greenfield and Yeager (1983).
resources; and it multiplies choices that enhance individual freedom. But just as water, fire, nuclear energy, and other powerful forces must be confined in order to yield their benefits to mankind, the quantity of money must be kept within bounds—because if it gets out of hand its destructive power is too well known.

To control the quantity of money, classical economists insisted that central banks ought to abide by two principles: (1) convertibility, which required currency in circulation to be convertible into metallic money on demand, and (2) central banks should limit the quantity of money so as to keep the general price level stable. However, as revealed by Ricardo's passage in the introduction and repeatedly affirmed by many crises over the decades, notwithstanding the devastating one in 1929, these principles left too much discretionary power to central bankers. In the 20th century this was certainly true under the gold exchange standard and much more so after 1972, when convertibility was abolished and all money became fiat paper money whose value is based solely on the trust of citizens in their government.

Thus, in view of the central banks' aberrations in the management of the quantity of money and the severe consequences that all too frequently resulted for the people, it was hardly surprising that some economists would come up with ideas and recommendations to curb their discretionary power. In the postwar period, the leading one among them was Milton Friedman (1948) who proposed 100 percent reserves along with the creation (withdrawal) by the Fed of amounts of money equal to the budget deficits (surpluses). Under this rule, banks would become S&Ls and the Fed would be limited to balancing the positive and negative cash flows of fiscal policies. Later, Friedman (1959, 1962, 1968, 1969, and many other publications) emphasized that the monetary rule should be expressed as an increase of k percent in the money supply per annum. In all these writings he defended his proposed rule on political economy concerns. For example, in the study in which he laid the foundations of monetarism, Friedman (1969) offered three rationalizations. The first stems from the appointment of the chairman and the members of the Fed by politicians.

12 Regarding Friedman's views on the issue of the viability of free banking there is some controversy. For example, Selgin (2008: 288) writes: "Although Friedman ultimately concluded that there is 'no reason currently to prohibit banks or other groups from issuing hand-to-hand currency' (Friedman and Schwartz 1986: 52), his opposition to official paper currency monopolies remained lukewarm."
Because of their associated incentives, Friedman suspected that central bankers might abrogate their duty to maintain a stable price level and instead use their privilege of seigniorage to favorably influence the economic and electoral cycles, something that he considered unacceptable and dangerous. His second rationale emanated from the impact of money in the real economy. From his researches over the years Friedman had come to realize that the effects of money in the short-run are so important that its management cannot be entrusted to the discretion of central bankers who are closely affiliated with politicians. Lastly, Friedman believed that if the Fed did follow the aforementioned rule, its effectiveness would be enhanced.

Beginning in the 1970s, Friedman’s arguments in favor of rules in the conduct of monetary policy started to be reinforced by new theoretical and empirical studies. Research efforts highlighted the issues of time consistency in the policy regime and the influence that the reputation of the policymaker exercises in this regard. The seminal papers by Kydland and Prescott (1977), Calvo (1978) and Barro and Gordon (1983) showed that the effectiveness of economic policies based on fixed and known rules is systematically higher than policies based on discretion. In particular, they found that discretionary economic policies change the plans of individuals and increase uncertainty. Consequently, such policies are bound to be accompanied by adverse effects that are more serious than those of economic policies based on rules. Strongly reinforcing those results were the results from studies of the conduct of monetary policy using parameter estimates from economy-wide econometric models. In a series of papers, which begun with Lucas (1975) and culminated with Lucas (1980, 1981), it was established that parameter estimates from such models are not invariant with respect to changes in the policy instruments, particularly when people’s expectations are important. In the extreme, the studies showed that if people have rational expectations about future economic conditions and markets are self-coordinating, discretionary monetary policies are ineffective. Only sudden or unexpected monetary policies that take people by surprise could have some effect. But as

13Empirical studies from many countries show that a policy of maintaining a stable price level in the long run is highly conducive to economic growth (see Masson 2008).
people learn from experience, they take precautionary measures and neutralize the effectiveness of interventions by monetary authorities.\footnote{In retrospect it seems that the supporters of the Rational Expectations School ought to have stopped short of concluding that bubbles are not possible because all market participants act rationally and through learning and experience can foretell the future. Market participants may indeed act rationally and learn through experience. But they do so within a given environment of technological knowledge and institutions and cannot foretell the future because they cannot know in advance future changes in these environments. Hence, bubbles are still possible and monetary policies may have an effect, but as long as policy instruments influence the structure of the economy, central banks cannot fine-tune their interventions and they risk doing more harm than good.}

Considering the very strong empirical basis of the “Lucas critique,” the Fed switched to estimates from macroeconomic models based on rational expectations in the 1980s. However, as these did not perform any better than the old “wrong” models, the sentiment started slowly to shift toward monetary policies based on rules. This trend received very significant boosting from the transfer into economics of schemes of thought and analytical tools from the theory of chaos, which is widely used in the natural sciences (see Parker and Stacey 1994). According to this theory, policy authorities cannot fine-tune the structural features of the economy so as to push it toward equilibrium. The reason is that all short-term effects, either positive or negative, are followed by feedback effects and it is impossible to know in advance how these will affect the structural characteristics of the economy in the long run. To corroborate this assertion, let us see how a policy can be implemented, either as a reaction to something negative (e.g., rising unemployment) or as an initiative to prevent some undesirable development (e.g., emergence of unemployment). The policies in these two cases will have different feedback effects. In particular, policies to reduce unemployment may have much better results than policies to prevent the occurrence of unemployment, as happened in many economies following Keynesian policies in the 1970s. But even if unemployment is reduced and the economy reaches some sort of equilibrium, this will be temporary, because new disturbances stemming, for example, from innovative entrepreneurship will start a new round of adjustments that will most
likely pass undetected by the authorities to promptly revise employment policies. Conversely, if the authorities do not intervene, as was mostly the case before 1929, the economy would absorb the feedbacks from the disturbances moving along a path of continuous adaptation (as in the theory of chaos) and it will not remain in equilibrium.\(^\text{15}\) This is exactly the difference that explains why state interventions may give rise to more negative than positive results. In other words, such interventions are “second best” because they destroy the flexibility of the economy and they lack the self-coordinating feedback mechanisms for timely adaptation to disturbances.

The turn in the 1990s found investigations into the design of a monetary rule characterized by simplicity and good tracking properties in full swing. According to the study by Asso, Kahn, and Leeson (2007), after successive approximations, experts acceded to the monetary rule proposed by Taylor (1993), which is summarized as follows: The central bank’s policy should strive to equate the interest rate on short-term loanable funds with the sum obtained by adding the rate of inflation, plus half the difference between the nominal GDP from its trend, plus half the difference between the rate of inflation from its target rate, plus two. Research shows that from 1993 to 2001 the Fed behaved as if it followed this rule and much of its success was attributed to having done so.\(^\text{16}\) In turn, this success led to the view that the gap between classical and Keynesian monetary policies had been bridged and at last the discretionary powers of the Fed had been tamed. However, in the wake of the 2008 crash, many of the old concerns about the discretionary power of central banks

\(^{15}\)If the reader suspects that this process is reminiscent of the one adopted by neo-Austrians to describe the process of continuous change in the economy, the reader is correct. In their view, in this process there is no equilibrium, and hence it is utterly futile to attempt to achieve one through policy initiatives. The only thing that transpires are the decisions of a number of people who, acting in a process of continuous trial and error, lead to beneficial or nonbeneficial results. Therefore, the essence of the economy is in the predisposition of people to act, whereas what is maximized by voluntary exchanges is the flexibility of the economy to receive and adapt to disturbances.

\(^{16}\)The Fed has never revealed explicitly that during this period they were following some specific monetary rule. But according to Calomiris (2009: 68), Garrison (2009: 193–94), and other researchers, the data show that from 1993 to 2001 the Fed behaved as if it was following the Taylor Rule.
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resurfaced with the acute urgency that Crook (2009) expressed in the Financial Times:

Friedman’s incongruous naivety is at odds with his skeptic personality. In his own book Capitalism and Freedom, he says: “As matters now stand, while this rule [the k-percent rule] would drastically curtail the discretionary power of the monetary authorities, it would still leave an undesirable amount of discretion in the hands of Federal Reserve and Treasury authorities with respect to how to achieve the specified rate of growth in the money stock, debt management, banking supervision, and the like.”

Both Friedman and Taylor seem to be aware of the fallibility of agency intervention into the supply of money; and yet, inexplicably, both seem in the end to take for granted that the agency in question will be willing to renounce discretion when push comes to shove.

By implication, recent events proved the hard way that such central bank notions as “commitment” and “credibility” are pious pronouncements that do not amount to much when “push comes to shove.” In the face of this development, the urgent question is how to forestall the Fed from creating the next asset bubble, the crash of which may bring down the international monetary system.

Representative Democracy and Bubble-Neutral Monetary Regimes

The 16 world-renowned economists on the Committee on International Economic Policy and Reform do not deal with the above question directly in their 2011 report on “Rethinking Central Banking.” However, their answer may be inferred from page 28, where among other qualifications they state: “Central Bank independence ultimately rests on political consensus—on the convergence of views among leading political interests that society’s broader economic goals are best served by this independence.” That is, the solution they propose is to render the Fed “independent” and do so by “political consensus.” Does their proposal have any real value? It has not, for at least two fundamental reasons: (1) political parties in representative democracies are beset by moral hazard problems that make political consensus unlikely, and (2) democracy stands on the
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principle of not granting independence to any person, collective entity, or institution—even if it were certain this would serve society’s broader goals.17

Constitutionally Backed Monetary Policy Rules

The previous analysis led to three findings. First, if the Fed had not deviated sharply from the Taylor Rule, which it appeared to be following up to 2001, no real estate bubble would have formed and the Fed would have spared the United States and the world from the ruinous consequences of the 2008 crash. Second, the Fed deviated from the policies that were recommended by the Taylor Rule when “push came to shove.” Third, it is not just the Fed that is prone to bubbles but also Congress, the president, and banking regulators. Consequently, the high-level voices that call now for the abolition of the Fed should be construed as a demand for the complete overhaul of the current monetary regime, not just piecemeal reforms that have been tried and failed. Thinking in this direction, prudence would recommend that before considering a new bold monetary regime without a central bank, some intermediate regimes may be easier to adopt politically and may save precious time.

One reform would be to pass a constitutional amendment that would require the Fed to conduct monetary policy by following a fixed rule known to economic agents in advance. Contrary to the

17Milton Friedman (1962: 50–51) explained convincingly why unqualified central bank independence is undesirable:

Any system which gives so much power and so much discretion to a few men that mistakes—excusable or not—can have such far-reaching effects is a bad system. It is a bad system to believers in freedom just because it gives a few men such power without any effective check by the body politic—this is the key political argument against an “independent” central bank. But it is a bad system even to those who set security higher than freedom. Mistakes, excusable or not, cannot be avoided in a system which disperses responsibility yet gives a few men great power, and which thereby makes important policy actions highly dependent on accidents of personality. This is the key technical argument against an “independent” bank. To paraphrase Clemenceau, money is much too serious a matter to be left to the Central Bankers.

This quotation is reminiscent of Ricardo’s warning. Moreover, aside from this conceptual stand on central bank independence, under prevailing arrangements it is extremely difficult to monitor the degree of independence that the central bank actually exercises (Cargill and O’Driscoll 2013).
standard formulation of Friedman’s original idea, the proposed constitutional amendment would not set a specific monetary rule. Since economic conditions and central bank thinking change, the Fed should be able from time to time to change the monetary rule. But the degree of its discretion should be bounded by the prerequisites that the monetary rule is fixed and known, and that when the rule is changed, economic agents should be informed in advance. In this framework, the pressures from politicians on the Fed to change the monetary rule in order to serve certain social policies would be mitigated by the requirement that the change would have to be announced in advance. For then, economic agents would have the time to gauge the consequences and take measures to hedge against them.

Introducing a constitutional wedge of the above form would strengthen the resistance of central bankers to pressures by politicians to influence the economic and electoral cycles via seigniorage so as to enhance their chances of re-election. But the incentives of central bankers which give rise to the moral hazard problems would not be affected and this would be a major weakness.

Constitutional Upgrading of the Central Bank

In a monetary regime consistent with representative democracy the independence of the central bank might be conceived on grounds similar to those of the other three branches of government. For example, the judicial branch in the United States is independent from the legislative and the executive branches. But its independence is bounded by a system of checks and balances, which precludes members of the Supreme Court from exercising absolute power—that is, power irreverent to the objectives pursued by the other two branches of government, as expressed and mandated through the laws. Analogously, the executive and the legislative branches of government are independent but bounded to respect the decisions arrived at by the Supreme Court. Hence, it would constitute a major regime change if by a constitutional

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18James M. Buchanan (2010: 257) also has argued for a constitutional amendment, noting that “monetary authority must be formally constitutionalized by amending the Constitution, a process that, in itself, would modify public attitudes.” He does not propose a specific rule.
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amendment the Fed was upgraded into a fourth branch of government, bounded only by the checks and balances that would be spelled out in the amendment. In this framework, the independence of the Fed would be circumscribed by the law and honored as such by the other branches of government. Like the Supreme Court justices, the governors in the Fed would be appointed for life, so that all their incentives to capitalize on their knowledge and social prestige by jumping to private practice would be quashed. The differences among the political parties regarding the orientation of monetary policies would be reflected in the views held by those who are appointed as governors and in the influence they might exercise in the stance of the Fed as a collective entity. Finally, monetary policy would be driven by concerns to serve the longer-run interests of society, not the short-run interests of politicians and organized pressure groups.

In the heat of everyday debates about inflation, unemployment, debt sustainability, exchange rate valuation, and competitiveness, the position of the governors of the Fed would differ significantly from that of Supreme Court justices. Their decisions quite frequently would be dragged into bruising battles among the political parties. Many would read in them biases toward one group or another, and they would be accused of social insensitiveness. To reduce the adverse influences of such divisive debates on the credibility of monetary policy, the proposed upgrading of the Fed should be supplemented with a monetary policy rule that would make policy transparent and enable the Fed to stay firm in the course of bubble-neutral monetary policies. Moreover, in the interest of better coordination and enforcement, it may be advisable to bring micro- and macro-prudential policies and agencies under the authority of the Fed, if further research showed that the moral hazard problems of regulation would be reduced.

Buttressing the Fed in the above manner requires that it can control the supply of money or the policy interest rate. Otherwise, the only viable monetary regime is free banking.

In the original U.S. Constitution, the Founding Fathers provided for money that would be based on a commodity standard like gold or silver. Hence, the acts of Congress that established the Fed in 1913 and abolished convertibility in 1972 might be considered unconstitutional. Unlike these major monetary regime changes, my proposal calls for a constitutional amendment.
Monetary Regime without a Central Bank

Under a rules-based monetary policy, the Fed may target either the quantity of money or its opportunity cost (i.e., the interest rate), but not both. Until 1982 it targeted mainly the quantity of money using M1, i.e. the narrowest and most precisely defined monetary aggregate. However, subsequently, monetary targeting waned and in 1993 it was abandoned altogether.\textsuperscript{20} Benjamin Friedman (2006) attributes this change to the views Alan Greenspan expounded regarding the usefulness of rules in conducting monetary policy while he served as chairman of the Fed from 1987 to 2006. But in the light of Milton Friedman’s (2006) assessment, the likelihood is that Greenspan’s pronouncements had to do more with the blurring of the various monetary aggregates rather than his ideological inclinations. One ground for this conjecture is that all aggregates used in monitoring money growth rates lost gradually their sharpness and their usage in fine-tuning the changes in the money supply became superfluous, if not dangerous. According to monetary experts, this shift occurred because of the opening up of the country’s borders due to globalization, the acceleration in offshoring, and the importance of the U.S. dollar as the preeminent international reserve currency, which implies that a large portion of the U.S. money supply circulates abroad. Another ground is the shift away from money and toward interest rate rules that took place in the literature and in professional opinion. Reflecting on its importance, it is perhaps more than a coincidence that the abandonment of money targeting was announced by the Fed in the same year as the publication of Taylor’s (1993) highly influential paper. Finally, Greenspan’s vows in favor of discretion proved innocuous because the policies that were adopted up to 2001 coincided closely with the ones that would have been recommended by the Taylor Rule. Hence, if the political economy arguments that were advanced previously to explain the errors of the Fed after 2001 are not convincing, the question is how else we might explain them so as to prevent their repetition.

\textsuperscript{20}Taylor (1993: 199, 204) thinks that in 1986 the Fed started following an interest rate rule consistent with the Taylor Rule.
An explanation is that the observed aberrations of the Fed reflected not errors but policy limitations. This would be plausible if the Taylor Rule was abandoned after 2001 because the Fed had lost control of the interest rate. Could this be the case? It could because, when Garrison (2009: 191) compared the evidence from the periods of Miller-Volker (1978–87) and Greenspan-Bernanke (1987–2014), he found that “just as the blurring of the money-supply definition virtually destroyed the viability of a money-supply rule, the federal government’s housing policy and attendant financial innovations during the Great Moderation have virtually destroyed the viability of interest-rate targeting.” 21 If Garrison is right, the case for rules-based monetary policy hinges in principle and in practice on the necessity for the Fed to regain control over the money supply or the interest rate in a way that will be transparent to private agents. Is it possible? For, if it is not, the case in favor of a monetary regime without a central bank becomes the only viable alternative.

Unfortunately the vast majority of the relevant literature since 2008 has focused on piecemeal technical reforms to enhance the analytical and applied capabilities of central banks to control bubbles. Examples abound. Just to mention a few, De Grauwe (2008) presents arguments in favor of the view that central banks may be able to improve macroeconomic stability (i.e., lowering the variability of output and inflation) by targeting stock prices; Teo (2009) compares the welfare implications of exchange rate and interest rate targeting and finds that under certain conditions the former gives results which are superior to the latter; and Shiratsuka (2011) recommends that central banks incorporate into their models information from macro-prudential analyses regarding changes in investors’ attitudes toward risk taking.

If one searched for research efforts allowing for the fallibilities of the central banks themselves, one would find very few. Among them are the studies by Calomiris (2009) and Garrison (2009). Calomiris (2009: 88–90) stands firm in the view that the Fed may regain control, provided that the government introduces the

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21 The Great Moderation lasted from the mid-1980s to the mid-2000s. Hence, it largely coincided with the period during which Greenspan served as chairman of the Fed.
extended list of reforms he proposes. Meanwhile, Garrison (2009: 198) holds that “once the current recession . . . is behind us, there can be no simple return to normalcy. Money-supply targeting is operationally nonviable, and interest-rate targeting will be seen (by the market and, it is hoped, by the Fed) as nonviable.” In his view, the only viable alternative is to replace the present monetary regime with one driven by choice among currencies, along the lines that Hayek (1976) and Selgin and White (1994) have suggested.  

However, neither of these two courses of action looks feasible in the foreseeable future. From a political standpoint, some of the reforms proposed by Calomiris (2009) may go through fairly easy, whereas those that relate to the too-big-to-fail banks may remain on the to-do list for a long time. The prospects for their adoption are extremely slim, given the moral hazard problems inherent in the current system. As for the scrapping of the Federal Reserve System, this would require either an upheaval in the political system or a crash of such monumental proportions that the citizens themselves would take the control in their hands and impose a decentralized market-based system of currency provision and circulation. Which event may happen first is impossible to say. But given the inertia of representative democracy in issuing blank checks to be paid by future generations, the latter possibility cannot be precluded.

Garrison’s conjecture that interest-rate targeting has become operationally nonviable can be reinforced by drawing on Phelps (2010) and Dowd, Hutchinson, and Kerr (2012). According to these authors, the crisis erupted because the managers and shareholders of big financial institutions failed to perceive the nature of the risks that were associated with their decisions. Consequently, they failed to hedge against them appropriately. They did not realize that the risks emanated from Knightian uncertainty, which is incalculable and renders the course of future events unknown. In the words of Phelps (2010: 137):

One of the towering lessons of the present crisis is that it has made vivid to us what has long been obvious to all but the most doctrinaire academicians. Radical uncertainty, known as “Knightian uncertainty,” is always present in some respects and is always a significant consideration—at least, in a modern economy or even a traditional economy operating in a modern global economy. . . . An important consequence of this flare-up of uncertainty is that the central bank does not know the level to which to set the “policy rate of interest” and thus the direction in which to start moving the policy rate.

