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A Life for Liberty

Pedro Schwartz at 90

Collected Essays on Politics, Economics, and Freedom



INSTITUTO JUAN DE MARIANA

IN COLLABORATION WITH LF LIBERTY FUND

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Introduction

INTRODUCTION

Pedro Schwartz, one of the most prominent voices for classical liberalism in Spain and worldwide, reaches an extraordinary milestone on January 30, 2024, as he turns 90. This occasion calls for a tribute to a scholar, economist, and public intellectual whose unwavering commitment to individual, political, and economic freedom has shaped debates and inspired audiences across generations.

Known for his unique ability to combine rigorous scholarship with accessible communication, Pedro Schwartz has left an indelible mark on both academic and public discussions. His intellectual journey spans disciplines, addressing topics ranging from economic policy to political philosophy, all while maintaining a sharp focus on how ideas of liberty translate into the practical and ethical dimensions of everyday life. This blend of profound analysis and relatable insight has positioned him as a leading voice in advancing a freer, more prosperous society.

To honor this remarkable trajectory, the Instituto Juan de Mariana and Liberty Fund are joining forces to publish a collection of Pedro Schwartz's essays written for the Library of Economics and Liberty (EconLib). This volume will bring together his contributions from 2013 to 2020, providing a fresh lens on his thought during a transformative period in global economic and political discourse.

This initiative not only celebrates his prolific career but also seeks to preserve and expand his intellectual legacy. The compilation showcases over 50 articles where Pedro Schwartz applies his analytical brilliance to address contemporary challenges with clarity, depth, and an unwavering commitment to liberal principles. His writing, often featured in leading journals and media, demonstrates his ability to engage with current issues while remaining grounded in the foundational ideas of classical liberalism.

With the publication of this special volume, Liberty Fund and the Instituto Juan de Mariana aim to inspire a new generation of thinkers, economists, and citizens with Pedro Schwartz's profound insights into freedom and its many dimensions. Liberty Fund's global reputation for promoting the study and understanding of liberty, combined with the Instituto Juan de Mariana's leadership in the Spanish-speaking world, ensures this project will have an enduring impact.

This collaboration stands as a testament to Pedro Schwartz's intellectual contributions and his relevance in today's complex world. As classical liberal principles face renewed challenges, the works of Pedro Schwartz remain a guiding light, providing both inspiration and practical solutions for those dedicated to preserving freedom.

With this release, we celebrate not only Pedro Schwartz's 90 years of life but also his enduring contributions to the ideas that will continue to shape our future.

Free Trade? Anything But

March 4, 2013

In his State of the Union address, President Obama revived a long mooted idea: a Transatlantic Trade and Investment Partnership (TAFTA). The aim of this initiative is to abolish or drastically reduce barriers to trade in goods and services between the United States and the European Union and turn the North Atlantic into a huge single market. The prize is alluring, but the hurdles are high. The Partnership will not be easy to set up, given the complicated regulatory barriers that fence off trade and services and the use that numerous and powerful interest groups make of them. Also, TAFTA may be against international law. The essence of the Treaty establishing the Word Trade Organisation (WTO) is the "most favored nation" principle, so that any advantages granted by the parties in a trade zone stopping short of a full customs union must be extended to all countries having a previous agreement with them. True, this rule is more honored in its breach than in its observance. Witness what Jagdish Bhagwati has called the 'spaghetti bowl' of bilateral trade agreements, shamelessly adopted by advanced countries in thrall of special interests1. The parlous state of the Doha Round, whose aim is to extend the benefits of trade by an agreed application of the most favored nation rule, is another evidence of general prevarication.

But there is another, more serious obstacle to making a North Atlantic Partnership area a success; TAFTA may go against the laws of economics. Jacob Viner warned that mutually trading concessions within a free market agreement may be tradediverting rather than trade-creating, and hence to some degree self-defeating. Defenders of free trade zones such as the European Common Market and TAFTA argue that the larger the area, the smaller the negative trade diverting effects on its members—but what about those left out in the cold? Mexico and Canada, who share a trilateral trade agreement with the United States and have signed bilateral agreements with the European Union, have no other way out but to join unconditionally, if they are accepted. They must be content to feed on reheated spaghetti.

The gains from TAFTA

Even before any Partnership, the U.S. economic relationship with the EU is the largest and most complex in the world. According to the Office of the United States Trade Representative, it generates flows of goods and services of some $2.7 billion a day.2 Transatlantic investment is responsible for roughly 6.8 million jobs. A total of 15 million American and European jobs are directly or indirectly linked to transatlantic commercial activity. The stock of U.S. foreign direct investment (FDI) in the EU totaled $2.1 trillion in 2011, and the stock of European FDI in the United States amounted to $1.6 trillion. These figures may be put in perspective by comparing them with the GDP of the areas concerned, to wit, some $15 trillion each.

1 Jagdish Bhagwati's Spaghetti bowl effect. Wikipedia. 2 Office of the United States Trade Representative, Executive Office of the President. European Union.

The Office of the U.S. Trade Representative reports very large figures for trade across the North Atlantic (latest figures). U.S. exports to the EU accounted for 21 percent of overall U.S. goods and services exports. U.S. imports from the EU amounted to 19 percent of overall U.S. goods and services imports. Within this total, service figures loom larger; the U.S. purchased 25 percent and supplied 31 percent of all EU private services exports. Especially revealing of the ongoing integration of the area is the fact that majority

U.S-owned affiliates sold some $499 billion worth of services in the EU in 2010, while sales of services in the United States by majority EU-owned firms were $382 billion. Intrafirm trading—trade that takes place within the same company—accounts for more than half of total U.S. trade with the EU.

Given the large figures involved, TAFTA liberalization should result in annual gains of at least 1-2 percent of the GDP of the whole area, accruing in perpetuity, some $600 billion per year to both partners. If the liberalization could be extended to the whole world, the gains would larger for all concerned.

Technical hurdles

Despite these hoped for gains, I am skeptical. Creating an Atlantic Partnership implies much more than lowering tariffs. That is the easy bit. And as the weighted average tariff on goods in the United States and the European Union is below 3 percent, the gains from lowering them might not be that large. The sensitive area is agriculture; in the United States, the simple average tariff imposed on agricultural imports is around 9 percent, and the comparable figure for the European Union is no less than 18 percent. A zero tariff could be within reach if the United States forgot about sugar and corn quotas and the European Union gave up its Common Agricultural Policy and its hostility to genetically modified foodstuffs. Easier said than done.

The real obstacles are non-tariff barriers. They would loom large even if all concerned were true friends of free trade. There are genuine differences in property rights protection between the United States and the European Union, especially as regards intellectual property and patents, since the procedures are judge-based in America administrative in Europe. And agreement about accounting standards is still not within reach despite the many years of negotiation. Technical standards differ widely and not all are hidden forms of trade protectionism: examples include differences in data and consumer protection norms, the procedure for the approval of drugs for human use, financial regulations, corporate governance rules, and telecommunications standards, reexport and trade facilitation among many others.

There may be a way to cut through this red tape if there is a will.3 This way is mutual rule recognition, whereby what is cleared through the proper bodies in America

3 For more discussion of the possibilities of freer trade between the United States and the European Union, see Cabrillo, Schwartz, and Garcia-Legaz. (2006) New approaches to free trade: in favour of an open atlantic prosperity area. Fundación para el Análisis y los Estudios Sociales.

would be automatically accepted in Europe and vice versa. This is what Europeans tried with the Bolkenstein Directive and it has not worked very well among EU States. Is it realistic to expect a better outcome in a future TAFTA?

Similar interests

For more on these topics, see European Union by Marian L. Tupy and Protectionism by Jagdish Bhagwati in the Concise Encyclopedia of Economics.