In either event, what particular form such a decentralized system might take may be glimpsed from the fast growing literature on free banking, an excellent summary of which can be found in White (2011).
Conclusion

The 2008 crash in the United States showed that, while a rules-based monetary policy may be necessary to prevent central banks from contributing to the creation and bursting of assets bubbles, it may not be sufficient. The reason is that, under the present institutional circumstances, the relations of central banks to politicians, regulators, and organized pressure groups are beset by serious moral hazard problems, which induce them to deviate from the monetary rule when push comes to shove. This problem is generic to all countries organized as representative democracies with more or less free-market economies, but it applies especially in the case of the Fed because the U.S. dollar, as the world’s leading reserve currency, circulates widely abroad. As recent events made obvious, its fallibilities may bring down the whole international financial system. That is why the question of how to forestall another and perhaps bigger crash in the future is most urgent.

Assuming that the Fed can control the quantity of money or the policy interest rate, thinking ahead of events would recommend upgrading the Fed’s constitutional status to a fourth power of government, much like the judicial branch, and passing a constitutional amendment that binds the Fed by a firm monetary rule. By expanding its independence within the established framework of checks and balances, appointing its governors for life to stem the moral hazard problems, and following a monetary policy rule, the Fed should be able to stay the course in pursuing a bubble-neutral monetary policy. It should be noted, however, that there is a fair amount of literature that questions the ability of the Fed to control its target variables. If that is the case, and it is confirmed by further research, soon a dilemma will arise as to the appropriate reforms.

In view of this outlook, some experts hold that the Fed can reestablish control over its target variables provided the government introduces a wide range of reforms, while other experts argue that the Fed has lost control and there is no going back to money or interest-rate targeting. Acting along the first approach would require a far-reaching reform of the existing monetary system. Proceeding along the second approach would require scrapping the Federal Reserve System and replacing it with a market-based
monetary regime. In either case, the reforms are going to be highly unsettling in the short run. But since under the present institutional circumstances another bigger crash can be conceived as unavoidable, we should not let it happen.

References


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INCOME INEQUALITY: PIKETTY AND THE NEO-MARXIST REVIVAL

Thomas H. Mayor

Karl Marx formulated his ideas in the middle of the 19th century when much of Europe, particularly England, was well along in what is often referred to as the Industrial Revolution. The central Marxist idea was that those who had wealth would reap the benefit of this revolution and become ever more wealthy while those who lived from their labor alone would be relegated to a bare subsistence. In his view, capital accumulation and increases in productivity do not benefit those who work for a living. Allegedly, those who own the means of production (wealth) and supposedly perform no work, receive all of the benefits.

It has, of course, long been obvious that this idea is false. Marx apparently did not understand that as capital and wealth increase and innovations occur, workers become more productive, and firms have an incentive to offer higher wages so as to compete away workers from rival firms. Thus, far from being antagonistic to the interests of workers, innovations and the accumulation of wealth (regardless of who owns that wealth) increase the demand for labor, raise real wages, and are a boon to workers. Those effects, although not recognized by Marx, are standard features of all introductory textbooks in economics.
The Marxist view that increases in wealth accumulation, productivity, and economic growth benefit only the owners of capital has been and should be resoundingly rejected given the enormous increase in the incomes of workers in advanced countries over the past two centuries. Such facts cannot be ignored.

Nevertheless, the last few years have witnessed an upsurge in populist rhetoric espousing the view that the economic system is somehow rigged to benefit the wealthy at the expense of the general citizenry and that the resulting income inequality is an urgent issue. These populist arguments have been a key characteristic of political movements in many parts of the world and doubtless an important explanation for economic stagnation or disintegration where those movements have been able to implement their policies. Yet, despite this long and dismal record of failure, similar views appear to be gaining traction in the United States. The “top 1 percent” has become a common pejorative in social media.

U.S. politicians talk about business owners not being responsible for their own success. Even columnists in the Wall Street Journal write about how workers are not keeping up with increases in productivity (implying, of course, that wealth holders are more than keeping up).

A recent addition to the populist upsurge, Thomas Piketty’s Capital in the Twenty First Century, is headed to be one of the all-time best-selling books in the field of economics. Members of the populist community who have rushed to purchase a copy apparently regard the book as confirmation of their world view. Reduced to its essence, the Piketty argument is that a free market economy systematically favors the wealthy by causing the share of national income accruing to wealth holders to increase over time. To counteract this alleged tendency, Piketty proposes punitive taxes targeted at those with high incomes and wealth. As an important intellectual rationale for the modern populist cause, the book’s core conclusions and arguments deserve close scrutiny.¹

Well, is the system rigged in favor of the wealthy at the expense of the general public? The short answer is no, not even close. To show why, let us examine the Piketty argument in more detail. Although

¹The Piketty book also includes an analysis of income distribution based on tax return data that appear to show rising inequality. The deficiencies in these data have been adequately addressed elsewhere by Reynolds (2014) and Feldstein (2014).
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the book is quite lengthy, its main points are succinctly summarized in the author’s concluding chapter (Piketty 2014: 571) where he states the following:

• The principal destabilizing force has to do with the fact that the private rate of return on capital, \( r \), can be significantly higher for long periods of time than the rate of growth of income and output, \( g \).
• The inequality \( r > g \) implies that wealth accumulated in the past grows more rapidly than output and wages. This inequality expresses a fundamental logical contradiction. The entrepreneur inevitably tends to become a rentier, more and more dominant over those who own nothing but their labor. Once constituted, capital reproduces itself faster than output increases. The past devours the future.
• The consequences for the long-term dynamics of wealth distribution are potentially terrifying, especially when one adds that the rate of return on capital varies directly with the size of the initial stake.

Well, there you have it. According to Piketty, Marx was right after all.2 The free market is rigged in favor of the wealthy, and the future of a system of free and voluntary cooperation, is “terrifying.” But is Piketty right? Let us answer this question by first examining the logical basis for his \( r > g \) inequality. We can then examine the empirical

2Many readers of Piketty will interpret his book as an attempt to rehabilitate the basic ideas of Marx. He surprisingly credits Marx with proposing “the first scientific analysis of capitalism and its collapse,” concluding that “economists today would do well to take inspiration from his example” (Piketty 2014: 9-10). On pages 227–28, he argues that Marx’s view that wages could not increase under capitalism was understandable because when he formulated his theories he did not have sufficient evidence of productivity increases. But Piketty is clearly wrong on this point. Marx was fully aware of the enormous advances in productivity that were taking place in the 19th century. In fact, such recognition plays a central role in his early writings such as The Communist Manifesto (1848) as well as his later writings such as Das Kapital (1867). The Communist Manifesto (p. 10), for example, states “the bourgeoisie, during its rule of scarce one hundred years, has created more massive and more colossal productive forces than have all preceding generations together.” While showering all of this praise and absolution on Marx, Piketty (p. 5) refers fleetingly to Adam Smith as having “political prejudices.” Smith, of course, probably contributed more to our current knowledge of economics than any other person. His ideas concerning scientific economics are at the core of modern textbooks. Marx’s ideas are long discarded. For a discussion of Marxist influence in the Piketty book, see Goldberg (2014).
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evidence for r and g. Following Piketty, this article defines r and g in real terms net of inflation. Thus r is the rate of return on capital or wealth over and above the rate of inflation, and g is the rate of growth in national income or output over and above the rate of inflation.

The Fallacy of Piketty’s Basic Proposition

Piketty argues that $r > g$ implies that the typical passive owner of capital (what he calls the rentier) will claim over time an ever increasing share of income and output. But this inequality is false; it implies no such thing. It is easy enough to see why. Piketty apparently believes that $r > g$ necessarily indicates that wealth is growing faster than output, and therefore an increasing share of national income is going to the owners of capital. But this will only be true if r does indeed measure the rate of growth of capital or wealth. Piketty’s r, however, does not measure the rate of growth of capital or wealth because it does not take into account subtractions from wealth such as (1) investment expenses, (2) taxes paid on investment income, (3) personal consumption out of that income, or (4) contributions to charity. No matter how large $r$ may be relative to $g$, if all of $r$ is taxed, consumed or donated to philanthropic causes, there can be no growth in wealth due to investment income, and hence the outcome that “terrifies” Piketty cannot come to pass. The correct condition for an expanding share of income going to the owners of capital (at least as a first approximation) is the following:

$$r - e - t - c - d > g,$$

where $r$ is the real rate of return on wealth net of inflation, $e$ is the rate of investment expenses as a percent of wealth, $t$ is the tax rate as a percentage of wealth, $c$ is the personal consumption rate as a percentage of wealth, and $d$ is the rate of donations and charitable giving as a percentage of wealth. The left-hand side of the inequality represents the percentage of wealth that can be reinvested each year after accounting for that portion of the investment income stream that is diverted for expenses, taxes, consumption, and donations.

It is clear that Piketty’s inequality condition is false except in the limiting case where expenses, taxes, personal consumption, and donations are zero. This does not, of course, mean that the typical rentier is not able to expand his share of national income over time if the values of $r$, $e$, $t$, $c$, $d$, and $g$ are such that the corrected inequality...
Piketty holds. To resolve this issue, we need to examine evidence regarding the likely values for these six parameters. To do so, this article focuses on U.S. data.\(^3\)

Can Rentier Income and Wealth Grow Faster than the Economy?

A few examples will illustrate why the corrected inequality is far less scary than what Piketty imagined and why it is extremely unlikely that the typical wealth holder can grow his income and wealth faster than the overall economy. Over the past 50 years or so U.S. Treasury bills, the asset often referred to in the financial literature as the risk-free asset, have yielded an average annual nominal return of a little less than 5.5 percent according to U.S. government data. With an average inflation rate of about 4 percent over this period, the real, after-inflation rate of return on Treasury bills was about 1.5 percent.\(^4\) Income taxes are, of course, assessed on nominal, not real, returns. The combined state, local, and federal tax rate on income from these very safe investments would likely have averaged close to 50 percent over this period for wealthy individuals. Thus, the applicable tax rate as a percentage of wealth would have been close to 2.75 percent (half of the nominal return of 5.5 percent), indicating a real after-tax return of minus 1.25 percent per year (1.5 percent less 2.75 percent). On Treasury bills, expenses (\(e\)) would be negligible. We have no readily available estimate for what is a likely value for personal consumption (\(c\)) and donations (\(d\)), but in this example it makes no difference. Even if wealthy individuals spend nothing on personal expenditures or donations, the rate of growth of wealth is decisively negative because the tax more than consumes any real income, particularly if we add in state and federal inheritance taxes. So much for the rentier growing ever richer over time without taking on any risk.

\(^3\)Piketty’s book includes material from a wide range of countries and over a long period of time. The extensive destruction of European wealth in the two great wars, however, makes much of this material misleading and of questionable relevance. He also spends much of the book discussing 19th century data, which, although interesting, are similarly deficient. On balance, U.S. postwar data are likely to be more informative, more relevant, and more reliable in studying the behavior of an advanced liberal market system under normal conditions.

\(^4\)Economic Report of the President, 2011, provides Treasury bill rates in Table B-73 and the consumer price index in Table B-60.
Of course very wealthy families are not likely to place the bulk of their investments in risk-free assets, so let us take an example at the opposite end of the risk spectrum. A portfolio invested 100 percent in U.S. common stocks, according to the best available evidence, would have produced a long-run average return of about 7 percent per year over the rate of inflation.\(^5\) Needless to say, the long run was liberally sprinkled with lengthy periods of zero and negative returns. Piketty’s wealthy rentier, even if he had resisted the urge to sell during these periods, would nevertheless have had a difficult time achieving this average return because it does not account for the costs of brokerage, bid-and-ask spreads, and management. A net real return of 6 percent per year may be more realistic. State, local, and federal income taxes, not to mention estate taxes, would likely take a third to a half of this net return depending on such factors as the mix of capital gain income versus dividend income and the residency of the wealth holder. If it is, say, 2 percent of wealth (one-third of the 6 percent real return), then the wealth holder would receive a real return of about 4 percent without accounting for expenditures on personal consumption, charity, or other donations.

How likely is it that our risk-taking rentier earning a 4 percent after-tax rate of return will actually be able to grow assets faster than the rate of growth of the economy? Well, that depends on how fast national income is growing, in other words, the value of \(\gamma\). Here we have very good historical data. The average real, after-inflation, rate of growth in U.S. GDP over the past half century, 1960 to 2010, was 3.1 percent per year based on the official U.S. national income accounts.\(^6\) Thus, had our typical wealth holder invested 100 percent in the riskiest asset class and consumed nothing out of earnings, not for personal consumption or donations, he could have increased his holdings as a share of total income by slightly less than 1 percent per year—up until death, when the state and federal estate taxes are levied. Even in this extreme example, it is quite unlikely that the

\(^5\)Jeremy Siegel’s estimates of long-run returns to U.S. common stocks are widely regarded as the best available. He finds the average, pre-tax, real return from 1913 to 1997 to be 6.7 percent per year. He also provides average rates of return for various subperiods (Siegel 1998: 118).

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typical wealth holder would experience a rising share of national income. Over time, therefore, his relative wealth and income position would be falling.

Piketty himself estimates that the average real return on wealth after taking into account all asset classes and some of the investment expenses is typically in the 3 to 4 percent per year range (Piketty 2014: 206). This appears consistent with reported data in the financial literature. If we take the mid-point of this range, 3.5 percent, add a conservative inflation factor of 2 percent per year, then the nominal investment income would be about 5.5 percent per year. An average U.S. state, local, and federal tax rate for wealthy individuals with a mixture of assets would likely be 30 percent or so on investment income, which reduces the 3.5 percent real return on wealth to a maximum of about 2 percent per year after taxes. Assuming zero spending for personal consumption or charity, we would therefore expect wealth to grow at about 2 percent per year. Since 2 percent per year in the growth of wealth is less than the long-term average growth in national income (3 percent per year), the typical wealth holder, using Piketty’s own estimate of r, would find his relative position falling behind the growth in the economy by 1 percent per year even if he spent nothing on personal consumption or charity and even if he never had to pay estate taxes.7 Despite Piketty’s expectations to the contrary, these numerical examples are quite robust. It is virtually inconceivable that Piketty’s typical rentier can grow his net worth faster than the general expansion of the economy.

The foregoing analysis may be surprising to much of the intellectual and political class, but it will come as no shock to Americans (or citizens of other advanced countries) who have retired from active work and are trying to maintain the purchasing power of their accumulated savings, nor will it come as a shock to professional money managers or scholars who routinely study financial markets. But for some reason, Piketty chose not to examine this readily available and absolutely essential source of information.

7If future growth rates turn out to be less than 3.1 percent, it is possible that rates of return will also fall below historical rates, thereby offsetting any tendency for rising inequality.
The Share of National Income Flowing to Wealth Holders

If there is indeed a populist law of capitalism such that “capital reproduces itself faster than output increases,” it should also be apparent in the official national income statistics gathered by the U.S. government. Compilation of those statistics began shortly after World War II, and they provide a reasonably accurate picture of trends in income shares over the past half century. Income is reported in the following categories: (1) compensation of employees, (2) unincorporated business income, (3) rental income of persons, (4) interest income, and (5) corporate profits. The usual convention is to calculate labor’s income as the sum of compensation of employees and some fraction of the income of unincorporated business. If unincorporated business has about the same split between capital and labor as the overall economy, a 70 percent allocation to labor is appropriate. The specific percentage chosen is not critical because unincorporated business usually accounts for less than 10 percent of total national income. Rental income of persons is also likely to have a labor as well as capital component. But for simplicity we can ignore this relatively small item.

Table 1 shows the average percentages of income flowing to labor in the U.S. national income accounts by decade over the half century from 1960 up to 2010. As is readily apparent, there is no clear trend in the data. The measured share of income flowing to labor (and consequently capital’s share) has been remarkably stable. In fact, it would be difficult to find support for even a 1 percentage point

<table>
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<tr>
<th>Decade</th>
<th>Labor Share in National Income (%)</th>
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<tr>
<td>1960–69</td>
<td>69.42</td>
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<tr>
<td>1970–79</td>
<td>71.72</td>
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<tr>
<td>1980–89</td>
<td>70.66</td>
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<td>1990–99</td>
<td>70.22</td>
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<tr>
<td>2000–09</td>
<td>70.40</td>
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change over the last half century. While there is no reliable estimate of the potential measurement error in these statistics, it seems reasonable to suppose that a difference of one percentage point would fall far short of statistical significance.

The proposition that the split of income between capital and labor has been quite stable over time has long been an accepted fact in the macroeconomic growth literature. I cite data just for the last 50 years because that period is more likely to tell us how a liberal market economy behaves under normal circumstances and current institutional arrangements, and because the data are likely to be more reliable than older estimates. However, what evidence we do have for the period prior to 1960 also supports the notion of constant or near constant income shares. For example, Professor Paul Baran of Stanford, a well-known Marxist scholar and no enthusiast for capitalism, reviewed the pre-1960 evidence and concluded that “the relative share of aggregate income going to labor has remained generally stable (or showed merely short-term fluctuations)” (Baran 1962: 57).

U.S. data cited above indicate that capital’s share of total income is typically about 30 percent if we take it to be all of national income except for the portion attributed to labor. This figure is, however, overstated in several respects. First, the 30 percent includes corporate income taxes that do not flow to the owners of capital. Second, the 30 percent measures nominal income flows to capital, not real flows. At an inflation rate of 2 percent per year and a capital output ratio of, say four, the overstatement could possibly be as high as 8 percent of national income. Finally, a significant portion of corporate profits may in fact be labor income, properly defined. In a dynamic economy many innovations and the income flowing from

\[8\] Karabarbounis and Neiman (2013) analyze 1975 to 2012 data for the U.S. corporate sector (about 60 percent of the total economy) and found a downward trend in labor’s share of corporate income. Their data, however, show virtually no change between 1975 and 2000. Moreover, 1975 had a higher share than 1960. It appears, therefore, that much of the observed trend may be attributed to the choice of a beginning date and perhaps to cyclical events since 2000. These factors plus the large potential for measurement error suggest that no reliable evidence exists for a meaningful long-run trend in the U.S. corporate sector.

\[9\] This article uses the word “liberal” in its classical 19th century meaning: an absence of coercion, fraud, or undue government interference or favoritism. Needless to say, crony capitalism, where well-connected individuals use government coercion to enhance their wealth, is also not an acceptable feature of a liberal market system.
these innovations should not be attributed to capital investment but rather to the active work of entrepreneurs, inventors, or other creative individuals. In 2004, a young college student, Mark Zuckerberg, and a few of his friends had a brilliant idea for a social networking company. With almost no investment, they created a business (Facebook, Inc.) that achieved a 2014 market value in excess of $175 billion. This enormous creation of wealth is not due to any appreciable amount of investment. It is in fact almost entirely due to the creative labor of a small group of entrepreneurs. Countless numbers of innovations occur every year, and their contribution to measured profits is doubtless a substantial portion of the income conventionally attributed to capital.

If all of the foregoing factors were properly assessed, the share of capital in national income might well be no more than half of the unadjusted figure from the national income accounts, 15 percent or so rather than 30 percent. The lower and more accurate percentage is perhaps less scary to populists.

Evidence from Family Histories

As noted, observed rates of return on various assets and the income flows, as measured by official U.S. government data, imply that Piketty’s basic thesis is wrong. Income received by wealth holders does not have a systematic tendency to grow faster than output and to take up an ever growing share of national income. In fact, evidence on rates of return suggests that “old” capital, which Piketty refers to as rentier wealth, will diminish in importance over time while “new” capital due to innovations and savings becomes dominant. If this conclusion is true, one would expect to find that great family fortunes created by innovators would dissipate over time.  

Is this in fact the case? Yes, indeed it is.