Jeremy Bentham, the utilitarian philosopher, used to call pressure groups “sinister” that were always out to defend their privileges under cover of darkness. These groups will use technical hurdles to keep barriers down. And failing that, they will appeal to feelings of fairness and altruism to put genuine reformers in the wrong. Free trade in food will harm the environment. The cinema or education cannot perform their much needed and indispensable role without public subsidy. Public procurement needs to be fair to local firms.

National airlines and airports cannot be left in the hands of foreigners for reasons of defense. Complex regulations must govern the medical and legal professions for fear of a fall in quality. There will be a race to the bottom as free trade forces national workers to compete with the underfed and exploited foreign masses whose products unfairly compete away the social conquests of national workers. And failing all that, we can ask our central banks to wage a little currency war.

In the end, our hope for free trade lies with the Internet, with anonymous money, with offshore financial centers. The freedom to trade cannot be put in the hands of governments.

The European Central Bank Changes Its Spots

April 1, 2013

Almost from the start, the single currency was seen as a necessary ingredient of a unified Europe. The Treaty of Rome that launched the Common Market was signed in 1957; the Werner Report outlining the path towards full economic and monetary union was commissioned in 1969 and made official in 1970. Despite this relatively early start, the creation of a solid euro is taking time; from the beginning it was beset with incident. It was not finally launched until the year 1999. The honeymoon lasted until 2007. Since then, progress has become less than smooth, to say the least.

The original euro

The intention was to make the euro a special kind of currency, a sort of European Deutschemark with no need for a government to back it. Monetary sovereignty would reside in a fully independent European Central Bank. Its remit according to the Maastricht Treaty (1992) was strictly reduced to issuing the euro, to managing an area-wide interest rate, and contributing as far as possible to the financial stability of the Eurozone. The ECB was to be a rule-bound institution. Its only obligation was to maintain the purchasing power of its currency. Knowing that repeated budget deficits and continuous accumulation of sovereign debt sooner or later lead the issuer of the currency to print excessive amounts of money, a parallel document, the Stability and Growth Pact (1997) put a limit to member states' deficits and debt. This transfer of monetary sovereignty to the ECB and the limiting rules accompanying it meant that neither member states nor the European Union could use the euro as an instrument of discretionary economic management. In practice, no devaluation and no inflation imposed a harsh discipline on the Ministers of Finance of the Euro area—a welcome brake on democratic profligacy. This well-meaning project had its failings, as experience has shown. Some small instrumental changes, especially regarding the over-lenient interest rate policy, would have given the new currency greater stability. But nobody made clear from the start its possible costs in terms of budgetary discipline, structural reform and reduction of entitlements. A pampered electorate should have been told the price to be paid for the great advantage of a stable currency. In sum, the euro could have been a sort of pale replica of the gold standard, aspiring to the solidity of gold but free of gold's automatic rigidity. Better that than nothing.

An "American" euro

The current crisis has led the European authorities and the Bank to throw away the monetary ideal of rule-bound action, independence from politics and attention to the long run. The ECB is now a lender of last resort not only to the commercial banks in its club but to governments in its area. Far from being independent of politics, it is in continuous consultation and collaboration with European and national authorities. The current president of the ECB has gone so far as to says that the Bank will "do whatever it takes" to save the euro, which markets have

understood as creating all the liquidity necessary to stop speculators. Thus, the ECB is now turning itself into a traditional government banker, ready to aid and abet in counter-cyclical monetary management, protectionist exchange rate policy, and 'controlled' inflationism.

Euro-enthusiasts would like the euro to be another dollar, not only for the privilege of cashing in the seignorage income of a world currency but also because it would help Europe on the way to becoming a federal country. Whenever the Eurozone authorities show lack of decision in facing some euro crisis, as in the case of Cyprus, the cry goes up that "We need more Europe!", meaning 'we need a more federal Europe'. Why not issue Eurobonds along the lines of the American Treasury to replace of so many different euro-denominated national bonds? Many would like the ECB to be turned into another Fed with full capacity for indefinite Quantitative Easing. They sigh for the likes of the United States President, Federal Reserve Chair, and Treasury Secretary to appear together before the media to issue a common policy statement when a crisis arises.

Mundell, the sorcerer's apprentice

Robert Mundell (1961) is the main author of the theory of monetary unions, on which the blueprint of the euro was based. He made two points: He criticized the reliance on flexible exchange rates to solve a country's balance of payments difficulties, and he outlined the conditions for successful monetary unions, an arrangement he much preferred to dispersed monetary sovereignties.

His first point is well taken if one wants a world of stable currencies and solid forward contracts. The classical gold standard of the second half of the 19th century was precisely an arrangement of this kind. This was not Mundell's idea. For him, a single currency was an instrument of political power.

His list of conditions for a well functioning monetary union is really a list of impossibilities in the case of the euro. A single currency could only function optimally in single market, where workers would be ready and able to relocate. If this was not so, it was enough if in places of low productivity, wages and prices were fully flexible downwards. If the EU had made real progress towards becoming a single market, the euro would not find itself in such straits as now.

In a recent lecture, Mundell (2011)4 wants Europe to imitate the beginnings of the monetary and financial union in America after independence. The creation of the dollar as a legal tender currency posed no problems of its own; the states' debt was the problem. For Mundell, the crisis of the euro is one of fiscal insolvency, to be remedied by a measure of fiscal consolidation, but mainly by merging all European sovereign debt into a single Eurodebt and placing it on the world's capital markets. This was Alexander Hamilton's idea in 1792, to issue federal debt for all the states of the Union. The result, notes Mundell, is

that the United States has over $5 trillion in debt outstanding around the world today. EU bonds would permit Europe to

4 Robert Mundell. "Making Europe Work." Paper for Global Jean Monnet Conference on "European Economic Governance in an International Context." November 24-25, 2011. PDF file.

place perhaps €4 trillion worth of debt and so attend to the needs of Greece, Ireland, Portugal, Spain, Italy and even Cyprus without turning a hair. But Mundell undermines his own argument by quoting Thomas Jefferson in 1810, who said, thinking of Hamilton, "And we were told that the public debt would be a blessing". Just ask the Americans of 2013.

John Major and the men of system

For more on these topics see Monetary Union, by Paul Bergin, in the Concise Encyclopedia of Economics and "Nothing New on the Euro Front", by Wolfgang Kasper, Library of Economics and Liberty, December 5, 2011. The political aim of "an ever closer union" led the framers of the euro to impose a single currency. John Major, then Chancellor of the Exchequer in Lady Thatcher's Government, proposed launching a common currency to run in competition with national currencies. He called it the "hard ecu", offering people a choice currency they could freely adopt. It was to be an electronic money to be used in business and tourism. Its value would initially have been equal to a basket of European currencies, but would not depreciate subsequently relative to any member currency, even if one of them lost value. This would have made the ecu as hard as the hardest currency in the basket. Jacques Delors, then President of the Commission, rejected Major's plan out of hand because he was more interested in the politics of union than in the economics of competition. (Schwartz 2013) The euro would have fared much better as a choice rather than as an imposition. The euro is the product of men of system, whom Adam Smith so memorably portrayed in his Theory of Moral Sentiments (1759): "The man of system [...] seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board. [...] In the great chess-board of human society, every single piece has a principle of its own, altogether different from that which the legislature might chuse to impose upon it."5

5 Adam Smith. paragraph VI.II.42, The Theory of Moral Sentiments. 1790. Library of Economics and Liberty.

Gold Is Money, in Spite of Mr.Keynes

May 6, 2013

John Maynard Keynes never liked the automatic character of the classic gold standard, by which the currencies of the different nations were linked to a predefined amount of gold. But he went even further. He denied gold any useful role in the monetary arrangements of the civilized world. In this column I express some skepticism regarding the reintroduction of a fixed gold standard as it existed during the second half of the 19th century. But contrary to Keynes and other monetary interventionists, I will defend the freedom and the opportunity of having private and public gold currencies to compete with the fiat moneys of present day governments. Gold can be used as money without it being imposed by law. We should be free to make payments in gold or gold instruments and hold them among our assets, but it is not for governments to fix the rate between their paper money and gold. That would skew the market and defeat the object of the innovation: to have individuals enjoy a real choice of currencies. Government currencies have dismally failed us in the past and are still failing us at present. We need effective monetary competition for individual freedoms to flourish. Hence, I will argue in favor of the creation of public and private currencies, none of which should be proclaimed legal tender and one or more of which could be linked to gold.

Why Keynes disparaged gold

Keynes' earliest economic work was Indian Currency and Finance, published in 1913 before the start of the Great War. In that essay, he looked for ways to allow monetary authorities as much flexibility in the management of their local currency as was possible within the gold standard. India's currency was then the silver rupee, whose nominal value was fixed on the British gold sovereign. Its silver content, however, was so much below its face value that it really was a sort of paper currency, "a note printed on silver."6 This for Keynes had four advantages: it saved expensive silver; it did away with the temptation to melt down coins when the price of silver went up; it kept the rupee one month with another on a par with gold without consuming physical gold; and it left the government of India the possibility to supply the economy with abundant rupees if the need arose, as long as their convertibility into gold was not endangered.

During World War I the belligerent nations suspended the operation of the gold standard. After peace was restored, the question was whether England should go back to gold at the pre-war parity. In a second work on money and finance, A Tract on Monetary Reform published in 1923, Keynes of course rejected the return to the pre-war parity; since prices had sharply risen during the suspension, it demanded a savage deflation. In the end, Churchill took the plunge with unfortunate effects for the British economy.7 Keynes moved even further away

6 John Maynard Keynes. Indian Currency and Finance. (Palgrave Macmillan), 1971, page 26. 7 Keynes forcefully criticized the measure when it happened. See "The Economic Consequences of Mr. Churchill," found in his Essays on Persuasion.(1925).

from the gold standard in his Tract; he proposed that sterling be a managed nominal currency. In sum, he did not want gold to be used as currency at all!

Keynes's Tract is still worth a visit after nearly a century. In it he showed that clear understanding of financial matters which made him both a monetary theorist and a practical businessman of note. Using

Keynes as a foil has much to be said for it. The Tract poses a strong challenge to those among us who would not leave monetary policy to the discretion of central bankers and government ministers. It is one of his better writings, so well argued in its contrarian way that I have been known to call Keynes the Lucifer of economics—the fallen angel bought down by his very brilliance and arrogance.

From the point of view of sound theory, the Tract is a much better piece than Keynes' most famous work, the General Theory of 1936. In the Tract he correctly defines inflation as a monetary phenomenon, "an expansion in the supply of money to spend relatively to the supply of things to purchase."8 He understands that inflation is a tax on money and consequently attributes "the progressive deterioration in the value of money through history [... to] the impecuniosity of governments and the superior political influence of the debtor class."9 He includes expectations in the so called 'quantity theory' of money—the direct relationship between money supply and inflation. And he properly formulates the less than automatic connection between the domestic purchasing power of a currency and its exchange rate. Perhaps the reason why he stayed within the orthodox camp was that he declared it beyond the scope of this essay "to deal adequately with the diagnosis and analysis of the credit cycle."10 Would he had not strayed from this path as he did in the General Theory and had held to the monetary theories of Marshall and Fisher! But, no. The Keynes we now remember is the one who misunderstood the Great Depression, believing it to have been caused by a fall in aggregate demand and wanting the State to become the main investor of the economy so as to counter the business cycle.

Is there nothing to criticize in the Tract from the point of view of a defender of gold as an important element in the monetary arrangements of a modern society? Yes, there is. First, Keynes never got to a full understanding of why gold is valued as money. Second, he showed too much faith in the good behavior of monetary authorities.

In different parts of the Tract Keynes derides "the primitive passion for solid metal,"11 of the "superstition" of the advocates of gold "for gold still enjoys the prestige of its smell and color,"12 "the gold standard [...as] a barbarous relic,"13 and speaks of central bankers "having no use for barren metal."14 He even makes a

8 Keynes' A Tract on Monetary Reform, page 2. 9 Ibid, page 8. 10 Ibid, page 148. 11 Ibid, page 128. 12 Ibid, page 132. 13 Ibid, page 138. 14 Ibid, page 137.

passing mention of the Golden Calf.15 These thoughts were later echoed in the famous passage toward the middle of the General Theory where, tongue-in-cheek, he presented gold as the great Platonic lie to increase employment:

Gold-mines are of the greatest value and importance to civilization. Just as wars have been the only form of large-scale loan expenditure which statesmen have thought justifiable, so gold-mining is the only pretext for digging holes in the ground which has recommended itself to bankers as sound finance. [...] Ancient Egypt was doubly fortunate [...] in that it possessed two activities, namely, pyramid building as well as the search for the precious metals, the fruits of which, since they could not serve the needs of man by being consumed, did not stale with abundance. The Middle Ages built cathedrals and sang dirges.... 16

In the Tract Keynes did however mention the fact that gold "has a utility in itself for other purposes, aside from its use as money."17 He also accepted that the gold standard had guaranteed the stability of exchange rates among countries for half a century and by a happy coincidence the stability of internal prices, too.18

He concluded that the only monetary use of gold "is as a war-chest to be held against emergencies."19 All these, however, were back-handed compliments.

It is clear that Keynes much preferred "a more scientific standard" than the gold standard- to wit, a currency managed to stabilize the internal price level. Who were to be the scientific managers? In the Tract he said that "a chief object of stabilizing the exchanges [under the gold standard] is to strap down ministers of finance."20 He then proposed that the Bank of England be put in charge of "regulating the supply of currency and credit with a view to maintaining [...] the stability of stabilizing the internal price level."21 So the managers of monetary policy should not be politicians, but civil servants (like Keynes?). Two remarks are in order. One is that Keynes sought the stability of domestic prices; he was no inflationist. The other is, why did he think that managed moneys would not be inflationary? We now know that neither politicians nor central bankers are angels.

The difficulty of a gold standard

For more information, see Gold Standard, by Michael D. Bordo, in the Concise Encyclopedia of Economics and the EconTalk podcast Gene Epstein on Gold, the Fed, and Money. For an historical contrast of a multiple standard system, see The History of Bimetallism in the United States, by J. Laurence Laughlin.

It is unduly materialistic to say that gold is not useful because it cannot be consumed and yields no financial return. Apart from its industrial applications, there is the non-material value of gold in private use. Ordinary people value gold

15 Ibid, page 155. 16 Keynes' The General Theory of Employment, Interest, and Money, pages 130-131. 17 Keynes' A Tract on Monetary Reform, page 62. 18 Ibid, page 126. 19 Ibid, page 153. 20 Ibid, page 136. 21 Ibid.

for being beautiful, incorruptible and rare. We use it symbolically and ceremonially. We love to give it and to hold it. We also see it as a resource for a rainy day.

From the point of view of money, gold is far from being a "barbarous relic." As money, gold has the advantage of its divisibility, its high concentration of value per unit of weight, the easiness of assaying it and its anonymity. Additionally and from a macro-political point of view, it can yield the service of imposing a limit on the activities of profligate governments, since they do not control its supply. Keynes did mention this service when he spoke of the gold standard strapping down ministers of finance, but he did not proceed to the conclusion that a rationally or scientifically managed monetary policy bent on maintaining the stability of the domestic value of money is mostly an illusion. That is why so many defenders of the market economy and democratic capitalism look back with nostalgia at the times when monetary affairs were governed by the gold standard.

The trouble with the gold standard is that it has proved to be incompatible with the social habits and institutions of 20th century democracies. The gold standard imposes a fixed exchange rate between the national currency and gold. The remedy of devaluation to align domestic costs to international prices is out. It is true that over the long run this kind of arrangement also results in stable domestic prices,22 but for this welcome result to be attained without causing unacceptable unemployment, wages must be flexible, labor unions weak and the welfare state small. One need only see the present resistance to cuts in

entitlements demanded by the quasi gold standard character of the euro to understand that a return to the gold standard would be politically and socially virtually impossible.