Evidence on family wealth is naturally difficult to obtain. Recently, however, the business biweekly Forbes Magazine has expanded its long-standing research on wealthy individuals to include American families with a net worth in excess of one billion dollars (Kroll and Dolan 2014). The results are striking and unequivocal. The survey

10 It is of course more likely that the relative value of small fortunes will be diminished over time by personal consumption and multiple heirs than large fortunes. Hence, if large fortunes tend to fall over time, it is even more likely that the totality of rentier wealth falls over time as well.
found 185 families meeting the $1 billion threshold with a combined net worth of 1.202 trillion dollars. Of these families, sixteen have fortunes dating back to the 18th century—a reasonable sample of what we might call “old” wealth. The combined amount of current, 2014, wealth for these families is $146 billion spread over 4,803 family members, a per capita average of $30.3 million. To be sure these are large sums, but all of the “old” wealth combined is only a little more than 12 percent of the current total family wealth in the Forbes survey.

John D. Rockefeller is commonly credited as being the richest businessman of all time. His fortune is sometimes estimated to have been in the range of $340 billion or so in today’s dollars. Yet the Forbes survey estimates the Rockefeller family’s current net worth to be a much reduced $10 billion spread over 200 descendants, a decline of perhaps 97 percent in absolute terms and 99.9 percent in per capita terms. If Piketty were correct, we would expect to see much more than $340 billion held by current members of the family, not much less.

The economic history of the Rockefeller family is not an isolated case. It is in fact the norm. Most of the large 19th century family fortunes have become so attenuated that they fail to meet the $1 billion threshold for inclusion in the Forbes survey. Nowhere on that list, for example, is to be found the Vanderbilts, the Carnegies, the Morgans, or the Astors, families with initial fortunes estimated to be in the range of $185 billion, $310 billion, $41.5 billion, and $121 billion, respectively, in current dollars (Warner 2014). The relative absence of old wealth in the Forbes survey is doubtless due in large part to taxes, personal consumption, and donations. Yet, the ultimate truth is that wealthy families can perpetuate their relative wealth over long periods only by producing successive generations of talented entrepreneurs who can create new wealth. But such talent is extremely rare and not easily transmitted from one generation to another. It is this scarcity of entrepreneurial talent that prohibits the creation of an aristocracy of inherited wealth in a liberal market system.

Although the family wealth data discussed above may be off by several orders of magnitude, it hardly matters. The evidence is so overwhelming that there is little doubt that Piketty’s fear of an ever growing concentration of wealth and income accruing to some rentier class is totally misplaced. What we see in the family wealth

\[11^\text{These historical wealth figures should be taken as merely suggestive.}\]
data is precisely what would be predicted based on the historical return data and the national income data previously discussed. All three sources of data are perfectly consistent with one another and perfectly inconsistent with Piketty.

Do Larger Wealth Holdings Earn Higher Rates of Return?

There is one final aspect of Piketty’s thesis that begs attention. In several passages from his book, including the summary statement quoted above, he states that relatively large wealth holders are able to achieve higher rates of return on investments than relatively small wealth holders, such that over time the inequality due to wealth has a tendency to accelerate. One can imagine that this proposition will be readily accepted in the populist community. But is it true? The answer is an unequivocal “no,” as should be apparent to anyone with a slight knowledge of the financial literature.

Piketty was apparently led astray on this issue by examining the returns for U.S. college endowments between 1980 and 2010. He found that Harvard, Yale, and Princeton, with very large endowments, reported higher average rates of return than colleges with much smaller endowments. As a result, he concluded that larger pools of capital have higher rates of return than smaller pools of capital as a general proposition. But the experience of college endowments over this period is hardly representative. It is well known that the larger Ivy League colleges were among the first to put sizeable allocations of assets into riskier, higher-yielding nontraditional investments, whereas most colleges continued with conservative investment strategies. This shift was very fortuitous because it came at the beginning of a sharp recovery in the prices of risky assets. Moreover, colleges with large endowments and a long-term investment horizon can afford to place a higher percentage of their endowment in risky, higher-yielding assets, whereas many colleges with smaller endowments have higher proportions in pools with a comparatively short time horizon. Much of this short-term money will be invested in Treasury bills, limited maturity fixed income instruments or the equivalent with correspondingly lower rates of return.

None of the experience with university endowments lends credibility to Piketty’s argument that the larger the pool of wealth the higher the rate of return. His argument will, in fact, be a great
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surprise to the professional money management community which believes just the opposite. Actively managed mutual funds that become too large are thought by that community to be at a disadvantage in achieving high returns. One of the largest pools of wealth is managed by Warren Buffett for his holding company Berkshire Hathaway. He often states that Berkshire’s size has become a limiting factor for future returns.

Professional money managers, to be sure, have an incentive to convince the public that their fees are justified by market-beating performance. The “diseconomies of scale” argument fits this narrative because it implies that a talented money manager can achieve above-average returns until the investment pool becomes too large. A voluminous literature regarding financial markets tells a different story; significant economies or diseconomies of scale do not appear in actual market data. This finding is of course a corollary of the efficient markets hypothesis, whose basic message has been verified thousands of times by many different researchers. In 2012, Eugene Fama, the economist who has possibly contributed most to this hypothesis, received the Nobel Prize in economics precisely for his work demonstrating its validity.

Over the past half century, much has been written about the efficient markets hypothesis. Curiously, however, little note has been given to what I believe is its most profound insight, at least with regard to political economy. That insight is nothing less than the demonstration that financial markets are profoundly egalitarian; large wealth holders have no advantage over small wealth holders. One might find this fact surprising since wealthier investors might be more likely to hire professional money managers who can achieve above average rates of return, but the empirical evidence indicates otherwise. On average, professional management adds little or nothing to investment performance. The fact that passive, unmanaged

12Short selling in the market is usually thought to be the domain of the most sophisticated professional investors, perhaps those with special knowledge about individual companies. However, an early examination of short-selling data showed that the efficient markets thesis held up exceptionally well even under this challenging test. Portfolios held by actual short sellers were unable to outperform randomly chosen short portfolios (Mayor 1968). Hundreds of studies with similar findings may be found in the scholarly literature.

13A good commonsense explanation of the hypothesis may be found in Burton Malkiel’s early book on the subject (1973) or his updated review article (2003).
index funds with low expenses tend to outperform managed funds is testament to the power of this democratic principle.

One final, but important point should be added. Simple economics tells us that economies of scale in the management of pools of capital are virtually impossible in a functioning market economy. Why is this the case? Suppose it were true, counterfactually, that large pools of wealth systematically earn higher returns than small pools of wealth. If so, profit-seeking entrepreneurs would have a powerful incentive to aggregate small pools into large pools so that owners of small pools could receive the same benefits of scale and rates of return as owners of large pools; this is, of course, Adam Smith’s “invisible hand” at work. Mutual funds and similar financial instruments would be able to accomplish this task. It is hard to understand how a trained economist such as Piketty could overlook this simple, fundamental principle of market economics.\textsuperscript{14}

\textbf{Is Wealth Inequality Such a Bad Thing?}

Piketty and Marx are clearly wrong; liberal market capitalism has no tendency for an increasing concentration of wealth. But even if such concentration were to occur, would it be such a bad thing? The current generation of populist politicians and their intellectual supporters certainly think so. They must also think that their opinion is

\textsuperscript{14}Piketty has an additional view which is at odds with the economics literature. He believes that high rates of capital accumulation have only a small tendency to lower the average rate of return on wealth due to a high value for what economists call the elasticity of substitution between capital and labor (Piketty 2014: 216). He argues that the elasticity has a value in the range of 1.3 to 1.6, which implies that a rapidly growing stock of capital will lead to a higher share of output accruing to capital. A value of 1.0 produces constant shares because the larger amount of capital is exactly offset by a reduced rate of return. A value less than one actually implies that the share of output going to capital will fall with rapid capital accumulation. He cites no literature to justify his unusual opinion, nor does he provide any analysis of his own. A number of economists examined this issue many years ago. The general conclusion seems to have been that the elasticity was likely to be less than one. For example, see (McKinnon 1962), (Solow 1964), (Lucas 1964) and (Mayor 1971). Recently, a study using more advanced statistical techniques found the U.S. elasticity to be 0.5 or possibly even less (Antras 2004). Another recent study in the \textit{American Economic Review} found little evidence for values of one or greater after examining the available literature (Leon-Ledesma, McAdam, and Willman 2010). Some early studies based on cross-section data found values closer to one, but they should not be given much weight owing to endemic specification problems (Mayor 1969).
Piketty and the Neo-Marxist Revival

so self-evident that no supporting proof is required. Piketty, for example, devotes 685 pages to the “terrifying” prospect of inexorably growing inequality, but nowhere is to be found any explanation for why it is so abhorrent that some people have more wealth than others. Within elite intellectual circles, the desirability of income and wealth equality is so widely held that it probably never occurs to members of this circle that a thoughtful, rational defense of their views might be appropriate. That’s too bad, because even a modest understanding of economics might cause them to reexamine their opinions.

What is the root cause of this antipathy toward wealth? Certainly one explanation is the thoughtless tendency to view the economy as containing a fixed amount of wealth or income. In this perception, economics becomes what game theorists call a zero sum game. The rich can only become richer at the expense of the poor, and the poor can only get ahead by taking from the rich. The casual reader of Piketty’s book would probably come away with this impression, although nowhere is it explicitly espoused. The most basic principle of economics, however, is that voluntary transactions must necessarily benefit all participating parties in a liberal market economy in the absence of coercion or fraud. Otherwise no transactions would take place. The only way one person can become rich, therefore, is by making other people better off than they otherwise would have been.

J. K. Rowling had been a school teacher before she published her series of books on Harry Potter. Her current net worth is popularly estimated to be in excess of one billion dollars based on book sales, a series of movies, and other derivatives. Book sales alone have been estimated to have been 450 million as early as 2011. Purchasers of her books were not coerced into buying them, so we can safely assume that they valued their copies at something above the purchase price. Suppose, in order to provide a concrete example, the average book sold for $20, the average royalty to Ms. Rowling was $3, and the average purchaser would have paid $30 rather than go without the book. In this case Ms. Rowling’s pre-tax wealth would have gone up by $1.35 billion dollars (assuming 450 million books

15 This is of course an application of standard welfare analysis. The value of a good to any consumer is what that consumer would be willing to pay rather than do without. The benefit a consumer receives from a purchase is that value less the actual purchase price, what is referred to as “consumer surplus.” As an aside, this fan would have paid at least $50 for each of his copies.
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sold × $3 per book). But her fans would have gained even more in this example, $4.5 billion, to be exact (450 million books purchased × $10 per book). And the story does not end there. Many of the 450 million books that were sold will be read by others through loans or secondhand sales, thereby creating more benefits not captured by Ms. Rowlings.

Statistics on wealth distribution, of course, would record Ms. Rowlings’s new wealth as an increase in inequality even though she created billions of dollars of unmeasured but very real benefits for other people. Now the challenge to populists and intellectual elites is to explain how we would have been better off (and less “terrified”) had Ms. Rowling remained a school teacher and had her potential fans been deprived of $4.5 billion or more in benefits.

The Rowlings story is not complete, however. Presumably, the income inequality crowd would be less terrified if Ms. Rowlings had taken all of her billion dollars of after-tax profit and spent it on personal consumption. In that case wealth inequality would not increase, and any increase in income inequality would be temporary. But this outcome would be far less beneficial for the general public. As is taught in every introductory economics class, the increase in capital brought about by saving wealth rather than by consuming it has three important impacts on the economy. National output and income increase because of the greater application of capital to production. The rate of return to capital will fall as its supply increases. And wage rates will increase as the supply of capital becomes more abundant relative to that of labor. Once again, an increase in wealth inequality brings about benefits to those who themselves have no significant wealth. Nineteenth century novels, a favorite source of data for Piketty, often depict savers as greedy, selfish misanthropes who yield no assistance to their fellow man, a viewpoint doubtless amplified in many college literature classes. Yet rational analysis tells a different story.

What can we conclude? The populists and Piketty have it backwards. A liberal market economy free of coercion or fraud provides the best outcomes for all of its citizens when inequality of wealth and income is high. The economy is not a zero sum game, and those who achieve great wealth and high incomes invariably provide even more wealth and income to their fellow citizens than to themselves. If someone is looking for a general law of liberal market capitalism, this is it. Far from being terrified, we should all hope for future increases in inequality.
Income Inequality: Is It All about Envy?

If rising populism and neo-Marxist ideology are solely due to viewing economic activity as a fixed pie where one person’s slice comes at the expense of another person’s slice, then there is hope for a rational future. As demonstrated above, only a modest amount of economic analysis and basic intelligence is required to dispel such a view. I am quite hopeful that this is the case for most ordinary Americans. I am less hopeful about many of our intellectual elites. Some may well prefer a future where there are more poor people as long as there are fewer rich people. This sort of value judgment is not easily met with rational argument. It may be deeply rooted in the psychology of envy and resentment. And, to be sure, these feelings may be cloaked with moral rationales and faulty economics.

Even the most envious persons among us, however, may be inclined to mute their view if they would only realize how little innovators and creators receive from the wealth they generate. In the J. K. Rowling example given above, it is likely that her lifetime personal compensation will end up being less than one-tenth of the wealth she creates. Yet her contribution is significantly shielded from erosion by copyrights which make the payment of royalties obligatory for a long span of time (assuming of course that the copyrights can be enforced). Relatively few innovations have copyright protection regardless of how effective that protection might be. Patents on new drugs and inventions can provide relief from competition for a dozen years or so. But most innovations cannot be protected at all. The experience of George P. Mitchell illustrates the point.

Mitchell, the son of Greek immigrants, died in 2013 after a lifetime of work as an independent oil and gas producer. His self-made fortune was estimated to be in the range of $2 billion. But he gave away hundreds of millions of dollars to civic and charitable causes during his lifetime. He also spent millions of dollars of his own money trying to figure out how to free oil and gas from shale formations when virtually everyone else had given up on the quest. In 1998, at age 89, his company finally achieved the breakthrough which led to the current surge in U.S. oil and gas production. The increase in U.S. wealth due to this breakthrough will doubtless be far in excess of a trillion dollars. Since most shale resources are outside the United States, the ultimate benefit to the world will likely be many multiples higher. After spending millions of dollars looking for the right formula, Mitchell himself...
and his team of engineers received very little in return. He built the
business, but other people received the benefits.

The Mitchell experience is not unique. The creators of the modern
world have typically received a vanishingly small amount of
the wealth they have created. The extent to which this is true will
shock most people. Yet with little effort it can be demonstrated. The
best available information on per capita income was developed
at the Organization for Economic Cooperation and Development.
According to that study, annual per capita real income in Western
Europe grew from $400 to $19,256 over the 2,000 year period,
1–2001 AD, about a 48-fold increase (Maddison 2003: 262). The use
of more recent data from the United States suggests about a 65-fold
increase. But two important factors are left out. Average work weeks
have shown a substantial decrease over time and national income sta-
tistics are highly deficient in measuring quality changes, especially
with regard to health and technology. It certainly is reasonable to
suppose that for the most advanced countries a 100-fold increase in
average living standards has occurred over recorded history, with
almost all of this increase in the past two or three centuries.

Experience tells us that this incredible growth in productivity was
due to a relatively small number of innovators and creators. All work-
ers contribute to current production and living standards, but few
workers are responsible for innovations that permanently raise out-
put and income per capita. There are, to be sure, no reliable statistics
on how these innovations came about or as to who made them.
Perhaps no more than 1 percent of the population has contributed
significantly to permanent increases in per capita output. If so, it fol-

Conclusion

Fifty years ago there was broad consensus in the United States
that programs to elevate the skills and earnings of the least success-
ful members of society were necessary and appropriate. Differences
Piketty and the Neo-Marxist Revival

of opinion naturally existed as to how this should be accomplished, but the desirability of achieving successful outcomes for the poor was never questioned. Also absent from that debate was any angry rhetoric about the high incomes and wealth of the most successful members of society. Indeed, the slogan of the day was “the war on poverty,” not “income inequality.” Broadly accepted was the idea that society’s least successful members should be elevated, not that society’s most successful members should be punished.

Today’s dialogue is far different. The current policy agenda of populist politicians and their elite intellectual supporters is almost entirely directed at leveling instead of elevating. The main roadblocks to success for America’s least advantaged citizens are never mentioned much less dealt with. Today’s populists, in fact, favor high energy taxes and burdensome regulations that cause very large percentage reductions in the real incomes of poor people and proportionately small impacts on the well-to-do. They favor the status quo in education, rather than meaningful reforms to give parents the power to force competition and accountability, even though education is one of the surest routes to economic success. They favor minimum wage laws that tell employers it is illegal to hire workers whose productivity falls below a certain level, thereby adding to an already disgraceful unemployment rate among disadvantaged youth. But of course employers are free to give jobs, training, and skills to young “interns” from the middle and upper classes (who need no current income), thereby providing them with a boost toward a successful career. Instead of conducting a war on poverty, our current populists and their intellectual enablers are conducting a war on poor people.

But perhaps the worst aspect of the current populist movement is its attack on the very foundations of modern civilization. Everything we have learned from human history since leaving our hunter-gatherer heritage is that civilization makes the most progress when it nurtures and honors individual human achievement. This is the first and most important law of political economy.16 The enormous improvement in living standards, health, and quality of life is due to the achievements of a relatively small number of talented individuals.

16 Economists have increasingly recognized that successful societies have institutions that allow creators the freedom to achieve and to receive the rewards from that achievement. Failed societies do not. Acemoglu and Robinson (2012) and North (1981), for example, provide convincing arguments for this proposition.
Perhaps 99 percent of our current standard of living can be attributed to 1 percent or so of our fellow humans. That 1 percent has given us staggering benefits while reaping very little in return. Yet, how many times has one heard the phrase that high achievers have an obligation “to give back to the community?” Those who utter this phrase, regardless of their intent, further the cause of economic illiteracy. Highly successful people who have accumulated wealth honestly through their business have doubtless given far more to others in the course of that business than they will ever take for themselves or give to charity.

An ever present danger to civilization is that the general public, with calculated encouragement by populist politicians and their elite intellectual supporters, will fail to realize the extent to which their well-being, and especially its improvement, depends on the success of a relatively small number of their fellow citizens. In fact, popular sentiment may be encouraged to destroy unknowingly the basis for that well-being.

The recent book by Thomas Piketty is especially disheartening in this regard. It will be interpreted by the general reader as an invitation to attack achievers and wealth creators. And it will have undeserved credibility given to it by those who advocate its destructive message. All of the basic ideas in that book are false. “Wealth accumulated in the past” does not have a propensity to grow faster than output and wages. It has not in the past, and it will likely not in the future. Nor does the income from that wealth have a tendency to rise faster than the wages of ordinary citizens. It has not in the past, and it will likely not in the future. Families of high achievement can only maintain their relative wealth position in society by nurturing descendants of similar achievements. But this cannot be the norm because exceptional talent is obviously, well, exceptional. Finally, rates of return on large pools of wealth are not higher than rates on smaller pools of wealth, and they will not be in the future. There is accordingly no reason for Piketty or anyone else to be “terrified” that all of the world’s wealth will end up in the hands of a few rentiers.

Charity is universally regarded as a good thing if freely given and freely accepted, but implying that successful people achieved their wealth at the expense of others and therefore need to make amends by giving it away is a socially destructive myth. The phrase “give back to the community” delegitimizes wealth creation and conditions the thoughtless into supporting policies that undermine their own well-being. Educated citizens should shun its use.
Perhaps more telling is what does not appear in Piketty’s book. At no point does he tell us that wealth creation benefits the general public, that the creators of that wealth receive only a small fraction of the benefits they convey to the general public, or that a greater degree of wealth inequality in a liberal market economy free of coercion or fraud is in fact a sign that greater benefits are being produced for the general public by those creators. A world without wealth and income inequality is in fact a world of universal poverty.

References


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The Impact of Economic Inequality on Economic Freedom

Ryan H. Murphy

Contemporary economic policy debates are dominated by concerns regarding the rise in inequality (Stiglitz 2012, Piketty 2014). Primarily, this has led to a focus in re-invigorating redistribution. For instance, Robert Shiller (2014) has recently argued for indexing top marginal tax rates to inequality and using the revenues to fund transfer payments. Secondarily, there are the longstanding objections to “neoliberalism” in general, which has encouraged globalization and the liberalization of markets. To the extent that liberal reforms have improved economic institutions, might today’s inequality subsequently derail them?