Milton Friedman's real gold standard

For many years meetings at the Mont Pelerin Society were enlivened by the discussions between gold bugs, who wanted to see a return to the gold standard, and Chicago economists, who defended flexible exchange rates. In 1961 Milton Friedman read a paper which to my mind reduces the difference with a new proposal.23 He explained the operation of the classical gold standard as keeping a fixed exchange between national currencies and gold and giving up all policies designed to evade the discipline of gold. To this, some members added a doubling of the official price of gold so that the starting point would be graced with abundant liquidity. Friedman for his part wanted to say good-bye to fixed exchange rates between national currencies and gold, to all commitments of governments to buy and sell gold at a fixed price, and to lift all restrictions on gold dealings by individuals and companies. There was confusion, he said, between "the use of gold as money, which I shall call a 'real' gold standard; [and] governmental fixing of the price of gold [...], which I shall call a 'pseudo' gold standard." He concluded that a 'pseudo' gold standard was "in direct conflict with liberal principles."24

22 "In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again." From Keynes' A Tract on Monetary Reform, page 65. 23 The title of the paper was "Real and Pseudo Gold Standards", where "pseudo" was the classical gold standard and "real" was Friedman's proposal of a gold currency with fully flexible exchange rates. 24 Friedman's "Real and Pseudo Gold Standards," pages 446-447.

Friedman proposed that there should be a free market in gold bars and coins and in gold certificates issued by depositors of physical gold. These last could be used as money if people freely accepted them.

Side by side with such a standard, there could, of course, exist strictly national currencies. For example, in the United States from 1862 to 1879, greenbacks were such a national currency which circulated side by side with gold. Since there was a free market in gold, the price of gold in terms of greenbacks varied from day to day [...]. Most prices in the United States were quoted in greenbacks but could be paid in gold valued at the market rate. [...] Silver and gold, or copper and silver, have often simultaneously circulated at floating rates of exchange.25

This real gold standard system, with free trade and payments in gold and floating exchange rates between gold and the local currency could make the use of gold more widespread around the world. It would also have the advantage of taking out of the hands of governments and central banks the monopoly powers that they now enjoy and abuse.

A Swiss referendum Examples of parallel currencies abound, usually as a means of defense against the loss of value of the local money caused by improvident governments in need of the revenues of the inflation tax. They usually are a feature of black markets when governments impose capital controls and artificial exchange rates. If such monetary competition were free, it would set a limit to abusive monetary policies around the world. But projects to create a gold money need not be a remedy of last resort in failed states. A referendum is afoot in Switzerland to obtain legal permission to launch a gold coin currency in parallel to the Swiss franc. Since the Swiss National Bank has joined the band of central banks bent on Quantitative

Easing, gold may turn out to be the only defense of the Swiss against the inflation that is to come. Perhaps others could take up this idea.

25 Ibid, pages 456-457.

Education Vouchers

June 3, 2013

George Shultz used to say that people loved to argue with Milton Friedman, especially when he was not there. I am going to do exactly that, argue with Milton when he is not in our midst anymore. I would have loved to hear his views about the remarks I am going to make on his idea of education vouchers. My criticism does not take a whit from my admiration of him: he was my master at-a-distance through his books and articles on microeconomics, on consumption theory, on money, on inflation, on expectations—you name it. Indeed I am attracted to the idea of school vouchers and have been known to defend them, but I think they are only a "second best" remedy for the failings of school systems where the state plays a large role.

By "second best" I mean the kind of engineered solution that tries to take a way around some immoveable legal or institutional restriction that makes the best solution unattainable. In the case of education the first best is, surprising though it may sound, totally private education, supplied by for-profit schools and financed by families and charities. This would not only be better for individual liberty and public morality but also surprisingly feasible if we attend to educational history and present day experience, as we shall see. The example of developing nations, where private education has proved to be vastly superior to public education, especially for the poor, should make us think twice about any statist intervention education.

The restriction that makes this first best of totally private school systems look unattainable is the secular practice of having sovereign authorities meddle in all the dimensions of schooling. The dogma that education must be intervened, managed, and directed by the authorities is so ingrained in the West that it seems impossible even to think of totally private schooling systems financed by families with no public subsidies. But, as Friedman himself said in 1962 when proposing the remedy of school vouchers, Government intervention has resulted in making education the most backward of the major industries in the West from a technical point of view, "because it is a socialist enterprise controlled by a monopoly." An added perverse effect of such relentless interventionism has been the undereducation of the poorest and less gifted in our midst, thus increasing the division of our societies and indeed of the world into "skilled and highly schooled haves versus unskilled and poorly schooled have-nots".26 If Government intervention in education is is here to stay, despite its disastrous consequences, then some kind of second best remedy would be called for and this remedy, said Friedman, is school vouchers.

Government and education

Friedman proposed the idea of school vouchers in his best-selling book Capitalism and Freedom (1962). 27 He started by distinguishing three possible points of public

26 Friedman (1998), pg. 349. 27 Friedman first mooted the idea of educational vouchers in his (1955) essay, later rewritten as ch. 6 of Capitalism and Freedom.

intervention in education: requiring schooling, financing schooling, and administering schools. A case could be made "both for the impositions of a minimum required level of schooling and the financing of this schooling by the state". However, having government administer schools and in effect nationalizing part of the education industry did not follow from the other two and could not be justified.

A strong case can be made to oblige parents to have their children properly taught to a certain level. It was defended by no less an individualist than John Stuart Mill, as early as 1848. The reasons Mill gave are interesting because they have been taken up by most defenders of public schooling. Mill thought that education was an instance of the consumer often being an incompetent judge of its worth and therefore an exception to the principle of laissez faire. When parents are unschooled, how can they appreciate the advantages of education? Hence, the Government could "impose on parents the legal obligation to give elementary instruction to children."28 Mill then proceeded to make an apparently commonsensical remark: that the common wages of unskilled labor could not bear the full cost of such an education—a remark on which I will throw some doubt later on. His conclusion was that the government should make sure that such elementary education be supplied free or at trifling expense. Mill however stopped short of having the State be the main or sole provider of education. At most, the State could enter into free competition with private schools, but it should not prescribe the content of school programs, for this would be a danger for public liberty. "A government which can mold the opinions and sentiments of the people from their youth upwards, can do with them whatever it pleases".29 At most, Governments should concentrate on guaranteeing the quality of education by setting up public examinations at regular intervals of a child's life.30

This was Friedman's position, expressed in words of a century later. The principle was that parents should be able to choose the kind of education they want their children to receive. They could send them to a free public school financed by taxes. If they preferred a fee-paying school and did not have sufficient means, they should be granted government help. The distinguishing point in Friedman's scheme was that this help should come in the form of a voucher given to the parents rather than a subsidy granted to the school. "Parents who choose to send their children to private schools would be paid a sum equal to the estimated costs of educating a child in a public school", if the school of their choice was an approved one. Friedman added a further detail: parents could add money of their own to the voucher if they so chose.

The positive effects of this scheme would be mainly felt on the supply side of education. Public schools, though financed by tax money, would feel the pressure of competition from voucher funded private schools, where parents could as easily send their children. On their part, private schools would be in competition not only

28 Mill (1848), pages 948-9. Also available online at http://www.econlib.org/library/Mill/mlP73.html#Bk.V,Ch.XI. 29 Ibid, page 950. 30 See also Mill's On Liberty, ch. V.

with the best public schools but also with for-profit establishments, as parents of all classes could top up vouchers with their personal money to pay for innovation.

The State of schools

The idea of having the State guarantee that all citizens are schooled to a minimum level is appealing but has up to now proved to be unattainable in most countries. Public democratic education has failed those who most need it. In most advanced democracies a whole underclass leaves school early, is functionally illiterate, and is incapable of the simplest calculations.