It is often difficult to find firm evidence linking negative outcomes to inequality (Deaton 2003, Porter 2014). However, some economists have argued that inequality may harm the quality of institutions. For example, Acemoglu et al. (2013) have argued that concentrations of wealth may subvert democracy. This argument is also present in political science (Bartels 2008), and Easterly (2001) has made similar points. Such arguments offer a more rigorous conception of the popular notion of inequality subverting politics, a concern that is especially salient following Citizens United v. Federal Election Commission, and more recently, McCutcheon v. Federal
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Election Commission. Acemoglu has made this point explicitly regarding Citizens United, saying, “Instead of trying to stem that tide, we’ve done the opposite and we’ve now opened the sluice gate and said you can use that money with no restrictions whatsoever” (Garofalo 2012). Generally, the debate has centered on the notion that inequality will weaken institutions by swinging policies toward favoring the economic interests of the rich.

The approach here will differ, looking at the effect of inequality on free economic institutions. The measure used will be the Economic Freedom of the World (EFW) index, published by the Fraser Institute (Gwartney, Lawson, and Hall 2013). The index runs from 0 to 10 using five components of economic freedom, with higher index values corresponding to greater economic freedom. This index has been used in a variety of academic journals to investigate a broad range of issues (Hall and Lawson 2014). Numerous studies using this index have investigated whether economic freedom worsens inequality (Berggren 1999, Scully 2002, Carter 2007, Clark and Lawson 2008), finding mixed results, but not whether inequality may worsen economic freedom. Also relatedly, recent research by Young and Lawson (2014) finds that economic freedom is associated with a higher share of labor income.

Using a similar index for the United States, Apergis, Dincer, and Payne (2014) argue that there is a bidirectional relationship between inequality and economic freedom, with the possibility that policies that are meant to reduce inequality will reduce economic freedom, which will then only make inequality worse. Bennett and Vedder (2013) investigate the relationship between the two variables, also using U.S. data, and find similar results. In this article, I do not seek to identify bidirectional effects; rather, I wish to investigate the long-run effects of inequality on economic freedom in an international context.

This article also fits with the growing literature that uses the EFW index as the dependent variable. While the index has been used a large number of times as an independent variable, far less work has gone into explaining economic freedom. Recent scholarly work has examined the impact of foreign aid (Bearce and Tirone 2010), personal characteristics of politicians (Dreher et al. 2009), and culture (Jing and Graham 2008) on economic freedom as measured by the EFW index. Inequality too may play a role in determining economic freedom.
The primary method this article employs is to control for economic freedom at the beginning period, in effect differencing the data, and then determine the impact of the Gini coefficient, a common measure of income inequality, in the first period on the EFW index in the future period. We find that a one standard deviation increase in the Gini coefficient reduces (worsens) the EFW index by 0.18–0.26 standard deviations, depending on the specification. This magnitude persists across the other three specifications of the baseline model, though it loses significance upon the inclusion of fixed effects.

In addition, the same procedure was applied to each of the five subcomponents of the EFW index. Of the five subcomponents, inequality has the largest impact in the later period on the size of government. The most counterintuitive result is the mixed results regarding the impact of inequality on regulation. Upon inclusion of fixed effects, a one standard deviation increase in the Gini coefficient improves the regulation score by 0.46 standard deviations. While the effect is only significant with 90 percent confidence, the magnitude is very large. Besides the impact of inequality on regulation, its impact on the other components of the EFW index is generally intuitive.

Data and Method

Differencing (or controlling for levels in the first period) alleviates many concerns regarding endogeneity, but the tradeoff that arises is that there is often little variation from year to year. The approach used in this article avoids that problem by comparing periods 10 years apart. The most parsimonious specification employed is to use the Gini coefficient in year t to predict economic freedom in year $t + 10$ while controlling for economic freedom in year t. This specification can be found in Equation 1. Despite its simplicity, this specification is reasonably robust. Any proposed variable attacking this result must be correlated with the change in EFW and the Gini

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1 The Gini coefficient is bounded by zero and one. Zero corresponds to perfect income equality (the income of everyone in society is identical) and one corresponds to perfect income inequality (one person in society has all the income).

2 While it loses significance, the magnitude of the coefficient actually grows.
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coefficient at the beginning period, and it is not immediately obvious what would do so, especially upon the inclusion of fixed effects.³

\[(1) \quad EFW_{t+10} = \beta_0 + \beta_1 EFW_t + \beta_2 gini_t + \epsilon.\]

In addition to this estimation, an analogous method was used to measure the effect of inequality on each of the subcomponents of the EFW index. Area 1 (i.e., the first subcomponent) measures the size of government in the economy, with higher scores corresponding to smaller governments. Equation 2 provides the parsimonious specification for predicting Area 1 as an example. Area 2 measures the integrity of the legal system and the enforcement of property rights. Area 3 measures the soundness of money. Area 4 measures the freedom of trade internationally, and Area 5 measures the regulatory environment. Of these components, the most obvious conduit by which governments may respond to inequality is Area 1, by means of increasing transfer payments. However, it is easy to imagine ways in which inequality may affect other Areas, for instance inequality leading to a backlash against trade liberalizations.

\[(2) \quad Area_{1t+10} = \beta_0 + \beta_1 Area_{1t} + \beta_2 gini_t + \epsilon.\]

Table 1 provides summary statistics for each of these variables.⁴ In addition to those already mentioned, data on ethnic, linguistic, and religious fractionalization from Alesina et al. (2003) are included. Unfortunately, only cross-sectional data are available for fractionalization, but it is hoped that these variables help to capture the cohesiveness of the observed countries that is unrelated to, but may be correlated with, inequality. Data on the Gini coefficient are from the World Bank’s online databank, which contains observations beginning in 1978.

The sample size these data yield may be smaller than expected. Until 2000, the EFW index was available only once every five years going back until 1975, and only for a much smaller number of countries. Additionally, the most recent EFW index ranks countries based on 2011 data. I include only observations for which the World

³Consider: the fixed effect captures variables related to the country-specific trajectory, not just the country-specific levels, of EFW.

⁴The dataset was constructed such that country-years with Gini coefficient data available were first identified, and subsequently EFW data were matched to it. This explains why the Gini coefficient has more data points than the EFW index.
# TABLE 1
## Descriptive Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Obs</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gini Coefficient</td>
<td>465</td>
<td>42.364</td>
<td>11.0329</td>
<td>19.400</td>
<td>74.330</td>
</tr>
<tr>
<td>EFW, Year $t$</td>
<td>112</td>
<td>6.302</td>
<td>1.152</td>
<td>3.030</td>
<td>8.650</td>
</tr>
<tr>
<td>EFW, Year $t+10$</td>
<td>347</td>
<td>6.716</td>
<td>0.812</td>
<td>2.940</td>
<td>9.100</td>
</tr>
<tr>
<td>Area 1 of EFW, Year $t$</td>
<td>114</td>
<td>6.115</td>
<td>1.596</td>
<td>2.773</td>
<td>9.305</td>
</tr>
<tr>
<td>Area 1 of EFW, Year $t+10$</td>
<td>348</td>
<td>6.654</td>
<td>1.293</td>
<td>2.363</td>
<td>9.262</td>
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<tr>
<td>Area 2 of EFW, Year $t$</td>
<td>110</td>
<td>5.389</td>
<td>1.777</td>
<td>1.884</td>
<td>9.491</td>
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<tr>
<td>Area 2 of EFW, Year $t+10$</td>
<td>347</td>
<td>5.221</td>
<td>1.366</td>
<td>1.600</td>
<td>9.005</td>
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<tr>
<td>Area 3 of EFW, Year $t$</td>
<td>113</td>
<td>7.243</td>
<td>2.326</td>
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<td>9.832</td>
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<tr>
<td>Area 3 of EFW, Year $t+10$</td>
<td>347</td>
<td>7.932</td>
<td>1.437</td>
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<td>9.698</td>
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<tr>
<td>Area 4 of EFW, Year $t$</td>
<td>111</td>
<td>6.859</td>
<td>1.948</td>
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<td>9.485</td>
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<td>Area 4 of EFW, Year $t+10$</td>
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<td>7.131</td>
<td>1.102</td>
<td>2.376</td>
<td>9.708</td>
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<td>Area 5 of EFW, Year $t$</td>
<td>113</td>
<td>5.906</td>
<td>1.161</td>
<td>1.579</td>
<td>8.433</td>
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<td>Area 5 of EFW, Year $t+10$</td>
<td>354</td>
<td>6.629</td>
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<td>3.764</td>
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<tr>
<td>Ethnic Fractionalization</td>
<td>455</td>
<td>0.441</td>
<td>0.228</td>
<td>0.002</td>
<td>0.930</td>
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<tr>
<td>Linguistic Fractionalization</td>
<td>455</td>
<td>0.333</td>
<td>0.285</td>
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<td>0.923</td>
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<tr>
<td>Religious Fractionalization</td>
<td>455</td>
<td>0.397</td>
<td>0.219</td>
<td>0.004</td>
<td>0.860</td>
</tr>
</tbody>
</table>

Bank reports the Gini coefficient in the same year $t$ for which there is an EFW score both in year $t$ and year $t+10$. This means that $t$ may only take the value of the years 1980, 1985, 1990, 1995, 2000, and 2001. Ultimately, this means that no regression has more than 114 observations. A full list of the country-years in the sample appears in Table 2.
### TABLE 2
**List of Country-Years in Sample**

<table>
<thead>
<tr>
<th>Country</th>
<th>Years</th>
<th>Country</th>
<th>Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Algeria</td>
<td>1995</td>
<td>Italy</td>
<td>2000</td>
</tr>
<tr>
<td>Austria</td>
<td>2000</td>
<td>Latvia</td>
<td>1995</td>
</tr>
<tr>
<td>Belgium</td>
<td>2000</td>
<td>Luxembourg</td>
<td>2000</td>
</tr>
<tr>
<td>Bolivia</td>
<td>2000, 2001</td>
<td>Malaysia</td>
<td>1995</td>
</tr>
<tr>
<td>Cameroon</td>
<td>2001</td>
<td>Morocco</td>
<td>1985, 2001</td>
</tr>
<tr>
<td>Canada</td>
<td>2000</td>
<td>Nepal</td>
<td>1985</td>
</tr>
<tr>
<td>Chile</td>
<td>1990, 2000</td>
<td>Nicaragua</td>
<td>2001</td>
</tr>
<tr>
<td>China</td>
<td>1990</td>
<td>Norway</td>
<td>2000</td>
</tr>
<tr>
<td>Egypt</td>
<td>2000</td>
<td>Russia</td>
<td>2001</td>
</tr>
<tr>
<td>Finland</td>
<td>2000</td>
<td>South Africa</td>
<td>1995, 2000</td>
</tr>
<tr>
<td>France</td>
<td>1995</td>
<td>Spain</td>
<td>2000</td>
</tr>
<tr>
<td>Germany</td>
<td>2000</td>
<td>Sweden</td>
<td>2000</td>
</tr>
<tr>
<td>Greece</td>
<td>2000</td>
<td>Switzerland</td>
<td>2000</td>
</tr>
<tr>
<td>Guatemala</td>
<td>2000</td>
<td>Tanzania</td>
<td>2000</td>
</tr>
<tr>
<td>Haiti</td>
<td>2001</td>
<td>Thailand</td>
<td>1990, 2000</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1990</td>
<td>United States</td>
<td>2000</td>
</tr>
<tr>
<td>Israel</td>
<td>2001</td>
<td>Zimbabwe</td>
<td>1995</td>
</tr>
</tbody>
</table>
Results

Table 3 provides the baseline results. The Gini coefficient is negatively associated with lower scores for the EFW index in the future. Regression (2) provides the headline result. A one standard deviation increase in the Gini coefficient decreases the EFW index by 0.15 points 10 years later, about 0.18 standard deviations. This is a modest effect, but tangible and important considering the host of other variables that may change the quality of economic institutions. The effect is statistically significant at the 95 percent level. The effect is reasonably robust across specifications.

Time and country fixed effects were both also attempted. The result remains statistically significant in all specifications except that

| TABLE 3 |
| BASELINE REGRESSIONS |
| (1) | (2) | (3) | (4) |
| LHS | EFW, Year t+10 | EFW, Year t+10 | EFW, Year t+10 | EFW, Year t+10 |
| EFW, Year t | 0.518*** | 0.498*** | 0.424*** | 0.179 |
| (0.055) | (0.056) | (0.072) | (0.107) |
| Gini Coefficient | -0.017*** | -0.014** | -0.013** | -0.019 |
| (0.006) | (0.006) | (0.007) | (0.013) |
| Ethnic Fractionalization | -0.652* | -0.581 |
| (0.366) | (0.389) |
| Linguistic Fractionalization | -0.029 | -0.017 |
| (0.288) | (0.311) |
| Religious Fractionalization | 0.547* | 0.530* |
| (0.314) | (0.318) |
| Constant | 4.197*** | 4.253*** | 3.925*** | 4.149*** |
| (0.440) | (0.449) | (0.667) | (0.612) |
| Time Fixed Effects | N | N | Y | Y |
| Country Fixed Effects | N | N | Y |
| n | 112 | 112 | 112 | 112 |
| Adjusted R² | 0.459 | 0.474 | 0.474 | 0.906 |

* Denotes significance at 90 percent level. ** Denotes significance at 95 percent level. *** Denotes significance at 99 percent level.
which includes both country and time fixed effects, which is unsurprising given that the data are already effectively differenced and the data points are relatively few in comparison to similar models. In the model with country fixed effects, for instance, the model consumes 75 degrees of freedom when only 112 observations are available. Despite this, the point estimate of the effect of inequality is virtually identical to those of the other models.

Tables 4–8 replicate these regressions for each Area of economic freedom. The empirical results in Table 4 for Area 1 (size of government) are surprising. The first three specification all show the Gini coefficient having virtually zero impact on the size of government, but when country fixed effects are included, a one standard deviation

<table>
<thead>
<tr>
<th></th>
<th>(5)</th>
<th>(6)</th>
<th>(7)</th>
<th>(8)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>LHS</strong></td>
<td>Area 1 EFW, Year t+10</td>
<td>Area 1 EFW, Year t+10</td>
<td>Area 1 EFW, Year t+10</td>
<td>Area 1 EFW, Year t+10</td>
</tr>
<tr>
<td>Area 1 of EFW, Year t</td>
<td>0.493***</td>
<td>0.529***</td>
<td>0.551***</td>
<td>0.124</td>
</tr>
<tr>
<td>Gini Coefficient</td>
<td>0.009</td>
<td>0.006</td>
<td>0.002</td>
<td>−0.064**</td>
</tr>
<tr>
<td>Ethnic Fractionalization</td>
<td>−0.263</td>
<td>−0.606</td>
<td>(0.011)</td>
<td>(0.013)</td>
</tr>
<tr>
<td>Linguistic Fractionalization</td>
<td>−0.359</td>
<td>−0.146</td>
<td>(0.553)</td>
<td>(0.587)</td>
</tr>
<tr>
<td>Religious Fractionalization</td>
<td>0.882*</td>
<td>0.910*</td>
<td>(0.448)</td>
<td>(0.468)</td>
</tr>
<tr>
<td>Religious Fractionalization</td>
<td>0.359</td>
<td>0.146</td>
<td>(0.484)</td>
<td>(0.493)</td>
</tr>
<tr>
<td><strong>Constant</strong></td>
<td>2.990***</td>
<td>2.898***</td>
<td>4.226***</td>
<td>5.552***</td>
</tr>
<tr>
<td><strong>Time Fixed Effects</strong></td>
<td>N</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td><strong>Country Fixed Effects</strong></td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td><strong>n</strong></td>
<td>114</td>
<td>114</td>
<td>114</td>
<td>114</td>
</tr>
<tr>
<td><strong>Adjusted R²</strong></td>
<td>0.399</td>
<td>0.404</td>
<td>0.400</td>
<td>0.748</td>
</tr>
</tbody>
</table>

* Denotes significance at 90 percent level. ** Denotes significance at 95 percent level. *** Denotes significance at 99 percent level.
The increase in the Gini coefficient decreases the country’s score in Area 1 by 0.71, about 0.55 standard deviations. If the results of Regression 8 are believed over Regressions 5–7, this is significant evidence that inequality drives demands for increases in the size of the welfare state, contrary to the hypothesis that inequality will lead to lower taxes and social spending.

Table 5 reports the results of the impact of inequality on the legal system. These results are similar to, but weaker than, the results found for the overall EFW index. Like the overall index, the Gini coefficient loses statistical significance (but keeps its sign) upon the inclusion of country fixed effects. Using the results from Regression 10, we find that a one standard deviation increase in the
Gini coefficient decreases the score in Area 2 by 0.30 points, or about 0.22 standard deviations.

The results for Area 3 found in Table 6 are weak. This is not surprising given the public’s lack of familiarity with monetary policy in comparison to the other components of the EFW index. While the coefficient on the Gini coefficient in Regression 13 is statistically significant and negative, the result immediately disappears in all other specifications. And, as shown in Table 7, there are no discernable effects of the Gini coefficient on Area 4 of the EFW index.

### TABLE 6
**Regression Results for Area 3**

<table>
<thead>
<tr>
<th></th>
<th>(13)</th>
<th>(14)</th>
<th>(15)</th>
<th>(16)</th>
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</thead>
<tbody>
<tr>
<td>LHS</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Area 3 of EFW,</td>
<td>0.362***</td>
<td>0.350***</td>
<td>0.211***</td>
<td>0.051</td>
</tr>
<tr>
<td>Year t</td>
<td>(0.063)</td>
<td>(0.065)</td>
<td>(0.071)</td>
<td>(0.123)</td>
</tr>
<tr>
<td>Gini Coefficient</td>
<td>-0.029**</td>
<td>-0.020</td>
<td>-0.022</td>
<td>0.052</td>
</tr>
<tr>
<td></td>
<td>(0.014)</td>
<td>(0.015)</td>
<td>(0.014)</td>
<td>(0.039)</td>
</tr>
<tr>
<td>Ethnic</td>
<td></td>
<td>-1.610*</td>
<td>-1.701**</td>
<td></td>
</tr>
<tr>
<td>Fractionalization</td>
<td>(0.851)</td>
<td>(0.835)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Linguistic</td>
<td>0.210</td>
<td>0.584</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fractionalization</td>
<td>(0.669)</td>
<td>(0.658)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Religious</td>
<td>0.910</td>
<td>0.585</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fractionalization</td>
<td>(0.736)</td>
<td>(0.681)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>6.609***</td>
<td>6.459***</td>
<td>6.429***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.774)</td>
<td>(0.843)</td>
<td>(1.352)</td>
<td></td>
</tr>
<tr>
<td>Time Fixed Effects</td>
<td>N</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Country Fixed</td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>Effects</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>n</td>
<td>113</td>
<td>113</td>
<td>113</td>
<td>113</td>
</tr>
<tr>
<td>Adjusted R²</td>
<td>0.242</td>
<td>0.255</td>
<td>0.375</td>
<td>0.674</td>
</tr>
</tbody>
</table>

* Denotes significance at 90 percent level. ** Denotes significance at 95 percent level. *** Denotes significance at 99 percent level.
Results for Area 5, regulation, are perhaps the most surprising. In Table 8, the Gini coefficient has negative effects on economic freedom in the first three specifications, all of which are statistically significant, and these effects are of similar magnitude to others found here. However, upon inclusion of fixed effects, the sign flips and the result is statistically significant at the 90 percent level. Though such significance is weak evidence, it is worth noting that, if the point estimate is accurate, the magnitude is fairly large. A one standard deviation increase in the Gini coefficient, in this model, would increase the score in Area 5 by 0.44 points, or 0.46 standard deviations. However, the most we can say is that the evidence regarding the effect of the Gini coefficient on regulation is mixed.5

Conclusion

Overall, inequality appears to have a negative impact on economic freedom. While some of the evidence is mixed and at times counterintuitive, a one-point increase in the Gini coefficient decreases economic freedom (as measured by the Fraser Institute’s Economic Freedom of the World index) by 0.013–0.019 points. Equivalently, a one standard deviation increase in the Gini coefficient reduces economic freedom by 0.18–0.26 standard deviations. Inequality appears to increase the size of government and to have a negative effect on the rule of law, little effect on the soundness of money or trade, and ambiguous effects on regulation.