The main source for comparing educational attainment in the world is the OECD, especially the statistics gathered under the PISA program. The acronym stands for "Program for International Student Assessment", whereby the capacities of fifteen year-olds in reading, mathematics, and science are tested every three years in more than seventy countries. The scheme is praiseworthy and gathers much interesting information about different school systems around the world and their achievements and failings. I would like to underline some traits that do not necessarily stand out in the PISA studies but are relevant for voucher systems such as that proposed by Friedman.

In many advanced countries, especially those with an ethnically diverse population, PISA shows that a considerable proportion of fifteen year-olds drop out of school and many fail to get a job. Some countries showed low dropout rates in 2009, such Nordic Denmark with 2.9% or central European Poland with 3.6%. But many of the more advanced countries are afflicted by higher rates, such as the United States with 8.8%, the United Kingdom with 9.6%, and Spain with no less than 13.4%. In the United States, close to 30% leave school without a high school certificate.

However these statistics of young people graduating from school say too little about the baggage they have acquired during their long years of education. The percentage of pupils with poor reading results (in effect functional illiteracy) was 19% on average in the European Union countries in 2009, with the United Kingdom and Germany at 18% and Spain and France at 20%. The gap separating high and low achievers at school in the US is as worrying as in Europe. In America there is a clear difference between white and Asian students on the one hand and black and Hispanic students on the other, with a steady percentage of underachievers impervious to measures taken to reduce this gap. Again, around one fifth of American adults find it difficult to get information from printed materials.31

Public schools in America and in many other countries, from New Zealand to the United Kingdom and from Chile to Canada, suffer from evident shortcomings. This explains the spreading across many nations of a movement to supplement them with "schools of choice" or charter schools that are in whole or in part publicly financed but are less subject to regulation than their public peers. This movement has been beneficial, but the Friedmans were right to say that charter schools are a

31 Wikipedia "Education in the United States"

very limited step in the right direction; they are still part of the State system and by forcing them to be not-for-profit they lack the dynamism of private enterprise.32

In sum, despite all the advances, public education systems in diversified societies33 have proven to be highly unsatisfactory, especially for supplying low level education to those most in need of bettering their human capital.

Education (and health) vouchers in Sweden

The public education system of Sweden underwent what many would call a revolutionary transformation in the 1980s and 90s with the introduction of school vouchers. The change was extraordinary for a country famed for its socialist Welfare State, all the more so because the Health Service also moved from central planning to vouchers.

The whole change started with public dissatisfaction with the incapacity of the public school system to attend to the demand for nursery education. Education is a municipal service in Sweden under State

supervision. First a venture was started at Pysslingen to offer this pre-school service, and after a great struggle it was able to open its doors. Then the inhabitants of a small village called Drevdagen turned the local school into an independent establishment. In 1993 the non-Socialist Government of Carl Bildt reached a compromise with the Social-Democrats to launch the school voucher scheme. Vouchers collected by private schools were worth 85% of the average per head cost at municipal schools. Though families could not top up the education vouchers with additional money, greater efficiency allowed many private schools to make a profit. The main addition to the usual voucher scheme was that municipal schools also had to compete for vouchers or face closure. School choice reigned.34

For more on these topics, see the EconTalk podcast Ravitch on Education and Education, by Linda Gorman, in the Concise Encyclopedia of Economics.

The same voucher competition scheme was introduced for hospitals and clinics in Sweden and private for-profit corporations flourished and spread to the Continent of Europe. Only brain and heart surgery departments were kept in the public sector due to resource scarcities.

But there always is a serpent in Paradise. The well-educated young of immigrant parents find no work after leaving school! The two previously quiet locations of Rinkeby and Husby have been rent by riots. So, even the voucher system becomes a third best when a new institutional restriction is added: in this case, ethnic concentration and no jobs. (FT, 25-26 May 2013)

32 Friedman and Friedman, Two Lucky People, pages 349-50. 33 Finland is a contrary example that bears more study. Its school system is exclusively public, is thoroughly uniform, centrally organized and gives excellent results. The homogeneous character of that country makes such statism easier to apply than in ethnically and culturally more diverse countries. 34 See Svanborg-Sjöval, Karin (2012).

The beautiful tree

The web site of the Friedman Foundation for Educational Choice35 is well worth a visit to gauge the spread variety of the voucher scheme in America. A further step would be to apply the Swedish idea that public high schools should also be financed by vouchers handed them by the parents. So, what is my complaint about Friedman's version of school choice?

Let me take the education industry at the other end. In countries such as Nigeria, Zimbabwe, Ghana, India, and China there are flourishing private, for-profit schools that cater to the poor, the miserably poor. The story is told by James Tooley in his enchanting book The Beautiful Tree: A Personal Journey into How the World's Poorest People Are Educating Themselves. Tooley was sent by an international organization to study educational systems in Africa. He was told by local officials that the only private schools there catered to the rich. But then he discovered two things. One was that the State schools financed with international aid were a scandal of corruption and inefficiency; the other was that the miserably poor families in the slums chose to take their children to private enterprise establishments. The premises were cramped. They had to pay whatever they could afford. But in desperate cases the owner granted them a scholarship. The teachers did not miss a class; there was discipline in the classroom; their children were taught what would serve them in later life.

In the West we have been corrupted by entitlements. Mill was wrong when he said that unschooled parents could not appreciate the advantages of education. It is the poor who know that good schooling is the only way to a better life.

35 The Friedman Foundation for Educational Choice

Does Too Much Debt Really Matter?

July 1, 2013

Economists, especially in Europe, seem to be divided into two irreconcilable camps over the question of 'growth versus austerity'. From 2008 to 2012, the talk was all of consolidating public budgets, increasing taxes, closing down or merging unsafe banks, selling their assets at fire-sale prices, cutting down on pension and health entitlements, firing public employees, reducing trade union privileges and opening labor markets to competition—the classic panoply of measures the IMF used to demand of Third World countries when it moved in to rescue them. This time and for the Eurozone, the IMF was content to play second fiddle: the rescuers were Germany and other northern and central European countries; the peccant countries they had to rescue were those on the outer fringes of the Eurozone. The expectation was that this hard medicine would bear fruit at the latest in 2013 and bring renewed growth and employment after four years of contraction. Unexpectedly, and for reasons we hope to discover someday, there was a second dip in the recession. Public opinion, especially in countries suffering from high unemployment, became restless. In despair many Europeans leaders turned their eyes towards the United States, hoping to learn the lessons of its money-printing Federal Reserve and bond-issuing Treasury. The European Central Bank chief Signor Draghi promised to do "whatever it takes" to save the euro; Signor Monti was dealt a sharp lesson by Italian voters; the French President and the Spanish Prime Minister demanded growth-fostering measures to ease public deficit reduction; the European Council set in progress a program to help employ young people; and the European Community as a whole launched a plan to better rail and road transport on the Continent. Frau Merkel was cast into the role of a Dickensian Gradgrind who wanted everybody to stick to "Facts! Facts! Facts!" The policy climate had changed.

These moves were dictated by political convenience, but the change in policy direction was reinforced by the effect of a scientific dispute that reverberated beyond the confines of Academia; an econometric mistake committed by Harvard economists Carmen Reinhart and Ken Rogoff seemed to put the austerity camp in disarray. At least this is how Paul Krugman, in line with many others, presented his case for a deficit financed stimulus.

The Reinhart-Rogoff slip up

The controversy went like this. Reinhart and Rogoff (2010) had come to the notso-surprising conclusion that an excessive accumulation of public debt tended to reduce the rate of growth of a country. They went further. They thought they could see a threshold in the historical series of their sample of countries, whereby a debt equivalent to more than 60% of GDP in developing economies and of 90% for advanced economies was accompanied by a non-linear reduction in growth. Though Reinhart and Rogoff in their paper (2010) allowed for the possibility that the causation could go from low growth to high debt due to falls in tax revenues, the implication was that it was debt that led to lower growth when it went over the

threshold of 60% and 90%. This is how, in discussions about austerity versus stimulus, I myself, along with many others, understood the results.