Taken as a whole, this is not a cheery outcome. Those like Shiller who call for higher taxes and more transfers in response to the growth in inequality may be prophetic in the sense that policy is likely to move in that direction, regardless of whether or not the rationales for such policies hold water. Ironically, while those favoring more interventionist policies in response to greater economic inequality will likely win out, the predictions that inequality will allow the economic interests of the rich to capture more of the political process will be shown to have been wrong—that is, taxes will rise, not fall.

5One robustness check on these results was attempted. The results were essentially unchanged when the sample was split into OECD versus non-OECD countries. While replicating (when possible) each of the 24 regressions using restricted samples did not uniformly conform to the estimated ranges found above, qualitatively it gives no reason to doubt the conclusions reached.
One implication is that those who wish to promote economic freedom as measured by the EFW index should enthusiastically promote liberalizations that also promise to reduce inequality. Reforms that do both include educational reform, ending corporate welfare, and intellectual property reform. Prioritizing those liberalizations over others promises to improve the political climate for other liberalizations. Liberalizations of the past that likely increased inequality in the developed world,\(^6\) like globalization, though entirely justifiable on

\(^6\)This is not to say that globalization promoted *global* inequality, which has actually fallen (see Milanovic 2012).
their own merits, may hinder the market-oriented policy proposals of the present.

Proponents of free markets, from Hayek (1976) to Nozick (1974), are often skeptical of the very philosophical meaningfulness of inequality. Regardless of how inequality should be thought of from a normative point of view, in a positive sense we may say that it inhibits the development of free economic institutions. Therefore, proponents of free markets should be opponents of inequality.

### IMPACT OF ECONOMIC INEQUALITY

#### TABLE 8
**Regression Results for Area 5**

<table>
<thead>
<tr>
<th>LHS</th>
<th>(21)</th>
<th>(22)</th>
<th>(23)</th>
<th>(24)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Area 5 of EFW, Year t+10</td>
<td>0.567***</td>
<td>0.536***</td>
<td>0.446***</td>
<td>0.124</td>
</tr>
<tr>
<td>Economic Freedom Index</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gini Coefficient</td>
<td>-0.019***</td>
<td>-0.014*</td>
<td>-0.016**</td>
<td>0.040*</td>
</tr>
<tr>
<td>Ethnic Fractionalization</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Linguistic Fractionalization</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Religious Fractionalization</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>4.083***</td>
<td>3.966***</td>
<td>3.673***</td>
<td>1.592</td>
</tr>
<tr>
<td>Time Fixed Effects</td>
<td>N</td>
<td>N</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>Country Fixed Effects</td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>n</td>
<td>113</td>
<td>113</td>
<td>113</td>
<td>113</td>
</tr>
<tr>
<td>Adjusted R²</td>
<td>0.428</td>
<td>0.443</td>
<td>0.517</td>
<td>0.736</td>
</tr>
</tbody>
</table>

* Denotes significance at 90 percent level. ** Denotes significance at 95 percent level. *** Denotes significance at 99 percent level.
References


Impact of Economic Inequality

2012/03/23/451166/acemoglu-income-inequality-political-power.
WELFARE ECONOMICS AND SECOND-BEST THEORY: FILLING IMAGINARY ECONOMIC BOXES

Richard E. Wagner

Since the beginnings of the efforts of economists to give their discipline scientific grounding, economists have thought their theoretical efforts had relevance for addressing significant public issues. While the classical economists generally supported what Adam Smith described as the “system of natural liberty,” those economists also weighed in on numerous issues of public discussion. The tenor and substance of those efforts is set forth wonderfully by Lionel Robbins (1952) and Warren Samuels (1966). While the analytical default setting of those economists was to support the system of natural liberty, they also recognized the value of sound public policy in supporting that system. The classical economists thought that there could be publicly beneficial activities that the system of natural liberty would be unlikely to do well in providing. They also thought that there were activities provided through commercial transactions that could wreak significant effects on bystanders to those transactions. The amount of education acquired within a society was one such candidate (West 1965), with the care of the poor being another (Himmelfarb 1983). In such matters as these, the classical economists engaged in strenuous debate and discussion that served as a forerunner to the development of welfare economics during the 20th century.
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As welfare economics developed, it acquired the same formalistic character as the rest of economic theory came to acquire. It is common to describe the growing formalism as reflecting growth in the strength of analytical techniques; however, that growth also narrowed the domain of economic analysis by replacing plausible reasoning with demonstrative reasoning (Polya 1954). With plausible reasoning, models are vehicles to assist thinking about policy issues; however, there is much of relevance to those issues that cannot be collapsed into formal models—particularly judgment, sensibility, and tacit knowledge. In contrast, with demonstrative reasoning the model itself becomes the object of analysis. Policy discourse becomes a debate over models, in contrast to the classical use of models to assist a debate that ramifies well beyond any model. With the shift from plausible to demonstrative reasoning, the classical tradition of policy analysis grounded in a system of natural liberty morphed into policy analysis grounded in a system of unlimited domain for policy action.

That morphing of domains is illuminated lucidly by Meir Kohn’s (2004) comparison of value and exchange as providing antipodal orientations for economic analysis, and with Kohn’s analysis being examined at length in volume 20 of the Review of Austrian Economics (Wagner 2007). In short, Kohn’s depiction of the exchange orientation conforms to the plausible reasoning that characterized the classical system of natural liberty.

In contrast, Kohn’s description of the value framework conforms to the demonstrative reasoning that characterizes the unlimited domain of contemporary welfare economics. This distinction between orientations corresponds to Peter Boettke’s (2012) distinction between the mainline of economic theorists that extends back to the classical economists and the mainstream that arose late in the 19th century and dominates economic discourse today. The theory of the second best (Lipsey and Lancaster 1956) belongs to this contemporary system of unlimited domain, not to the system of natural liberty, though Davis and Whinston (1965, 1967) seek to locate some point of contact with the system of natural liberty, as does Harberger (1971). John Clapham (1922) explained that the effort to distinguish between industries with increasing returns and those with decreasing returns represented the creation of analytical boxes that could not be filled, and Arthur Pigou (1922) and Dennis Robertson (1924) extended that controversy. When viewed from the mainline of economic discourse, second-best theorizing, along with its welfare
Welfare Economics and the System of Natural Liberty

The system of natural liberty recognizes that people are seldom so innocently engaged as when they are making money and that seldom has much good come out of the efforts of people who claim to pursue the public’s good, to recur to Samuel Johnson and Adam Smith as two early proponents of that system. This system by no means entails an absence of policy activity by governments, as Lionel Robbins (1952) and Warren Samuels (1966) explain in careful detail. It does mean, however, that the system has a default setting oriented toward individual liberty. Violations of liberty are the exceptions and not the rule in such a system of liberty and justice. In contrast, such violations have become the norm over the past century or so, as no longer is there any general presumption against the deployment of political power wherever the possessors of that power choose to deploy it. The domain of the political is unlimited in contemporary welfare economics, in contrast to that domain being circumscribed within the classical version of welfare economics. This unlimited domain arises because statements about welfare are governed by presumptions about postulated preferences and not by presumptions about the requisites for human flourishing within a system of natural liberty when people live together in close geographical proximity (Cropsey 1950). Hence, welfare economics, along with second-best theorizing, becomes dominated by the demonstrative concerns of form rather than by the plausible concerns of substance, as Cropsey (1950), Nutter (1968), and Yeager (1978) explain to similar effect.

The classical economists were well aware that there were activities of general value to nearly everyone that were unlikely to be provided through normal commercial transactions. In contrast to contemporary public goods theory with its dichotomy between private and public goods, the classical theorists exhibited more subtlety and nuance in their analytical efforts. They would not, for instance, argue over whether lighthouses were private goods or public goods. While Ronald Coase (1974) described how the provision of lighthouses was organized in Britain from tolls collected from ships that came into harbor, this situation is irrelevant for the contemporary dichotomy between private and public goods. The British scheme for providing
lighthouses neither demolishes ideas about public goods nor does it deny claims about market failure. It is pointless to use lighthouses to make debating points for one side of the contemporary classification or the other. That classification as used in contemporary analysis illustrates the effort to create and fill imaginary analytical boxes.

Of course lighthouses are public goods. Of course lighthouses would not be well provided if they were financed by self-assessment when ships came into harbor. This situation does not, however, signify anything like market failure. If there is any failure, it resides in the elevation of resource allocations over institutional arrangements as the focal point of economic analysis. As Nathan Rosenberg (1969) explains pithily, Adam Smith’s focal point was on the institutional arrangements of human governance and not on resource allocations, because allocations were subordinate to and derivative from those institutional arrangements. To assert that something is a public good is simultaneously to imply that entrepreneurial gains potentially exist from developing an organizational arrangement that would accommodate provision of that good. All that the public goods claim accomplishes is to explain that any such arrangement will not take the form of the conventional spot transaction where a customer pays a price and receives the service. But this type of transaction is only one of the numerous forms of transaction that occur continually within societies (Wagner 2012a, 2012b).

Shippers and ship owners have strong interests in having their ships arrive safely in harbor, as do the people who work on those ships and also the people who await the arrival of the merchandise those ships carry. The contemporary dichotomy between private and public goods suggests a binary choice: either accept the failures of ordinary market transactions to provide lighthouses or embrace the provision of lighthouses through ordinary political processes. Coase (1974) did not deny that ordinary market transactions would fail to provide lighthouses. But neither did he embrace direct provision through a Bureau of Lighthouses. At his analytical core, Coase rejected the contemporary focus of welfare economics on resource allocations, as exemplified by the contemporary theory of public goods, and proceeded by recurring to the classical focus on the institutional arrangements through which social interactions are governed.

Within this alternative orientation, a rich menu of possibilities comes into play, all of which transcend the orthodox focus on the
private-public dichotomy. For instance, ship owners could form some club-like arrangement to provide and maintain lighthouses. This arrangement would have problems to overcome, but all human arrangements have problems to overcome. Some working organizational arrangement would have to be developed, and from this arrangement would spring decisions about governance, membership, dues, and other means of financing the organization, about the location and staffing of lighthouses, and about the resolution of disputes among the members, among numerous other decisions. Issues of possible free riding might arise. This possibility points to further issues that would have to be explored in arriving at a workable resolution. For instance, the club of ship owners might also own rights of dockage at harbors and exclude free riders from docking. Some excluded party might object to being excluded and file suit, possibly claiming that harbors should be operated as public utilities. The menu of potential possibilities is manifold, and all these possibilities are in play in actual historical situations. The contemporary dichotomy between public and private goods is of no use either for understanding such situations or for working inside them as participants.

At this point, we arrive at a fundamental dichotomy between the scheme of thought exemplified by the classical theorists of the system of natural liberty and the contemporary theorists of welfare economics and second-best theory. The classical theorists operated through plausible reasoning. In contrast, most contemporary theorists operate with demonstrative reasoning, and with the contrast sketched beautifully and crisply by George Polya (1954). The difference in approach, moreover, resembles the two parabolas $X^2$ and $-X^2$ in that they point one’s attention in opposite directions despite sharing a common point of origin. Likewise, theorizing from an analytical platform based on a system of natural liberty points analysts in the opposite direction than does theorizing from a platform where the domain for political action is unlimited. Murphy and Nagel (2002) embrace an unlimited domain for the political within society by arguing that private property is a myth because ownership is the rightful province of those who possess political power. Holders of political power might allow ordinary people temporarily to exercise what those people mistakenly describe as private property. Nonetheless, whatever rights a state allows people to exercise at one instant can be taken back at a later instant because all rights of ownership reside in the
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state, as distinct from society. In advancing their assertion, Murphy and Nagel are doing little more than reflecting the unlimited domain of contemporary welfare economics, wherein the province of state action is governed by nothing more than some economist’s formulation of the necessary conditions for Pareto efficiency.

Demonstrative Reasoning, Plausible Reasoning, and Policy Analysis

Demonstrative reasoning entails reduction of an analytical object to something that can be represented by a theoretical model. If there is anything excluded from the model, it is not of analytical interest. Demonstrative reasoning is the realm of proof, both of demonstrating conditions under which some solution to a stipulated problem exists and of proving that a solution does not exist. When this scheme of thought is applied to the phenomena of the social world, the model and its conclusions and implications end up becoming that world. For instance, an analyst might posit a production function that describes production and cost relationships for a firm. Under some conditions and models, price will equal marginal cost. If generalizable, such conditions will describe a competitive equilibrium as being Pareto efficient. If such conditions are not generalizable, we face the quandary that the theory of the second best is thought to address. But this also becomes a world where nearly anything is possible, depending on the particular assumptions on which a particular model is based. The central feature of demonstrative reasoning in any case is that the model is the phenomenon of interest to the analyst.

In contrast, for plausible reasoning, models are aids for thinking but the object of that thought entails more than the model can contain. The discussion in the preceding section about lighthouses illustrated phenomena suitable for plausible and not demonstrative reasoning. To apply demonstrative reasoning in such circumstances is possible only by denying the relevance of phenomena that cannot be collapsed into the model. The condition that price equals marginal cost is one of the standard necessary conditions for Pareto efficiency. Recognition that those conditions might often be violated leads into the second-best world that is filled with ambiguity, which means there are nearly limitless policy measures that might be advocated by referring to second-best formulations. Yet a scheme of thought that can countenance nearly anything is
surely not much of a scheme of thought for guiding policy action in reality.

Consider the standard analysis of production and cost. Firms are assumed to produce their outputs in least-cost fashion, which means that a cost function is a boundary condition that separates what is possible from what is impossible. It is impossible for a firm to produce below its cost function, but it is possible to produce above that boundary. What is the basis for presuming that production occurs on that border and not somewhere above it? There exists no library of studies similar to the time-and-motion studies of long ago that show myriad instances of production occurring in least-cost fashion. Whether production occurs in least-cost fashion is not demonstrable, but it is open to plausible reasoning. From what we know about human nature, it is reasonable to think that people will exercise more care in organizing production when they hold residual claims over the quality of their judgments than when those residuals are distributed randomly throughout society. Residual claimacy describes private property and the private ordering of economic activity. Yet collective property and political ordering of economic activity has huge presence in contemporary society, and there is no plausible basis, as distinct from assertion, that the same diligence is exercised when people are not responsible for the value consequences of their actions as when they are responsible.

Much of the theory of competitive equilibrium reduces to the injunction to set price equal to marginal cost. Second-best theory can be advanced to explain why particular efforts to set price equal to marginal cost might not be a Pareto improvement in the presence of numerous instances where that equality condition is violated. The condition that price equal marginal cost is a demonstrable feature of a particular theoretical model. That condition is an implication of a model that seeks to minimize the cost of producing any single output. Yet in the world of plausible action there is no observable entity that corresponds to the economic box labeled “marginal cost.” Marginal cost is a theoretical construct that pertains to a firm that produces a single product. The number of firms that produce single products might well be zero, and is small in any case.

Even such a simple firm as a small bakery produces many products, and would not reasonably confine its production to a single product. We may grant that a bakery produces bread. Almost surely, that bakery would also produce a variety of flour-based products
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including rolls, muffins, and cakes. Moreover, it wouldn’t produce just one type of bread, but would offer several varieties. A bakery that produces a single product would almost surely fail in open competition against bakeries that offered multiple breads, as well as complementary flour-based items. In this situation, however, marginal cost becomes an arbitrary matter of how the firm keeps its accounts. Multi-product firms are rife with common and joint costs that can be apportioned among the individual items of production only in some arbitrary fashion. To be sure, it is reasonable to think that the owner of a firm will want to generate as much useful information as economically useful from its accounts, to assist its officers in reaching judgments about whether to discontinue some lines of production or to create new lines. Choices about how to form such judgments will always be present, which means that the theorist’s marginal cost does not correspond to what the practitioner might describe as marginal cost, as the essays collected in Buchanan and Thirlby (1973) explain.

Second-Best Theorizing: Mainstream vs. Mainline Economics

The general theory of the second best, upon which Lipsey (2007) reflects after 50 years, uses demonstrative reasoning to demonstrate the general impossibility of Pareto improvements through piecemeal policy guided by the necessary conditions for Pareto efficiency. While this theory works against the offering of simple policy measures, it also opens into a vast expanse of hypothetical policy measures that feature an expansion in the violations of the conditions for competitive equilibrium as a means for pursuing Pareto efficiency in a second-best world. If reality conforms to all but one condition for Pareto efficiency, removal of the one impediment will be a clear improvement. But if two or more margins of imperfection exist, removing one imperfection can’t be demonstrated to be a Pareto-efficient move. Where much policy analysis councils removal of what are claimed to be margins of imperfection, second-best theory can countenance the addition of further imperfections as a corrective movement.

Taxation, trade, and environmental regulation provide much material for second-best analysis. Consider a model where there is a monopolist whose production is a significant source of water pollution, and with it being assumed, as nearly all such models assume, that there is no common-law remedy for pollution. According to the
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standard model of competitive equilibrium, the necessary conditions for competitive equilibrium are violated along two margins. One margin is production, where within the standard model of monopoly the monopolist produces at an output where price exceeds marginal cost. The second margin is pollution where the marginal social cost of production is presumed to exceed the marginal private cost. A regulatory policy with respect to monopoly would increase output until price equaled marginal cost. A tax policy with respect to pollution would increase price and lower output. A pollution tax might equalize private and social marginal cost, but would move consumers farther away from optimality. A regulation to force the monopolist to produce the competitive output would bring price into equality with marginal cost, but would also increase pollution damage. It is impossible to demonstrate as a general principle that a corrective policy applied to one margin will bring about global Pareto improvement when there are multiple margins along which the necessary conditions for Pareto efficiency are violated.

In providing a substantive illustration of second-best theory in action, Paul and Joseph Rubin (2014) explain that second-best theory can be used to justify the use of the Export-Import Bank to subsidize American firms engaging in international trade. They recognize that a superficial look would recommend abolition of the Bank because private banks will be able to make better judgments about profitability than a governmental bank. Yet Rubin and Rubin also explain that the American government through its Foreign Corrupt Practices Act makes it illegal for American businesses to pay bribes, which places those businesses at a competitive disadvantage in many parts of the world. An inefficient subsidy might be warranted in light of the inefficiency that arises from restricting the competitive ability of American firms. Following the spirit of second-best theorizing, the injection of a new margin of inefficiency might mitigate the inefficiencies that other policies create along other margins.

Second-best theory challenges the application of policy aimed at increasing the domain over which the conditions of competitive equilibrium pertain. First-best and second-best analyses both adopt the theory of competitive equilibrium as providing a solid point of orientation for policy prescription. This basing point is a feature of the theory of competitive equilibrium formulated in terms of demonstrative reasoning. This theory took its shape with respect to such bizarre assumptions as firms being universal price takers, with products
being homogeneous, and with knowledge being complete as a result of an effort among theorists to demonstrate conditions under which an equilibrium position could be found that would satisfy the law of one price (Stigler 1957). At one time it was thought that a large number of buyers and sellers would be sufficient to establish the law of one price, and with the desire to demonstrate that law being taken not from observation but from theoretical construction. At that point, Stigler explained, Francis Edgeworth pointed out that that large numbers wouldn’t be sufficient if those myriad buyers and sellers comprised matched pairs who knew only of each other. In this situation there would exist a large number of bilateral monopolies. The urge to demonstrate the law of one price then led to the assumption of full knowledge of all relevant options, and economic theory gained even greater distance from its classical moorings in plausible reasoning.