Three young economists from the University of Massachusetts, Drs. Herndon, Ash and Pollin (2013), criticized the Reinhart and Rogoff results regarding debt and growth by pointing out a number of statistical mistakes which led them to conclude that "when properly calculated, the average real GDP growth rate for countries carrying a public debt-to-GDP ratio of over 90 percent is actually 2.2 percent, not -0.1percent" as Reinhart and Rogoff claimed. More importantly for the case in hand, "average GDP growth at public debt/GDP ratios over 90 percent is not dramatically different than when public debt/GDP ratios are lower". (2013, Introduction) The three critics underlined that this took much of the sting from the arguments (which I used abundantly) against increasing public debt in a crisis.

For an easy-to-understand overview of the Reinhart-Rogoff controversy, see the EconTalk podcast Stevenson and Wolfers on Happiness, Growth, and the Reinhart- Rogoff Controversy, June 24, 2013. See also an earlier podcast Reinhart on Financial Crises with Carmen Reinhart on their earlier book, This Time is Different.

As is often the case, Reinhart and Rogoff were not really the out-and-out defenders of austerity that they were represented to be. One of the conclusions of their deservedly famous book This Time is Different (2009) was that financial crises were always followed by an "explosion" of public debt mainly due to falling tax revenues, but they did not proceed to link public debt causally with lower growth. They simply noted that full recovery from financial upheavals of the kind the advanced world was now suffering usually took pretty long to arrive.36

Ken Rogoff in fact was not remiss to call for extraordinary remedies for the recession following the present crisis. Thus, in December 2008 he prescribed a short burst of inflation, on the order of 6% for two years, as "extremely helpful in unwinding today's epic debt morass".37 I personally would be a much more singleminded budget cutter than Rogoff and less indulgent with bursts of inflation.38

Enter Paul Krugman

In April 2013 Krugman published an article in the New York Review of Books with the title "How the case for Austerity has crumbled". He wanted to put the last nail in the budget cutters' coffin by pointing to the mistakes of the Reinhart and Rogoff 2010 article on debt and growth, an article he added with some exaggeration that "may have had more immediate influence on public debate than any previous paper in the history of economics". The mistakes discovered by Hendon, Ash and Pollin seemed to have destroyed the whole case for austerity as the way to solve the debt

36 Reinhart and Rogoff (2009), Chapter 14 distill the following recovery periods from a long history of financial crises. On average, real housing prices tend to decline by 35% over six years; equity prices, 56% over three and a half years; unemployment increases by 7% over four years; output falls by more than 9% in two years; and after the financial crises of the period after World War II government debt, helped by falling tax revenues and calls on the public Treasury, tended "to explode" with average rises of 86%. 37 Rogoff (2008), quoted by Warsh (May 2013). 38 Cf. David Warsh (2013) verdict on Rogoff.

crisis. The only means to restart growth and reduce the weight of the debt accumulated during the crisis was to finance public expenditure indiscriminately with debt. Krugman also unfairly accused Reinhart and Rogoff of stark disregard for research ethics for not sharing their data. I find it difficult to see how Hendon, Ash and Pollin could have built their case without the Reinhart and Rogoff data. It is a long time since Krugman gave up research for sensational journalism.

The Reinhart and Rogoff reply, apart from the polemical fireworks, is interesting in that it revisits some points from their 2009 book. Number one, recoveries from deep systemic financial crises "are long, slow and painful". Two, post-crisis circumstances dictate that debt must be dealt with, but not too fast. Three, the real danger is not a spike in debt over the 90% threshold, but in the possibility of "debt overhang". Ironically, it was Krugman who in 1988 invented the notion of 'debt overhang' as that which a country suffers when its debt is so large that all the proceeds from national investment are appropriated by debt-holders. Krugman also seemed to have passed over an Economic Perspectives article written by Reinhart and Rogoff with Reinhart's husband (2012) in which attention was drawn to the fact that when public debt stayed at levels above 90% of GDP for five years, the overhang phenomenon lashed in and kept growth levels below the trend for at least ten years in a majority of the 26 episodes in advanced economies since 1800.

Fallacies regarding the public debt

The economist who clarified the question of public debt more than any other was James Buchanan, the recently deceased Nobel Prize laureate. We need his help to understand why the total amount of public debt matters for the personal and constitutional welfare of the residents of a country.

Buchanan's first book, originally published in 1958 under the title Public Principles of Public Debt has become a classic of financial theory. He there overturned the orthodox view of public debt prevalent at the time and still held by many fiscal theorists today. This orthodox and misguided view he summed up in three mistaken propositions.

1. The creation of public debt does not involve any transfer of the primary real burden to future generations. 2. The analogy between individual or private debt and public debt is fallacious in all essential respects. 3. There is a sharp and important distinction between an internal and an external public debt. (Buchanan, page 5) Now, I must be frank with my readers. Until I carefully re-read Buchanan for this essay I was one of those macroeconomists who held by these three tenets of fiscal orthodoxy. I have proclaimed my adhesion to them even in print! I can see now where the source of my mistake lay: I reasoned as if society was a sentient being, whose national debt had to be seen as a mere transfer between different parts and organs of a single entity, governed by an all seeing planner, whose job is to maximize a social welfare function. Internal debt issues were simple transfers of

funds among parts of the national society. The debt only weighed on the national welfare when it was due to foreigners.

The Ricardian equivalence mistake

The first proposition has the authority of David Ricardo (1817) behind it. Under certain very strict assumptions, the national public debt is discounted by individuals as if it were a tax. When individuals are supposed to care for their descendants as much as for themselves, then it does not matter whether a war or a public project is financed by taxes or by bonds. In so far as individuals were rational and their time horizon was infinite, the bond would be fully discounted by the buyer and equivalent to a tax on his wealth; the tax-payer would save the full present value of the future service of the bond. Ricardo himself said that this extreme conclusion was only partially true, but for him financing a present expense with bonds on the whole did not shift the burden to future generations.39 Ricardo's main object was to decry public expenditure in all its shapes and forms, so he wanted to underline that the way it was financed was of little import. (Buchanan, 1999, page 81)

Buchanan then gave an illuminating definition of what 'future generation' really meant.

I shall define a "future generation" as any set of individuals living in any time period following that in which the debt is created. [...] An individual living in the year to will normally be living in the year t1 but he is a different individual in the two time periods. [...] I shall not be concerned whether a public debt burden is transferred to our children or grandchildren as such. I shall be concerned with whether or not the debt burden can be postponed. (Buchanan, page 28, paragraph 2.4.6.)

It is not how the moneys are used that matters but the shifting of the burden from one 'generation' to another. Buying a bond voluntarily is no sacrifice for an individual who prefers to save a given sum rather than consume it. Neither is it a sacrifice for the people enjoying the results of the public investment thus financed. The sacrifice falls on the future 'generation' being taxed to return the funds to the bond holder. This generation will be different from the original one which received the benefits and was freed from the obligation to repay.

For an introduction to Ricardian Equivalence, see "Does It Matter How You Pay for a State Dinner? A Lesson on Ricardian Equivalence", by Morgan Rose. Library of Economics and Liberty, Sept. 12, 2001.

One conclusion of this analysis is that the operations of privately and publicly indebting oneself are strictly analogous except for the fact that in the case of public debt the burden of repayment may fall on someone who did not have the full

39 This theorem was taken up by Barro (1974) to show that issuing public debt to use the proceeds for anticyclical investment was useless, since the amount borrowed and spent by the Government to revive a depressed economy would be fully discounted by the purchaser of the bonds who would not see them as wealth.

enjoyment of those funds. Whether the funds are well employed or not is immaterial.

External and internal public loans

With the present crisis, the conviction has spread among specialists that foreign debt is more dangerous and less manageable than domestic loans. For those who conceive of national societies as wholes, when there is no external creditor, debt is owed by one part of the social body to another. Buchanan quoted Philip E. Taylor as saying that

to the extent that public debt is held by citizens of the debtor government, "we owe it to ourselves." [...] If on the other hand the debt is owed to citizens or governments of other societies, payments on the debt represent deductions from national product.40

The question very properly asked by Buchanan is who is part of the 'generation' having to service an internal debt, and is he the same as the one who enjoyed the proceeds of the loan? The fallacy stands out in another quotation of Buchanan's, this time a passage from Arthur Pigou (1949). "But interest and sinking funds on internal loans are merely transfers from one set of people in the country to another set".41 Thank you very much! Sets of citizens are interchangeable for the all-wise central planner.

Daniel Gros of CEPS has tried to show that, empirically speaking, foreign debt is quite another proposition from domestic debt. As an explanation he adduces that foreigners do not have the remedy of voting for "the higher taxes or lower expenditure needed to service the debt." And he proceeds with the usual remark that in the case of domestic debt "a higher interest rate or risk premium just leads to more redistribution within the country (from taxpayers to bond holders)". The case is different for debt owed outside the country; "higher interest rates lead to a welfare loss for the country as a whole because the government has to transfer resources abroad." (Gros, page 1)

These are well rehearsed arguments based on the fallacious idea that it is the country as a whole and not individuals who service public debts. Dr Gros' paper, however, is more interesting than most because he has regressed sovereign debt spreads on current account deficits. He has shown a remarkable correlation indicating that investors are wary of nations with a high proportion of debt when it is foreign owned and they show a large current account deficit. Inversely, he notes the remarkable case of Belgium with public debt nearly equivalent to 100% of GDP but low spreads throughout the crisis. Even more remarkable and well known is the case of Japan with the highest public debt rate among advanced nations, very low interest rates and no financial crisis—rather continuous immobility in the doldrums.

40 Philip E. Taylor, The Economics of Public Finance (Rev. ed.; New York, 1953), p. 187, as quoted in Buchanan (1958) page 59, paragraph 2.6.3.
41 Pigou (1949), page 30, as quoted in Buchanan (1958) page 59, paragraph 2.6.3.

By reducing the service of domestic public debt to a question of redistribution between inert taxpayers and bond holders, the real nature of the problem is hidden from view. Individual taxpayers and bondholders vote according to their own personal interest. In this case

... the community must compare one debt form which allows a higher income over future time periods but also involves an external drainage from such income streams with another form which reduces the disposable income over the future but creates no net claims against such income. [...] [With an] external loan [...] income in a future period would be higher than in the internal loan case by precisely the amount necessary to service the external loan. (Buchanan, pages 62-63, paragraph 2.6.15.)

The second case is an accurate description of the Japanese plight over the last twenty years, with extra low interest rates and spreads and very little growth.

How much public debt

The amount of debt a government will issue is of course related to how much public expenditure is considered proper. This discussion does not properly belong in this essay, except to say that the matter of what the state ought to do is usually discussed from the outside, as if the community were an organic entity with a single value scale embodied in a social welfare function. "...in this case", says Buchanan, "the fiscal problem reduces to one of simple maximization [...] by some omniscient decision maker". This cannot be the case in a democracy where the process is king.

The task of the expert here becomes that of showing how the decision-making process itself might be improved, how information concerning alternatives can be increased, and how individuals can be presented with "fair" alternatives. (Buchanan, page 119, paragraph 2.12.10.)

We are still left with the question of how much public debt an economy can sustain. Again the combination of taxes, inflation and public debt is one to be decided in the democratic process, with no expert presuming to "play God", as Buchanan used to say.

We have seen the extreme case of 'debt overhang'. There are earlier limits to deficits and debt issue. When replying to Krugman, Reinhart and Rogoff42 recalled situations of "debt with drama" which we have witnessed in Europe, when markets simply ceased to accept sovereign paper and the government found itself incapable of supplying its services. Whatever Krugman may believe, debt equivalent to 100% of GDP is in the end unsustainable. Even in the case of the United States, which enjoys the privilege of being the world's banker, there may come a moment when raising taxes will not be enough to defend the dollar and singeing cuts in expenditure will have to be made. There is a limit to the burden of pensions, health

42 Reinhart and Rogoff (2013).

services, and public works that present generations can leave for later taxpayers, who may refuse to pay the bill. In the end, a debt is a debt is a debt.

In Praise of Neo-liberalism

August 5, 2013

"Neo-liberalism" has become an all-purpose term of insult among people who reject capitalism root and branch. It also is used in derogation by social liberals who see it as the creed of a metaphysical sect, and by traditional conservatives who blame the greediness of its devotees for the present crisis. In fact, the people thus denounced are nothing more than a group of economists who take their subject seriously and want to rescue the philosophy of liberty from a century of slow decay.

The period 1875 to 1945 (or more precisely, to 1947) saw the inner logic of classical liberalism slowly unravel. Ironically, it was around the middle of the 19th century, just when free trade was triumphant, that classical liberalism took a turn in the wrong direction at the hand of John Stuart Mill; his proposal to fundamentally change the institution of private property was the first step on the primrose path. Mill was trying to respond to the growing attraction of socialism, which had started to take hold of the minds of intellectuals unsatisfied with mere equality before the law. He also tried to take account of nationalism, a rhetoric increasingly used by politicians to harness the free economy to state-creation and expansion. Come 1900,

nations around the world began to mimic Bismarck's Social Insurance. At the same time, Teddy Roosevelt surfed on the wave of Progressivism in the United States. After the upheaval of WWI, the reaction against classical liberalism deepened. The Soviets and fascism became respectable in some quarters of Europe. In America, Franklin Delano Roosevelt barefacedly called his political program "liberal," when it was fundamentally contrary to what had been taught by liberals from Adam Smith to Frederic Bastiat. After a short let-up in the last years of the 20th century, the tide is again turning against economic liberty. Markets and corporations are under constant scrutiny; legal means to avoid taxation are considered less than respectable; the size of government has expanded to the point where no more surplus can be extracted from taxpayers, present or future; public action has become discretionary rather than rule-based. The Welfare State is dogma.

It is no mere coincidence that the retreat from freedom coincides with economics coming under increasing suspicion. Ideas matter. A century of social change and scientific criticism has put economic liberalism on the defensive, so that private property and laissez-faire are made to carry the burden of proof. The economic conception of human nature is considered unrealistic, the straining for growth seen as prodigal, any and all inequality denounced as unjust. This has led either to ideological rejection of the economic point of view among egalitarians or to growing agnosticism among professional economists; in both cases economics has been reduced to a kit of technical tools when it originally was central to the liberal world-view. Part of the blame for this demotion, however, must be laid at the door of economists themselves. Perhaps it is the classical formulation of the free society that was at fault. Perhaps it is theory-less modeling and mechanical testing of the present-day that is responsible.

The thesis of this essay is that a reformulation of the tenets of the great classical economists will help undo the damage caused to liberalism by a century of negative criticism. I am averse to labels and do not much mind whether I am seen as a libertarian or an Austrian economist or a follower of the Chicago school, as long as what I hold makes sense from the point of view of truth and liberty. But I have now come to think "neo-liberalism" a useful label, for its defiant assertion that economic theory and policy must be put back at the center of the philosophy of liberty.