Within a scheme of plausible reasoning, the welfare analytics associated with second-best theorizing is largely irrelevant. A theory of competition grounded in plausible reasoning would recognize that competition is a verb and not an adjective (McNulty 1968). Free or open competition is a human activity that entails the creation and execution of commercial plans within a framework of private property and liberty of contract. Such competition bears but faint resemblance to the theory of competition, whether of perfect or imperfect varieties, used within contemporary welfare economics with its focus on various marginal equalities. As already noted, marginal cost is an accounting artifact within actual commercial life, though it is also plausible to affirm along the lines of Alchian (1950) that those firms that hit upon more helpful accounting schemes will fare better than other firms because their economic calculations will provide superior managerial guidance.

Second-best theorizing seeks to fill imaginary economic boxes by adopting models that appear to address reality but actually address only caricatures of that reality. For reality to be addressed, plausible reasoning must be pursued because it is impossible for an external observer truly to know what arrangements will represent improvement for those who must live with those arrangements, as Elinor Ostrom (1990) illustrates through her numerous examinations of common property settings. Models can be significant aids to sound thinking, so long as it is recognized that the answer to whether a policy measure would be an improvement over an existing situation
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is something that only the people who reside on the ground, so to speak, can answer. Sound policy within a framework of plausible reasoning entails a utilization of knowledge that is distributed among the members of a society and most certainly is not assembled within some professed expert’s models.

Where Do Policy Analysts Reside and What Does It Matter?

In their survey of the scholarship of Elinor and Vincent Ostrom, Paul Aligica and Peter Boettke (2009) explain that the Ostroms sought to develop analytical frameworks that allowed them to penetrate their material, in contrast to the orthodox efforts of social scientists to stand apart and gain distance from their material. This distinction is fraught with implications for welfare economics and the contemporary analysis of public policy even if it was not so significant at the time the welfare theory of natural liberty took shape. In those earlier times, governments were small, private ordering dominated economic activity, and the franchise was limited largely to property owners. The governance of polities was an activity that engaged the few, not the many. Those who participated in that governance had some emotional and behavioral distance from most of those to whom policy measures would apply. Policy discourse thus had a top-down character.

This top-down character has remained a staple of conventional policy analysis and espousal despite the dramatic change in institutional environment, through which governments became bloated, public ordering became ubiquitous, and the franchise became unrestricted. Within this contemporary institutional environment, policy espousal is a mass activity, not a restricted one, despite the widespread use of theoretical frameworks that remain essentially unchanged from the 19th century. The characteristics of policy espousal should be observed to reflect the different environments in which policy is espoused. Within contemporary environments, policy espousal would take on more of a bottom-up character than a top-down character. This change of character does not deny the presence of expertise in policy espousal, but it has that expertise penetrate into society as a primus inter pares, as against standing apart from the mass of society and acting on that society much as a shepherd acts to guide a flock of sheep.
Much policy espousal is conveyed by offering fables about prisoners’ dilemmas. The analyst posits a situation where what people can achieve through independent action is inferior to what they could achieve through collective action. This presumption leads instantly to the claim that political action to impose the superior outcome will be beneficial to everyone. This scheme of thought is popular, though we may well wonder why it is so popular. It has no descriptive power because reality never appears in this fashion. It is as if the only option for providing lighthouses is to live with nonprovision through market arrangements or to embrace provision by a Bureau of Lighthouses. Yet this by no means conveys the situation, as was noted earlier. In this respect, it is worth noting that the prisoners’ dilemma was originally a three-person and not a two-person game, and with the prisoners being reluctant duelists put in that position by the third player (Ellsberg 1956). In the three-player setting, a district attorney stood apart from the prisoners and imposed policy on them to promote the DA’s objective. This is a scheme of thought suitable for a presumptively benevolent monarch shepherding his flock.

For a democratically organized polity, however, there is no monarchical position outside the society. In this setting, there is no meaning to the notion of people being caught in a prisoners’ dilemma. People face problems all the time, of course, but there is no benevolent agent who stands apart from society and who possesses the knowledge required to impose improvement on society. There is nothing but the people inside society with their various forms of knowledge and expertise who seek to deal with their various sources of sensed uneasiness. The formalities of welfare economics and second-best theorizing do not speak to the problems of societal living together in close geographical proximity, for they posit an array of analytical boxes that can be filled only in a theorist’s imagination. In modern times, that imagination doubtlessly has a veneer of civility about it whereby the wielders of power prefer to use velvet gloves to mask that power as against using mailed fists to show it. Use of the prisoners’ dilemma allows power to wear velvet gloves by claiming that advocated measures are for the general good, just as the model shows. That model, however, is a construct of a theorist’s imagination, and with that theorist effectively embracing a polity of unlimited domain. The alternative is to embrace the mainline and substantive approach to policy espousal that resides within the domain of plausible reasoning and natural liberty.
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References


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The Rule of Nobody: Saving America from Dead Laws and Broken Government
Philip K. Howard

Philip Howard is a lawyer nationally known for his best-selling books and extensive commentary on the dysfunctions of the American legal and political systems and the adverse effects those dysfunctions have on individual behavior and the overall workings of society.

Beginning with his 1994 best seller, The Death of Common Sense, and throughout the rest of his career, Howard has chronicled an American society buried in law and legalism, tyrannized by jackpot justice trial attorneys, and strangled in red tape; a society smothered with rules and legalistic procedures that paralyze us, prevent us from taking responsibility, and keep us from using our common sense to confront and solve our problems in order to advance the common good.

In response to these problems, Howard has called for a restoration of common sense to government based on principles of freedom, responsibility, and accountability. He has called for a sweeping simplification of government that will allow people to make sensible choices and free them from the oppressive interference of lawyers. One of Howard’s books is even called Life without Lawyers. As a result of his continued focus on the widely acknowledged problems of our legal system, Howard is firmly
established as a well-known legal reformer. He has spoken in a wide variety of venues, including *The Daily Show with Jon Stewart*. In 2002, he founded Common Good in order to better champion his reforms.

In *The Rule of Nobody*, Howard returns to established themes, this time with a focus on government regulation. He presents a compelling description of the dysfunctional American administrative state—strangled in red tape, beset by absurdly detailed means-and-methods regulations with check-the-box compliance requirements, bogged down in endless permitting and other administrative proceedings, and burdened with costly litigation. A thicket of law and a horde of lawyers combine to restrict freedom, obscure responsibility, undermine accountability, and sap individual initiative, thus preventing America from effectively addressing the serious problems that confront it.

Howard laments that rules dictate daily choices and that nobody has authority, or responsibility, to get things done—thus, “the rule of nobody.” He underscores his point with anecdotes about sympathetic individuals trying to take responsibility and to get things done—school teachers trying to maintain classroom discipline, nursing home operators trying to provide compassionate care, an official trying to improve a port facility, and someone who just wanted to remove a fallen tree from a creek bed in his town.

Howard is certainly correct that America is strangled by red tape. What then, is the cause of this sorry situation, and what is the cure? According to Howard, our current regulatory mess results from our outmoded attachment to the rule of law and its misplaced emphasis on clear rules, predictability, and procedural safeguards to restrain the arbitrary exercise of state power and to protect the rights of the individual. Attachment to this “orthodoxy” is the key reason for the proliferation of rules and regulations that are so numerous, complex, and restrictive that public officials cannot apply their professional judgment, exercise authority, and take the decisive action that Howard claims is needed to effectively deal with the problems that confront our complex and interdependent modern society. According to Howard, “American government is failing not because officials who deal with the public have too much power, but because they have too little.” He asserts that “nothing will get fixed until we give back to officials the authority that goes along with their responsibility.” America needs a strong
government that can get things done and “implement our common goals.” After all, “the only purpose of government is to serve the common good.”

Howard believes we must recognize the “failure of the framers’ vision” and rethink the rule of law, limited government, and individual liberty. According to Howard, the proper role of law in a modern society is to set general policies and to proscribe in very general terms the outer boundaries of prohibited behavior inconsistent with those policies. Law should not attempt to prescribe specific behavior required to support a policy, nor should it proscribe in precise terms the behavior that will constitute a violation of the policy. Both of those tasks should be delegated to responsible administrative officials authorized to apply their professional judgment to determine on a case-by-case basis what behavior is needed to support the policy and whether a certain behavior has violated the policy.

“Think of law as a giant corral,” says Howard. Within the fences, the regulator oversees and directs, not by the application of detailed rules and regulations like we have today, but through an ongoing “regulatory conversation” between the regulator and the regulated that indicates what behavior is required so things are “up to snuff” and in accordance with government policies. This conversation is of course backed by the threat of sanctions. “Regulating softly only works . . . as long as government has a big stick.”

The obvious vagueness and unpredictability of this sort of “open legal structure” is, according to Howard, not a vice but a virtue. When the regulated are not sure of exactly what kind of behavior is required to avoid punishment, they will use the “regulatory conversation” to learn the sorts of behavior the regulator wants to encourage and “go to the middle” of the corral as “a kind of safe harbor,” conforming their behavior to that most closely supportive of the government’s policies and to advancing the common good.

Howard maintains that life inside the corral will be free and fulfilling, more so than today. He argues this point by redefining freedom and fulfillment in terms that reduce the individual to a mere component of the collective. He dismisses our traditional concept of individual freedom as “a thin brew of isolated actions and selfish pleasures.” In a complex and crowded modern society, “oversight is essential for us to feel free” and “defining freedom by absence of authority is a formula for futility and unimportance.”
Collective “enterprises . . . create the opportunities for real accomplishment. But joint endeavors require authority.”

Before we can move into the corral and live the more fulfilling collective life under the tutelage of our shepherd regulator, “democracy must be built anew,” and government must be restructured from its foundations up to “allow officials to focus on the common good.” To accomplish this restructuring, Howard proposes a series of reforms designed to enhance the power and increase the flexibility of administrative officials. Some of these are familiar and individually uncontroversial, but together they combine to support Howard’s “open legal structure” at the expense of constitutionally limited government, individual rights, and the rule of law. He calls for the appointment of committees of “experts” to recodify and radically simplify federal statutes. He proposes that all laws with a budgetary impact expire after a period of time. He argues that the powers of the president should be increased, and that Congress should merely “set [policy] goals and . . . leave ample room for the executive to make choices.” Judicial review of executive actions should be dramatically curtailed to limit the ability of individuals and corporations to use litigation to “second guess policy choices” of the executive and thus delay the implementation of needed regulatory action “for selfish ends” inconsistent with the broader interests of society.

Who determines what is in the broader interest of society? Howard calls for the presidential appointment of a nine-member Council of Citizens drawn from a pool of 100 people “of high distinction” to “represent the greater good” and “provide the moral keel for public choices.” This “independent body” of disinterested experts would provide a “counterbalancing force to the incessant demands of self-interest.” Its members would “evaluate the moral basis of policy choices.”

As our regulator shepherds apply their judgment to oversee, direct, and sometimes punish us, Howard acknowledges that they will make mistakes. After all, “government oversight . . . involves complex activities,” and the dialectic of “trial and error is the key to progress.” But we do not need detailed rules and regulations, enforced through judicial review, to hold regulators accountable and to protect us from official abuse because the regulators overseeing our corral will themselves be “hemmed in” by generally
stated policies “tethered to community norms of reasonable interpretation.” The reasonableness of every policy and every official act of interpretation and application can be judged by whether and the extent to which it advances the common good. “If a decision or law can’t be justified as being in the broader interests of our free society, it is morally invalid.” So, we will be able to call our regulators to account, but only for actions not consistent with the common good as generally expressed in policies blessed by the Citizen’s Council.

As objective analysis, Howard’s book must be judged a failure. Its basic premise, that our problems of governance result from the inadequate empowerment of public officials, is thoroughly refuted by the widely reported activities of the IRS, the EPA, the Department of Labor, the FDA, and other agencies. The Rule of Nobody is best understood as an argument for progressive governance and the administrative state wrapped up in a beguiling account of bureaucratic dysfunction and laced with personable anecdotes and appeals to commonplace but attractive concepts like common sense, personal responsibility, and the simplification of the legal system. All of the elements of the progressive credo are present: Individuals, on their own, are likely to act in ways that are selfish; we cannot be trusted to manage our affairs and make the choices needed for a complex society to progress; social progress is best directed by a governing class of experts, elite administrators freed from the restrictions imposed by outmoded concepts of limited government, inherent individual rights, and the rule of law who will be shepherds empowered to direct society for the “common good,” as they may define it; individuals must adjust their ideas of personal freedom and understand that freedom is only achieved through the imposition of authority; and, finally, personal fulfillment is only achieved as a part of the collective.

Howard is correct that the operations of the administrative state are in tension with and hindered by the Constitution and the rule of law, and that inefficiency and so-called gridlock are often the result. The Founders established a limited government of enumerated powers divided and constrained by law to protect liberty at the expense of efficiency. For 100 years, the progressives have pursued efficiency at the expense of liberty. Howard would like to resolve this historic tension in favor of the administrative state.
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There is, of course, a better way to resolve this tension: by recognizing that our Founders' vision is not a “failure,” as Howard maintains, but a majestic triumph. Our Founders held that all people are born possessing in equal measure certain natural rights, including the rights to life, liberty, and property. The right to property is especially important because it is property that provides each individual a foundation on which to build an independent life, enjoy liberty, and pursue happiness. The progressives, by contrast, hold that the rights of the citizen are created by the government, conditionally granted to the citizen, and then continuously adjusted as the government determines such adjustment appropriate to advance its evolving policies in support of progress and the common good.

The view that rights are simply the malleable artifacts of government action drives the modern regulatory state. Everything we find so troubling, from the endless maze that typifies the permitting process and the stifling details of means-and-methods regulation, to the heavy-handed enforcement actions brought against even the smallest operators, are the direct and inevitable result of a regulatory process based on a progressive world view that sees the provision, use, and disposition of property as activities requiring government permission rather than as basic human rights that the government is obliged to protect.

Red tape and bureaucratic dysfunction are not the fault of the rule of law; they are the essential manifestations of the micromanaging administrative state that seeks to supplant the rule of law with the rule of the regulator. Officials do not need more latitude to corral and shepherd the populace in pursuit of some abstract concept of the collective common good. People have had enough corraling, and we have suffered enough at the hands of collective utopians using the power of the state to impose their vision of a better tomorrow. Individual citizens need more latitude to exercise their common sense and personal judgment so that they can lead their lives, enjoy their liberty, and pursue their happiness. It will take years of hard work to tame the administrative state and restore the Founders’ vision. A good first step would be to reject the specious analysis and progressive nostrums contained in The Rule of Nobody.

J. Kennerly Davis Jr.
Former Deputy Attorney General for Virginia
Book Reviews

Mass Flourishing: How Grassroots Innovation Created Jobs, Challenge, and Change
Edmund Phelps

In his most recent tome, Edmund Phelps, the 2006 Nobel Laureate in Economic Science, addresses a topic crucial to successful national capitalist systems: the dynamics of the innovation process. Phelps develops his thesis around three main themes: In part one, he explains the development of the modern economies as they form the core of early–19th century societies in the West; in part two, he explores the lure of socialism and corporatism as competing systems to modern capitalism; and, in part three, he reviews post-1960s evidence of decline in dynamism in Western capitalist countries.

In the introduction, Phelps reviews available economic data on both output and real wages per worker in England during the era of “mercantile capitalism” (between 1500 and 1800), which emphasized the distribution of products to consumers. He concludes that “the mercantile economies brought strikingly few advances in economic knowledge.” Yet, the 19th century, specifically between 1820 and 1870, saw spectacular growth in two major economic indicators—output per head and average real wages—in America, France, Germany, and Great Britain. Phelps argues that “the explosions of economic knowledge in the 19th century must be the effect of the emergence of an entirely new economy: a system for the generation of endogenous (or ‘indigenous’) innovation.”

In part one, Phelps defines a modern economy as one with “a considerable degree of dynamism—that is, the will and the capacity and the aspiration to innovate.” Yet the foundation of dynamism is innovation, even on an international scale, where conception and development can originate in one nation while pioneering adoption takes place in another. Phelps argues that the dominant Schumpeterian model of punctuated equilibrium theory prevented economic thinkers from seriously considering a model of a modern economy generating economic knowledge through its own indigenous talent and insight into the innovation process.

However, unlike the scientism and historicism that came to rule academia, the modern economy empowers financiers, manufacturers, and consumers, whose ideas and deep personal engagement
create products and services and who have the responsibility to manage the innovation process from development to commercial adoption. This system fosters attitudes that attract innovators to novel opportunities and it generates the disruptive knowledge that gives the modern economy its dynamism. According to Phelps, the more an economy devotes itself to inventing and innovating, the more "modern" it is.

So how effective have modern economies been for their people? Phelps argues that the single most important economic indicator of material benefits is wages, and he reports that the daily wage per worker as a ratio to the national output per capita went up in France, Germany, and Great Britain from 1830 to 1910. That fact, coupled along with the aforementioned wage trend in the middle of the 19th century, led to two societal benefits: First, it allowed unskilled workers to accept more desirable work while also increasing economic mobility among all people; second, wages reduced poverty and improved public health and mortality. Through innovation, modern economies outperformed less-modern economies and significantly altered their material conditions of life.

As to nonmaterial benefits, modern economies transformed the work and careers of millions through self-actualization, employee engagement, self-expression, self-discovery, the freedom to act, and personal attainment. Moreover, there were three freedoms ("economic institutions") that boosted dynamic economies: personal liberty ("self-ownership"), the legal right to accumulate income earned from commercializing a successful product, and the legal right to invest this income in private property. Furthermore, the economic institution of the business organization—the proprietorship, partnership, and the joint stock corporation (along with its limited liability)—and the political institution of representative democracy both played important roles.

In part two, Phelps explains the "lure of socialism," which includes various factions, ranging from the extreme of communism ("centralized control of all enterprises") to the Fabian socialists' incremental reform in the scope of capitalism. On the economic failures of Marxian socialist economies in the 20th century, Phelps concludes that they were fatally lacking in dynamism, that is, the knowledge necessary to build a modern economy and the fundamental incentives necessary for managers to be entrepreneurial and innovative.
Corporatism, where the state is free to take whatever measures it chooses for the sake of solidarity and protection, is a late-19th century Western European criticism of the modern economy. Corporatists argued that the modern capitalist economy lacked leadership and direction. In the early 20th century, corporatism was entrenched in Fascist Italy, Nazi Germany, and to a lesser extent in Portugal and Ireland. In the United States, Phelps reports that the New Deal brought some corporatist initiatives, such as the National Labor Relations Act of 1935, which established the permanent right of employees to organize. Phelps believes, however, that a “new corporatism,” where “the state is less a guide choosing the heading than a pilot paid by the passengers to take them where they ask,” has alarmingly taken hold in the post–World War II American economy.

Based on economic data covering the period from the mid-1960s through the first decade of the 21st century, Phelps found that the relatively modern capitalist economies of the United States, Canada, Great Britain, and Norway consistently outperformed the relatively socialist-corporatist economies of Germany, France, Italy, and Spain on labor participation, inclusion, and productivity indicators. Furthermore, as to the development of indigenous innovation, Phelps concludes that the relatively corporatist economies performed less robustly because they lacked the economic institutions and culture to “enable, stimulate, and spur experimenting, exploring and trying things.”

The economic culture of a nation, consisting of prevailing attitudes, norms, and assumptions about business, work, and other aspects of the economy, “may affect the generation of nonmaterial rewards indirectly through their influence on the evolution of institutions and policies, but also very directly through their impact on participants’ motives and expectations.” To support his position, Phelps utilizes World Values Surveys (WVS) data for 1990–91 and 1999–2000 to argue that relatively modern capitalist countries that ranked highest in family satisfaction, including Denmark, Canada, the United States, and Ireland, also ranked highest in job satisfaction. Phelps identifies institutional causes of these nonmaterial disparities, such as recognizing stronger legal structures/property rights and establishing financial institutions, as well as cultural causes, including values associated with the interestingness of a job, acceptance of new ideas, the desire to have some personal initiative, a readiness to accept change, and a willingness to accept
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competition—all WVS classifications representing modern capitalist values.

In part three, Phelps describes the alarming slowdown in average growth rates of American labor productivity beginning in the early 1970s and extending to 2011 and 2012. Labor productivity was 1.57 percent in 2011 and 2012, compared to 2.33 percent in 1891, and multifactor productivity was 1.17 percent in those same years, compared to 2.26 percent in 1922. He concludes that “the waning of innovation was largely behind the increased joblessness and downward pressure on wages that have been endemic to the post-1972 period.”

What factors are behind the post-1960s decline in the dynamism in the American modern capitalist economy? Economic institutional sources include: unnecessary and self-dealing managerial hierarchies in large companies, professional managers focused on short-termism at the expense of innovative long-term projects, and risk-averse mutual funds and large investment banks speculating in currencies and government bonds rather than evaluating companies and industries on their specific merits. The economic culture, specifically the litigiousness of American society and an entitlement attitude, also plays an important role in this decline. Lastly, Phelps observes a disturbing increase in corporatism between the state and business, that is, a “parallel economy” of political influencers seeking company advantage and actively repressing market competition and innovation.

Phelps engages the concept of the “good life” (and “good economy”) through a humanist lens, using Aristotle’s “pursuit of knowledge” as a departure point. He also explores the concept of pragmatism, which involves knowledge valued for its practical applications, but he admonishes that “pragmatists do not specify what humankind wants to succeed at.” Phelps clearly espouses an individualist approach to the good life found in the “vitalist” school, which translates eudaimonia to a broader concept of individual “flourishing” and “self-discovery” and attaining the “highest good” while still being an active participant in the modern economy.

Phelps embraces John Rawls’ distributive justice approach in evaluating the modern capitalist economy and applies this conception of (economic) justice to the distribution of the rewards from work. This includes “the avoidance, where practicable, of economic inefficiency” thus requiring, by definition, a form of market economy. Yet
Phelps acknowledges that the static (“having a future always foreseen”) Rawlsian version of a market economy is flawed, being neither innovative nor dynamic. While many critics of the modern capitalist economy advocate a “balance” between work and home (a traditionalist value), Phelps sees such personal challenges as part of the good life, and we “cannot expect to find more flourishing by cutting back on challenges and hurdles.” He views the freedom and justice found in a modern economic society as the coexistence of traditional and modern economic values—entailing costs individuals must personally accept.

In his epilogue, Phelps identifies his policy prescriptions for restoring dynamism in modern economies. Recognizing that most legislators and regulators lack experience in the business arena, Phelps recommends that regulators intern in business enterprises and legislators self-educate themselves on how innovation works, thus hopefully reducing dependency on market distorting, inefficient subsidies and regulatory mandates for “targeted” industries. In the private sector, Phelps recommends reforms to discourage short-term perspectives by CEOs, mutual funds, and commercial banks, while encouraging long-term investments more valuable to shareowners, including efforts to encourage the establishment of new financial companies offering “relational” banking, which involves the development of personal financial service focused on the needs of the specific company. Phelps also argues that labor unions and professional associations impose restrictions on new entrants that often impede innovation, and that in order to address their political power they need to be active participants in the national dynamism debate. Lastly, in order to encourage youth to “refuel grassroots dynamism” in the American economy, “the main ideas of modern thought, including individualism and vitalism, need to be reintroduced in the economy.”

Like many economists, Phelps views “social responsibility” and “stakeholderism” as aims contrary to maximizing income for shareholders and employees. Managers, unlike academic economists, must be knowledgeable of the values and concerns of all relevant stakeholders to ensure long-term business success. In a real market economy, shareholders and employees are not the only stakeholders that impact the operations of the enterprise. Phelps’s thoughtful policy prescriptions are of interest and some are worth actively exploring, including educating legislators on the innovation process,
inviting business associations and unions into the dynamism debate, and encouraging long-term investment. Yet it should be remembered that institutional investors presently managing pensions are influencing company policies toward stable, longer-term investment prospects, and that there has been a growing trend to take public corporations private.

Phelps masterfully utilizes aggregate data on cross-comparative national economic productivity and adeptly complements it with international individual employee satisfaction survey results give the reader a rich empirical tapestry that support his theme. His focus on the philosophic underpinnings of the modern economy, even though he believes it is now restrained by corporatist ideology, is a clarion call to leaders of less-dynamic Western economies. Specifically, Phelps is spot-on in his indictment of the “new corporatism” in the American polity, which, from Obamacare to “green” energy subsidies, has become all too common. These policies have significantly contributed to the sick pallor cast over the U.S. market economy.

In conclusion, Edmund Phelps has written a convincing narrative of why modern economies have been the most successful economies in the 19th and 20th centuries, and why they need to regain their dynamism if they wish to continue into and throughout the 21st century.

Thomas A. Hemphill
School of Management
University of Michigan-Flint

Falling Behind? Boom, Bust, and the Global Race for Scientific Talent
Michael Teitelbaum

In Washington, doomsday prophets tend to be effective motivational speakers. They successfully persuade the electorate that their cause is worthy and prompt Congress to take action. In his book Falling Behind? Boom, Bust, and the Global Race for Scientific Talent, Michael Teitelbaum takes on a particular brand of doomsday prophet: those who see impending shortages in the science and engineering workforce. Teitelbaum walks his readers through five postwar cycles of boom and bust in the science and engineering
workforce, which he argues have been driven to a large extent by political machinations set in motion by labor shortage claims (claims that have been almost universally rejected by economists studying the issue). The institutions that currently shape the science and engineering workforce are largely the product of policy responses to these booms and busts. As a result, *Falling Behind?* is more than just a work of policy history. It is also a cogent analysis of contemporary R&D funding mechanisms, high-skill immigration policies, and PhD program structures.

Teitelbaum is well placed to write this book. Although he’s a demographer by training, through his work on immigration policy and his time as vice president of the Alfred P. Sloan Foundation, he has a long history of rubbing elbows with a wide variety of social scientists who are concerned with the science and engineering workforce. Teitelbaum’s service on several distinguished immigration reform commissions in Washington enables him to provide a first-hand account of the political wheeling and dealing described in the book.

*Falling Behind?* is organized around five cycles of boom and bust in the science and engineering workforce. The first three are uniformly instigated by government and strongly resemble political business cycles, which have been studied by economists. In the political business cycle literature, opportunistic politicians engineer booms (which end in busts) to improve their electoral prospects. Similar forces are identified by Teitelbaum in the science and engineering workforce during the first 50 years of the postwar period (rounds 1 through 3). These will be considered first. Rounds 4 and 5 are characterized by private-sector actors lobbying government and will be considered subsequently.

Round 1 (1948 to 1957) is the postwar boom in the physical sciences stimulated by concerns about the lost generation of scientists from the war and the growing threat of the Soviet Union. The atomic bomb proved that prowess in physical science was the key to national power but that the United States could not rest on its laurels. Congress responded by creating the National Science Foundation (NSF), although the most dramatic increases in the number of physical scientists came as a result of Department of Defense funding. The forces unleashed in round 1 were bolstered in round 2 (1957 to 1973) by the launch of Sputnik, the formation of NASA, and Kennedy’s pledge to put a man on the moon. The buildup of the
physical science workforce during rounds 1 and 2 came crashing
down in the 1970s, when job prospects and federal mega-projects
became scarce relative to their postwar peaks. Teitelbaum’s round 3
(1975 to 1995) was instigated by a wide variety of federal initiatives,
including the “war on cancer,” the Reagan administration’s defense
buildup, and public investments in science and engineering education.
This boom came to an end with the end of the Cold War and
the 1990 recession.

Rounds 1 through 3 are distinct from rounds 4 and 5 in that they
principally emerged as a result of political priorities and the
growth of the national security state. Although the stimuli under-
lying these early booms varied in validity, the alarm and the
response uniformly came from government. Teitelbaum’s account
of rounds 1 through 3 is strongly consistent with the political
business cycle literature, where incumbent politicians opportunisti-
cally engineer economic booms to ensure reelection, leaving sub-
sequent administrations to take the blame for the long-run
consequences. In contrast to traditional work on the political busi-
ness cycle, Teitelbaum is concerned with a specific and narrow
labor market. Yet the dynamics are the same: Politicians rustle up
a science and engineering boom that is well received by voters, but
in the end it’s always a bust.

The gap between Soviet and American scientific capacity and the
production of scientists and engineers was wildly inflated by the
political class, who had an aggressive policy response that was consis-
tently popular at the polls. In the case of Sputnik, Teitelbaum
reminds his readers that efforts to launch an American satellite may
have been deliberately delayed (or at least not actively rushed along)
because the drama of a race to catch up with the Soviets had a greater
political payoff than an earlier Project Vanguard success. The sense
of crisis that Sputnik incited gave rise to the Advanced Research
Projects Agency (ARPA, the predecessor of DARPA) and the
National Defense Education Act. It also generated a legal precedent
for the overflight of orbiting satellites that was in the interest of the
Eisenhower administration, and which the Soviets had resisted.
Similarly, the Apollo program and the Reagan military buildup also
galvanized public opinion, pushing the costs of unsustainable booms
in the science and engineering workforce into the future.

Rounds 4 and 5, in contrast, emerged as a result of lobbying of
government by the private sector due to pressures from tight labor
markets that were often interpreted as “shortages.” In round 4 (1995 to 2005), information technology (IT) and telecommunications industry booms led to heavy corporate lobbying for expansive specialized temporary visa categories. In 2001, those booms famously turned to busts, but only after Congress had accepted the shortage narrative and taken action on immigration policy. Round 5 (1998 to 2008) was a biomedical industry boom coinciding with the rapid buildup of the IT sector that resulted (again through heavy lobbying) in a doubling of the National Institutes of Health (NIH) budget over five years. This boom coincided with the publication of many widely cited but analytically weak reports claiming scientist and engineer shortages, particularly the 2005 report “Rising above the Gathering Storm” from the National Academies. After the NIH doubling, the biomedical research sector experienced what has been called a “hard landing” due to changing political fortunes and a tighter budget environment. Shortage concerns in mid-2000s resulted in further infusions of money into NIH and NSF budgets through the stimulus funding package of 2009.

If the first three rounds of boom and bust highlighted the political business cycle perspective—when policymakers orchestrate booms to generate political support—the last two rounds highlight the pitfalls of interest-group politics, regulatory capture, and public choice. Lobbying by the IT industry especially exerted pressure in an otherwise reasonable policy space—immigration liberalization and reform—resulting in a set of high-skill work visa categories so carefully tailored to industry needs that the inspector general of the Department of Homeland Security called one (the L-1) “the computer visa.” The lobbying effort for temporary work visas restricted to high-skilled workers reflects what Bruce Yandle called a “bootlegger and Baptist” dynamic, whereby pecuniary interest (the “bootlegger”) combined with moral suasion (“the Baptist”) achieves a jointly desired policy outcome (Yandle was referring to the strange bedfellows that supported blue laws). Teitelbaum’s list of prominent groups advocating for changes to the L-1 and H-1B visas is a veritable “Who’s Who?” of the relevant bootleggers and Baptists in recent policy debates. Industry associations and tech companies joined with pro-science and pro-immigrant groups to reshape the temporary visa system. The special advocacy of sitting senators—Arlen Specter in the case of the NIH budget doubling and
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Spencer Abraham in the case of immigration policy—was also essential.

Teitelbaum’s policy recommendations are refreshingly restrained. Most of the book is directed toward identifying problems with the current system of public and private institutions that structure the science and engineering workforce, but Teitelbaum does not confuse his strong grasp of the problem with a foolproof prescription for policy. Marginal adjustments away from the most pernicious elements of the current system are proposed, but little more. Teitelbaum insists on a Hippocratic Oath for policy: Despite the dire claims of pessimists, American scientific enterprise has a successful record, so above all we should do no harm to that enterprise. Many of Teitelbaum’s suggestions are common sense, but they take on new relevance in the context of the history of boom and bust that he presents. For example, he argues that we should let evidence and sound economics guide our immigration policy rather than the pleadings of high-tech companies for specially carved-out visa categories. Other recommendations are grounded in the minutiae of R&D funding mechanisms, such as the suggestion that OMB regulation of indirect costs on research contracts and grants should not provide additional incentives for universities to use debt financing to expand research facilities. Certain substantial problems identified by Teitelbaum, such as the perverse incentives professors face to overproduce graduate students, do not appear to have any easy solutions.

Those who want to push government out of the scientific enterprise will not be completely satisfied with Teitelbaum’s discussion of policy options. Teitelbaum believes that the public sector has a vital role to play in supporting American science. But as a seasoned policy analyst he is deeply skeptical of claims about public-mindedness in the actual implementation of science policy, making him an ideal guide for understanding a workforce that is lionized, but not well understood by either the public or most policymakers. Despite policy differences that readers may have with Teitelbaum, the concerns he raises about booms and busts in the scientific workforce (due in large part to failures of public policy) should command broad interest.

Daniel Kuehn
Urban Institute
The United States faces two major problems today,” writes James L. Buckley: “runaway spending that threatens to bankrupt us and a Congress that appears unable to deal with long-term problems of any consequence.” Contributing significantly to both, he argues, are the more than 1,100 federal grants-in-aid programs Congress has enacted—federal grants to state and local governments, constituting 17 percent of the federal budget, the third-largest spending category after entitlements and defense, with costs that have risen from $24.1 billion in 1970 to $640.8 billion in fiscal 2015. His “modest proposal”? Do away with them entirely, thereby saving Congress from itself while emancipating the states and empowering their people. If that sounds like a program for reviving constitutional federalism, it is.

Judge Buckley has the distinction of having served in all three branches of the federal government, first as a senator from New York from 1971 to 1977, then as Undersecretary of State for Security Assistance in the Reagan administration and later as president of Radio Free Europe/Radio Liberty, and finally as a judge on the United States Court of Appeals for the District of Columbia Circuit, to which he was appointed in 1985 and from which he took senior status in 1996. But it was after he retired to his home in Sharon, Connecticut, that he began drawing on this wealth of experience, on his local newspapers, and on work of the Cato Institute’s Chris Edwards to put together the ideas and evidence that fill this slim volume, culminating in his modest proposal.

And evidence there is—example after example of how Congress taxes Americans across the country and then, after deducting Washington’s share of the monies, sends the rest to the far corners of the nation to underwrite projects that local special interests may want but that local taxpayers, if they had a direct say in the matter, would never support with their own money, but now do in the belief that the federal government is paying the bill.

Take the author’s favorite example, a $430,000 grant from the Federal Safe Routes to School Program for widening sidewalks bordering two streets leading to a local school in Plymouth, Connecticut, population 12,000—the stated purpose, to fight obesity
by encouraging children to walk or bicycle to school. If Plymouth parents had been offered that money to battle their children’s obesity, Buckley writes, “it is anything but obvious that broadening sidewalks would have been their weapon of choice.” They accept the money “because they know that those recycled dollars will otherwise be spent widening sidewalks in another state”—a fitting example of the perverse incentives set in motion by this five-year program, financed by $612 million of federal highway trust funds. (Note the ambiguity in “federal highway.”)

There was a time in America when the federal government focused mainly on national concerns, the states on state and local matters, like the health and welfare of their citizens. That division of powers, the Constitution’s federalism, was never exact, of course, and it shifted over time, but it remained largely intact for a century and a half. During the New Deal, however, it was upended. Today, under the kind of “cooperative federalism” at issue here, the federal government’s tentacles reach into almost every area of life, areas once thought the exclusive domain of state and local governments—or of no governments at all. And the costs, monetary and nonmonetary alike, are richly catalogued in this book.

For the federal government, start with the expense of administering often overlapping programs that might otherwise be initiated and administered by state or local governments alone. Today there are 82 federal teacher training programs, for example, even though education is a traditional state function over which Congress has no constitutional authority whatever. A 2011 GAO report lists more than 100 programs dealing with surface transportation, 80 with economic development, 20 with homelessness, 47 with job training, and on and on, leading the report to conclude that variations within and among agencies make it all but impossible for Congress to conduct its oversight functions.

But huge as those costs are, they pale in comparison with those imposed on the states, starting with the bureaucracies that states have to create to administer the federal programs and running to the unfunded mandates, the federal rules that are imposed (e.g., the Davis-Bacon Act requires that local union wages be paid for federal projects), the distortion of state priorities, and the loss of local control and local accountability. As Buckley writes, “one of the most insidious aspects of grants-in-aid programs is the diffusion of responsibility that makes them so attractive to federal and state officials alike.
Each can claim credit for the highways or school lunches or whatever that the grants help finance and each can point a finger at the other should anything go wrong with them.”

We got to this state of affairs through the demise of federalism, of course. The story is doubtless familiar to Cato Journal readers, so I’ll simply summarize it. Among the “auxiliary precautions” James Madison crafted to control government and protect liberty, perhaps none is more complex than his “compound republic,” which helps explain why so much constitutional litigation has concerned this one issue. The Tenth Amendment, mischievously called the “states’ rights” amendment, outlines the doctrine. Reaffirming the very theory of the Constitution, it shows that the federal government has only those powers that the people gave it, as enumerated mainly in Article I, Section 8, all of which pertain to national concerns; the balance of powers, if not prohibited to the states, are reserved to them—or to the people, never having been given to either government. And states’ powers, Madison wrote in Federalist 45, “extend to all the objects which, in the ordinary course of affairs, concern the lives, liberties, and properties of the people, and the internal order, improvement, and prosperity of the State”—to be checked through state constitutions.

As it emerged from the Constitution, then, federalism maximized liberty not only by empowering the federal government to address truly national matters that were inadequately addressed under the Articles of Confederation, like national defense, international and interstate commerce, immigration, and protection for intellectual property, but by making states compete for the allegiance of their citizens. Individuals were presumed, by their choices, to maximize their own liberty. If local or state governments themselves failed on that score, their citizens could simply vote with their feet. That’s “competitive federalism.”

The lethal exception, to ensure union, was the convention’s compromise over slavery, of course. The Framers hoped it would wither away over time. It did not. It took a civil war and the Civil War Amendments to end slavery, and the Fourteenth Amendment, in particular, to bring the states under the Bill of Rights, thus “completing” the Constitution at last by incorporating in the document the grand principles of the Declaration of Independence. That marked also a fundamental change in our federalism. National power was enhanced not to restrict but to better secure liberty—to more
effectively limit state governments. Federalism doesn’t always entail the devolution of power, therefore. If its aim is liberty, it can go in the other direction.

But as the 20th century was dawning, a nascent Progressivism sought to reverse this course. Expressly rejecting the Founders’ limited government vision and distrusting free markets regulated mainly under the common law, Progressives envisioned a world in which social engineers—elites like themselves—would plan vast areas of life through social and economic legislation. Their early efforts, directed mainly toward the states, were often rebuffed by the courts. Yet they fared little better at the federal level when they joined Franklin Roosevelt’s administration.

After the landslide election of 1936, however, Roosevelt unveiled his infamous Court-packing threat. It failed politically, but the Court got the message. The upshot of “the switch in time that saved nine” was a constitutional revolution in three main steps. In 1937 the Court opened the floodgates for the modern redistributive and regulatory state by eviscerating the Constitution’s very centerpiece, the doctrine of enumerated powers. In 1938 it bifurcated the Bill of Rights, reducing economic liberty to a second-class status. And in 1943 it jettisoned the non-delegation doctrine, thereby enabling Congress to delegate ever more of its law-making authority to the burgeoning executive branch agencies it had been creating.

Federalism stood now on its head. With the structural limits on Congress’s power effectively gone, federal programs exploded. No problem, it seemed, was too small or local for Congress’s attention as members fell over one another bringing home the bacon. And since Progressives had earlier brought about the Sixteenth and Seventeenth Amendments, there was now plenty of bacon flowing to and through Washington thanks to the income tax, while thanks to the direct election of senators, members of that chamber could ignore their state legislatures’ interest in protecting states as states and attend instead to the interests of their constituents.

Before judging this as entirely Washington’s fault, however, we would do well to consult a dense 2012 tome by Professor Michael Greve, The Upside-Down Constitution, for it turns out that the demise of federalism is more complicated than it seems, and the states themselves are far from blameless. As Greve explains in exquisite detail, today’s cooperative federalism entails federal-state
collusion. Congress “induces” cooperation by offering up gobs of federal money for local projects, provided states themselves contribute some funds. Although a state may have other more pressing needs, it’s hard to turn down “free” money, especially if it enriches local interests craving federal funding, and if, as noted above, the funds thus forgone then fund other states’ federal programs. And on the regulatory side, as history shows, elites in “progressive” states impose “enlightened” economic regulations—favoring coercive unions, say, or minimum wage increases—putting them at a competitive disadvantage vis-à-vis other states, so they press Congress to impose those regulations on the entire nation. Once a program is established, of course, the “iron triangle” takes over as congressional committee, executive branch agency, and those same local interests all work to ensure its perpetuity. Perverse incentives endure in this classic prisoner’s dilemma.

Buckley engages these issues to a certain extent. But his discussion of Congress’s power to tax and spend for the “general welfare”—the power Congress cites as its authority to enact these grants-in-aid programs—is off center. He believes, for example, that the Court got it right in Helvering v. Davis, the 1937 decision upholding the Social Security Act’s old-age insurance provisions, citing three rationales the Court offered: “because the insurance was ‘plainly national in area and dimensions,’ that ‘laws of the separate states cannot deal with [old-age insurance] effectively,’ and that ‘[o]nly a power that is national can serve the interests of all.’ In so ruling,” he continues, “the Court has given us a simple, coherent standard for determining the legitimacy of Congress’s handiwork: the laws it enacts must serve a purpose that can only be achieved through action at the national level.” With that “test,” he believes, we can distinguish, for example, Medicare and Medicaid: “Medicare is a package of medical benefits that attach to the individual wherever he might be. Only a national government can keep track of a mobile population. Qualification for Medicaid, by contrast, is determined state by state.”

Clearly, that will not do if the question is whether Congress has the authority to enact either program. Medicaid recipients, after all, are as mobile as Medicare recipients; and states could determine qualifications for Medicare as easily as for Medicaid. Moreover, the three criteria the Court offered as justifying federal old-age insurance schemes, cited just above, are nothing but conclusory. States offered
old-age assistance long before passage of the Social Security Act. And if states cannot deal with old-age assistance separately, what makes us think they can do so collectively?

This effort to distinguish Medicare and Medicaid is instructive nonetheless, especially when we see where Buckley goes next. Where the Court went wrong, he believes, is not in Helvering but in its companion case, Steward Machine Co. v. Davis, which upheld the part of the Social Security Act that offered federal assistance in leveling the impact of various state unemployment compensation taxes. As Buckley writes, “[b]ecause the states were at liberty to decline the federal offer, the Court ruled that the program did not coerce their compliance ‘in contradiction of the Tenth Amendment.’ It therefore held that the program was a legitimate exercise of Congress’s authority to provide for the general welfare.” Like Medicaid, that is, but unlike Medicare or Social Security’s old-age insurance, the unemployment insurance provisions of the Social Security Act were administered through the states, not by the federal government, and both programs were “optional” (albeit, freighted with federal directives).

But why would those considerations be relevant to the core question: Does Congress have authority to enact any of those four programs? To answer that, Buckley has focused on the features of the programs. And he has because his test—the Court’s test in Helvering—is whether a given program “can only be achieved through action at the national level.” That, however, is not the Constitution’s test. The Constitution limits Congress not to national concerns but to certain enumerated powers or ends, as listed in Article I, Section 8, which just happen to be national, by design. Indeed, Congress might propose any number of programs that could be achieved only “through action at the national level,” but if they are not authorized because the powers to enact them have never been delegated by the people and enumerated in the document, then Congress may not enact them.

Like Alexander Hamilton, then, Buckley has read Congress’s power to tax and spend for the general welfare as an independent power, which takes us back to a debate early in our history when Hamilton introduced his Report on Manufactures in 1791. The debate that followed, before Congress shelved the proposal as beyond its authority, pitted Hamilton against Madison, Thomas Jefferson, and most everyone else. Echoing points he had made a
few years earlier in *Federalist* 41, Madison argued that the words “general welfare” were meant simply as a heading, informed by the 17 powers that followed. Indeed, as South Carolina’s William Drayton would say years later, when faced in 1828 with yet another redistributive bill, “[i]f Congress can determine what constitutes the General Welfare and can appropriate money for its advancement, where is the limitation to carrying into execution whatever can be effected by money?” And as many others would ask when facing similar bills, what was the point of having enumerated Congress’s other powers if it could do whatever it wanted under this sole power?

As history would have it, the Court revisited that early debate in 1936, in *United States v. Butler*, holding the 1933 Agricultural Adjustment Act unconstitutional as “a statutory plan to regulate and control agricultural production, a matter beyond the powers delegated to the federal government.” But in dicta, the Court came down on Hamilton’s side in the debate: The Spending Clause, it said, “confers a power separate and distinct from those later enumerated, is not restricted in meaning by the grant of them, and Congress consequently has a substantive power to tax and to appropriate, limited only by the requirement that it shall be exercised to provide for the general welfare of the United States.” A year later in *Helvering*, however, the Court elevated that dictum to law, repeating nonetheless that Congress’s power was still limited to providing for the general welfare—Hamilton’s and Buckley’s view, too. “The line must still be drawn between one welfare and another, between particular and general. Where this shall be placed cannot be known through a formula in advance of the event. There is a middle ground or certainly a penumbra in which discretion is at large. The discretion, however, is not confided to the courts. The discretion belongs to Congress, unless the choice is clearly wrong, a display of arbitrary power, not an exercise of judgment.” It fell effectively to Congress, therefore, to police itself on that limitation—the very Congress that as the years went on would be spending with ever greater particularity.

In sum, in dicta the *Butler* Court rejected the view that was held by most of the Founders; the view that prevailed, in the main, for our first 150 years; and the view that, more important still, fit far better the Constitution’s theory and structure. A year later, in the companion cases of *Helvering* and *Steward Machine*, the Court drew on that
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dictum to open the floodgates for the modern redistributive state, notwithstanding that the Constitution nowhere entrusts the respective subjects of the three decisions—agriculture, retirement, and unemployment—to the federal government. Is it any surprise that everything from education to childhood obesity to health care and more is entrusted today to the federal government?

Regarding the grants-in-aid programs that are Buckley’s concern, the only restraint on federal provision appears to be whether such programs might “coerce” the states—and that is recent. Thus, in 1987, in South Dakota v. Dole, the Court upheld a federal statute that withheld a portion of federal highway funds from states that declined to raise their drinking age, finding that the reduction at issue was relatively small. But in 2012, in NFIB v. Sebelius, the Court found Obamacare’s Medicaid expansion to be beyond Congress’s spending power because it coerced states to either accept the expansion or risk losing existing Medicaid funding. In other words, Congress went “too far.” That’s the kind of “bright line” constitutionalism we’ve come to as a result of the New Deal’s constitutional revolution—a veritable open invitation to political and judicial mischief.

Buckley’s “modest proposal” would partially restore our federalism by ending such programs—presumably lowering federal taxes in the process to enable states to collect the revenue needed to run their own programs, although he doesn’t go into that issue. It’s a tall order, to be sure, given the perverse incentives set in play by the modern reading of the Constitution. Yet recently, nearly half the states declined to participate in Obamacare’s Medicaid expansion, even though it would have been “free” for three years; and fully 36 states declined to establish state exchanges under the plan. There may be hope. At the least, if implemented, the proposal would move us closer to the original constitutional design, even if it left in place a host of programs the federal government now runs directly, like Social Security and Medicare, the absence of authority notwithstanding. In the process, it would encourage members of Congress to shift their focus from a thousand and one local concerns to those that are truly national, and that’s no small matter. This book’s virtue is that it brings this issue to the fore in a clear and compelling way. Its sharp focus on this single issue is its greatest strength.

Roger Pilon
Cato Institute
The American Warfare State: The Domestic Politics of Military Spending
Rebecca U. Thorpe

In The American Warfare State, Rebecca Thorpe attempts to answer what she calls “the fundamental puzzle” of American politics: “Why a nation founded on a severe distrust of standing armies and centralized power developed and maintained the most powerful military in history.”

The answer isn’t as obvious as it might seem. Thorpe, an assistant professor of political science at the University of Washington, traces the creation of a permanent war economy back to World War II, when war production expanded into new locales, especially the suburbs of major cities and the agricultural or underdeveloped areas of the South and West. “Widespread economic dependence on war investments,” Thorpe writes, “became an unintended consequence of a national mobilization strategy where multiple actors pursued their own independent goals.”

The legacy of that inadvertent geographic shift is a number of predominantly rural and sparsely populated areas that have grown disproportionately dependent on military expenditures. A subset of members of Congress representing these areas are, all other factors being equal, more likely than their fellows to support weapons expenditures, even if those weapons are not necessary to U.S. national security. Those same members are also more likely than other members of their own party to support the wars in which these weapons are used, an effect most apparent among Democrats.

Thorpe’s study deepens our understanding of what we already knew. She suggests that the post–World War II political economy of defense operates in a particular way. First, economic reliance is the sustaining factor, not total defense dollars spent; and second, analyses that omit subcontracts, and instead solely focus on prime contracts, fail to gauge the true impact of defense spending, especially to local economies.

Thorpe developed a proprietary database of defense contracts to measure “the concentration of the local defense economy relative to other industries.” Critically, her database includes not just prime contracts but also the myriad defense subcontracts that are
geographically more widely distributed. The data is limited, however, and Thorpe admits that the findings that flow from it are preliminary.

More generally, and to her credit, Thorpe does not exaggerate what questions her models (or anyone else’s) are capable of answering. Empirical studies can only demonstrate that members from “economically reliant districts are more likely to vote for large defense budgets” but cannot prove why they do so. The reason seems obvious enough—the economic benefits flow to their constituents and ultimately to the politicians—but must ultimately be inferred.

According to Thorpe, however, the political economy of military spending is only half of the answer to America’s paradoxical military might. How the military capabilities are used is the other, and Thorpe explores this as well.

Drawing on the established literature surrounding the Founders and the Constitution, Thorpe documents how “the balance of war power has shifted decisively in favor of the executive branch.” This phenomenon has been well documented, but, according to Thorpe, “existing accounts do not fully appreciate why the Constitution’s structural safeguards failed to prevent the consolidation of power or minimize war.”

In principle, Congress has a constitutional obligation to limit the executive’s ability to wage war, but in practice it has not and will not. Even if members of Congress were truly committed to cutting off funding for a particular war, they will not defund the military as a whole. As long as military assets are funded and at their disposal, presidents can effectively “force legislators to take the positive action of passing legislation in order to provide an effective check.”

This turns the Madisonian model on its head by downgrading “the standard for legislative approval of wars from a matter of absolute necessity to one of mere expediency.”

For much of the first 150 years of the nation’s history, Congress approved the necessary funds to fight and win wars but withdrew funding after the wars ended. This meant that for the most part—the Navy being an exception—the nation did not possess a standing military, thus denying the president the one tool that he was almost certain to use. If he wished to go to war, he was compelled to come to Congress not merely for the legal authority to launch the war but also for the funds (and forces) necessary to conduct it.
Since the end of World War II, however, the funding constraint has proved all but nonexistent. Congress simply doesn’t wield it, even against weak presidents, and not even to limit—let alone to terminate—unpopular wars.

The political economy of defense spending merely compounds this problem. Cutting defense spending is politically difficult, especially “for legislators representing areas that rely on a war economy for job security and growth.” In this way, Thorpe notes, “Local economic imperatives not only influence legislators’ political priorities, but also reinforce some members’ ideological commitments to American military supremacy and interventionism.”

Take the case of Vietnam. Thorpe explains that “many members proposed measures to cut off appropriations for military operations in Southeast Asia, but these initiatives were ultimately rejected or so weakened by amendments that they were almost entirely symbolic. Instead of eliminating military spending, Congress continued to pass legislation instructing the president to end the war while appropriating funds to carry it out.”

Subsequent case studies reveal a consistent pattern of congressional impotence. From Lebanon and Grenada in 1983, to Panama and Somalia under George H. W. Bush, to Haiti, Bosnia, and Kosovo, launched during the Clinton era, members of Congress occasionally griped about military operations they didn’t support—and, in most instances, had never actually authorized. But they never succeeded in imposing meaningful constraints on the conduct of those wars.

In short, the checks and balances of the Constitution have failed. “The constitutional framers’ reliance on institutional mechanisms and competing interests as a means to disperse power and limit war ultimately fell short of their professed aims.” Thorpe concludes, “Institutional checks and competing interests do not reliably limit power or promote the public good.”

Although Thorpe explains why this has happened, she offers no prescription for fixing the problem, perhaps because she doesn’t believe that there is a solution. That fatalism might be appropriate given our recent history, and the information presented in this book, but it is discouraging all the same.

Christopher A. Preble
Cato Institute
The image of a boom town is commonly used to describe exceptional conditions through which a village suddenly becomes a city. Often such conditions are the discovery of mineral deposits that attracts industry and commerce. While in their booming condition, such towns are oases of societal flourishing relative to their preceding state. In *Boom Towns*, Stephen J. K. Walters, a professor of economics at Loyola University in Baltimore, explains that cities in general have the capacity perpetually to be forms of boom towns. Cities can serve as magnets to attract people and capital, thus promoting the human flourishing that has always been associated with cities at their best. It is different if cities are at their worst, as Walters explains in bringing Jane Jacobs’s *Death and Life of Great American Cities* into his explanatory ambit. There are no natural obstacles to cities occupying the foreground of societal flourishing. There are obstacles to be sure, but these are man-made. Being man-made, they can also be overcome through human action, at least in principle even if doing so in practice might be difficult.

Walters’s analytical framework is centered on property rights and the ownership of capital. The boundary between boom towns and bust towns depends significantly on how towns treat property rights and, thereby, the returns owners are able to obtain from their capital investments in a city. Such capital is immobile, which makes it potentially subject to banditry and extortion by city officials. To the extent cities practice such hostage-taking, investment in those cities will be discouraged and bust-like conditions will emerge. Walters uses recent experience in the presence of state-wide tax limitations in California and Massachusetts to support his thesis. San Francisco and Boston had experienced significant declines in population until tax limits were imposed at the state level. In consequence, the return to capital invested in those cities increased and the decline in population was reversed.

While security of private property is pivotal for the generation of boom towns, flourishing cities also require public property that is well managed and complementary to the commercial and industrial efforts of its residents. Cities, however, may manage public property badly, undermining flourishing in those cities. Bad management of
public property reduces the return to private capital just as surely as extortionate taxation does. Such bad management can take the form of lavish spending on public construction projects as well as failing to provide clean and secure public spaces. The latter example is illustrated by what is known as the “broken window fallacy,” whereby allowing broken windows to accumulate signals a weak resolve to provide security for property, which in turn induces deterioration within the city by reducing the value of property rights. Walters hits his target head on in stressing the pivotal significance of property rights in accounting for the condition of cities, with the margin between flourishing and deteriorating cities governed by how property rights are treated within cities. Walters’s analytical framework makes heavy use of Jane Jacobs’s *Death and Life of Great American Cities*. In places I think he asks this framework to bear more weight than it is truly able to support. In this respect, a form of flying buttress could be constructed from other work by Jane Jacobs. In particular, I would recommend *Cities and the Wealth of Nations* and *Systems of Survival*. I could even add a third book, *Dark Age Ahead*, for its ability to portray the world that could lie ahead of us if the insights contained within *Boom Towns* are ignored.

In *Cities and the Wealth of Nations*, Jacobs explained that societal flourishing is a by-product of flourishing at the level of cities. Flourishing starts at the level of cities and those who live there, and spreads upward to the extent a society’s institutional arrangements facilitate such a spread. It does not start at the national level and spread downward. This bottom-up direction of movement is the opposite of contemporary practice of practically unlimited national government, and also of most contemporary theorizing in political economy. There are different forms of federalism. One form can be called “competitive federalism.” Within this form, cities would be in open competition with one another, which would tend to promote flourishing by keeping taxes low and public property well managed. An alternative form can be called “cartel federalism.” Within this form, governments collude against taxpayers, and with the federal government serving as the cartelizing agent that promotes higher taxes and the mismanagement of capital, often by subsidizing particular forms of capital at the expense of other forms.

In *Systems of Survival*, Jacobs explained that societal flourishing depends on an appropriate pattern of interaction between what she
described as commercial and guardian moral syndromes and their carriers. Commercial carriers act within the framework of private property that promotes societal flourishing by continually deploying capital into uses with higher value. Guardian carriers act to maintain the system of private property against myriad forms of predation that would undermine societal flourishing. It should be noted that the distinction between commercial and guardian is not identical to the distinction between private and public. For instance, commercial entities engage in such guardian activities as auditing. Likewise, political entities engage in commercial activity when they sell public property. What is of particular significance in Jacobs’s framework is her warning against the excessive commingling between the carriers of those syndromes that could generate what she termed “monstrous moral hybrids.”

A monstrous moral hybrid is what we now live with within what has become a deeply entangled system of political economy. By entangled political economy I mean something analogous to quantum entanglement in physics, though in saying this I should also note that I do not think it is helpful to think directly of importing such ideas into political economy because doing so would ignore the unique position of human agency. Nonetheless, the analogy is worth reflecting on even if interaction among humans is not a simple extension of interaction among particles. In physics, entanglement means that you cannot describe the position of one particle without referring to the position of another particle, in contrast to thinking of those positions as independent of one another.

In political economy, entanglement means that what constitutes good commercial practice cannot be determined independently from the actions of political entities, and vice versa. Good commercial practice cannot be determined by consulting only production possibilities and consumer desires. It is also necessary to engage in political action. Commercial lenders, for instance, cannot determine their loan portfolios by referring only to market conditions and circumstances. They must also refer to the desires of political actors, as illustrated by forming loan portfolios that includes a significant volume of loans that reflect political and not economic calculation. Within a system of entangled political economy, politicians engage in business and business people engage in politics. The resulting monstrous moral hybrids point to looming Dark Age Ahead if the threads of entanglement continue to grow.
Adam Smith once noted that societal flourishing is easy as a matter of principle. Only three simple conditions are necessary: peace, low taxes, and a reasonable administration of justice. It would seem that societal flourishing confronts us with no deep mystery. Yet attaining that condition is far from automatic. Clearly, there is something about Smith’s three conditions that make them hard to create or sustain.

For one thing, the relationship between liberty and democracy is a difficult and perilous one. They can be complementary under some institutional arrangements but not under all possible arrangements. For a liberal market order grounded on private property, the magic number is two. By this, I mean that most principles of economics can be illustrated by two-person interactions within a framework of private property. While many market transactions involve many parties, all of those parties choose to participate in those transactions. The voluntary participation treated in the simple model of exchange pertains just as well to multi-sided transactions.

In contrast, for democracies the magic number is three. Most principles of political economy can be illustrated only by referring to three-person interactions because three is the least number of people that are required to illustrate the democratic principle of majority rule. There are, however, two classes of ways by which three-person interactions can proceed. One way is through cooperative or consensual interaction. The other way is through majority faction of two against one, which modern public choice theory tells us can often involve one dominating two. The American republic was founded largely on a framework of cooperation and liberty, and has been transformed increasingly into one grounded on the shifting sands of faction and domination where a world of equal responsibility gives way to a world more accurately characterized by citizens becoming sheep to be tended by the one-time servants who have morphed into shepherds tending what they treat as their flocks.

This situation, moreover, was recognized by Benjamin Franklin in 1787. As he left the constitutional convention in Philadelphia, he is reported to have been asked “what kind of constitution did you create?” To which Franklin is reported to have responded “a republic, if you can keep it.” Franklin’s response is notable in several respects. One is that he clearly thought in terms of processes that evolve through time and not in terms of equilibrium. Another is that he recognized that a constitution of liberty could morph into a
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constitution of servility. After all, maintaining liberty was a costly activity, as it required eternal vigilance—and more. Stephan Walters has sketched wonderfully the principles by which cities and, derivatively, nations can boom. These principles are easy to state, but the actions necessary to implement them come at a price that is embedded in the responsibilities that accompany active participation in democratic governance.

Richard E. Wagner
George Mason University
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Founded in 1977, the Cato Institute is a public policy research foundation dedicated to broadening the parameters of policy debate to allow consideration of more options that are consistent with the principles of limited government, individual liberty, and peace. To that end, the Institute strives to achieve greater involvement of the intelligent, concerned lay public in questions of policy and the proper role of government.

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