The 1947 turning point

Why do I say that the century of slow liberal decay ended in 1947? That was the year when Friedrich Hayek founded the Mont Pèlerin Society. William Coleman, in his perceptive paper on neo-liberalism (2013) on which I want to build my present reflections,43 pointed out two developments from the early years of that Society: that Hayek, with the help of fellow-minded historians, economists and philosophers, wanted liberalism to face new problems not apparent in the great classical days, and that the increasingly pro-market stance of the members of the Society led to the resignation of liberal relativists such as Röpke. Indeed, Röpke's idea that the economic market left to its own devices tends to self-destruct had important followers at the time, such as Karl Polanyi and Joseph Schumpeter, and it is enjoying renewed popularity today when so many critics have suddenly discovered that the orgy of greed and dishonesty at the heart of capitalism is to blame for the late crisis.

The connection between ethical values and the free market does pose a problem, as we shall see. This problem is not solved by denying it, as Ayn Rand did when she extolled selfishness and proposed a kind of Superman worship. Neither is the opposite view satisfactory, that capitalism will run into excess unless it is embedded in the social mores of an ethical or even a religious society. In this essay, I will hold that the

values needed for the capitalist system to subsist and move forward are created by the system itself. In this I will follow Adam Smith's lead, who rightly pointed out that while beneficence is an ornament to society, justice must be regarded as "the main pillar that upholds the whole edifice," meaning by "justice" respect for property and contract.

Society may subsist among different men, as among different merchants, from a sense of its utility, without any mutual love or affection; and though no man in it should owe any obligation, or be bound in gratitude to any other, it may still be upheld by a mercenary exchange of good offices according to an agreed valuation. (Smith, The Theory of Moral Sentiments, Book II, Section II, para. 16.. Library of Economics and Liberty.)

John Stuart Mill at the Watershed

43 I warmly recommend the careful study of William Coleman's "What Was 'New' About Neo-Liberalism" (Economic Affairs, Volume 33, Issue 1, pages 78-92. February, 2013.). Readers of his essay will see how far Coleman has helped me formulate my proposal that economics be again made to hold the center of the philosophy of freedom. (Available online via Wiley, Online Library.)

Now let us see what happened to classical liberalism in the century before the founding of the Mont Pèlerin Society. In my view, it all started with Mill. Though one of the foremost philosophers of liberty, Mill was instrumental in the erosion of the philosophy he so much cared for in two ways: in the reforms he wanted to carry out regarding private property and in his romantic conception of individual freedom. In his Principles of Economics44 he had much to contribute to economic analysis, but he went clearly astray when trying to subvert the principles of private property. If we remember that in On Liberty45 he added an exaggerated defense of eccentricity, spontaneity and self-expression worthy of Rousseau; the way was open to a concept of society where individuals could expect to be given equal opportunities of happiness without responsibility.

Mill believed he made a most important contribution to political economy with his distinction between the laws of production and the laws of distribution. For him, the laws of production were akin to the laws of nature, in that they necessarily governed the actions of men in society: these were such as the Malthusian law of population, the declining productivity of land, the role of capital in productive activity, or comparative cost in the flows of international trade. But in the field of distribution, society could make its own laws:

It is not so with the Distribution of Wealth. That is a matter of human institution solely. The things once there, mankind, individually or collectively, can do with them as they like. They can place them at the disposal of whomsoever they please, and on whatever terms. (Mill, Principles of Political Economy, Book II, Ch. 1, para. 2.)

He did not mean that the consequences of new distributional arrangements should not be examined before changes were made, but that there was no natural limit to new experiments in distribution. He did examine the proposals of different schools of socialists and found them wanting for this or that reason. However, in the organization of property he thought society had a freer hand. The changes he proposed were based on Locke's justification of property by labor: one should have a right only to what one had produced with one's work. Whatever the practice in the society of his time, no one had the right to accrue wealth by inheritance or by the occupation of the productive powers of Nature.46

This is not the place to go into the consequences Mill drew from the exclusive justification of property by labor for the system of private property, nor the reforms he proposed for inheritance, land ownership and corporate organization. My point is another one. Mill thought that the proper institutions for a just society could be imposed from the outside by all-wise politicians led by all-seeing intellectuals. From a proper Smithian starting point, the institutions better suited

44 Mill, John Stuart, Principles of Political Economy with some of their Applications to Social Philosophy. William J. Ashley, ed. 1909. Library of Economics and Liberty. Accessed 24 July 2013. 45 Mill, John Stuart, On Liberty. 1869. Library of Economics and Liberty. Accessed 24 July 2013. 46 Though the principle of justifying property by labor has enjoyed wide popularity over the centuries, it is too narrow to explain the observable features of that institution. A better principle is 'finders keepers', especially regarding the property of natural resources, of the gains from speculation and of discoveries and inventions, whose benefits are only remotely connected with labor.

for social progress and economic development are endogenous to the market—and this includes the political market, as we shall see James M. Buchanan maintained.

The logic of classical liberalism

Coleman aptly compares classical liberalism to a "molecule" of values that were seen to hang together as chemical elements in a stable compound: freedom, wealth and reason.

Adam Smith was the clearest exponent of the idea that the "Natural System of Liberty" promoted wealth. Wealth in its turn would make for rational social conduct, as David Hume and Montesquieu maintained.47 Montesquieu was indeed one of the first to point out the civilizing effects of commerce. Human intercourse in a commercial society tended to bring about independence and rational selfcontrol.48 Freedom, wealth, and reason were seen as unbreakably linked, and the reverse was also held true.

Coleman adds that this triad of values was seen to be consistent with other values treasured by people outside the liberal fraternity. The individualism of classical liberals made them natural allies of the humanitarian anti-slavery movement; their defense of private property helped them with order-loving conservatives. Their belief in equality before the law chimed in with the egalitarianism of the left, and the connection they saw between the distributive shares assigned to individuals with their respective contribution to social production satisfied thinkers preoccupied with justice.49

Liberalism besieged

To start with, the alliance between liberalism and humanitarianism, order and equality started to break up. The free market exploited workers, liberals lit revolutionary flames, and wealth seemed to concentrate in the hands of the rich.

The gradual extension of the franchise led to the first doubts being entertained on the congruence of the liberty element within liberalism. With the growth of democracy, the interpretation of freedom started to change. Mill himself feared that minorities would be oppressed in majoritarian democracies and felt he had to devise constitutional barriers in his essay Considerations on Representative

47 “Le commerce guérit des préjugés destructeurs; et c’est presqu’une règle générale, que partout où il y a des mœurs douces, il y a du commerce; et que partout où il y a du commerce, il y a des mœurs douces.” “Commerce heals destructive prejudices: and it is almost a general rule, that everywhere there are soft customs, there is commerce; and that everywhere there is commerce, there are soft customs”. (Montesquieu, The Spirit of the Laws, T. Evans (London), 1777. See the link for an alternate translation, available at the Online Library of Liberty.) 48 Coleman points to the connection between reason and free thought, on the one hand, and individual autonomy of the other made by Kant and Mill, and others of the Continental school. The Adam Smith of the Theory of Moral Sentiments (1759) would not have subscribed to the connection between deductive reason and polite behaviour. For him the moral life came more from human intercourse than from logical premises. Confidence in free-standing reason was not part of the world-view of Scottish philosophers. 49 Of course, these connections did not fully hold with Mill, who however fought slavery with conviction and clashed with his sometime friend Carlyle over the issue.

Government.50A further crack appeared when democracy was put at the service of nationalism: should individuals be free or should nations?

Then, in the second half of the 19th century, doubt was thrown on the connection between wealth and freedom. That was the time of the spectacular development of positive science. The hopes and prosperity of humanity were seen to hinge on natural science and its applications. Rather than rely on the free market, should societies not harness technology directly by entrusting common affairs to technicians? Very early on the St. Simonians proposed world government by engineers. This idea took wing. Coleman tellingly mentions Thorstein Veblen‘s The Engineers and the Price System (1921) and the Soviet attempt to establish rule by engineers as the culmination of the process. The pseudo-scientific hubris of some neo-Darwinists also led them to question equality before the law, when they pretended to dictate an ethic where liberty and individualism had little role.

Finally, socialists took over the connection between science and reason. The market, apart from bringing dire consequences for equality and stability, was too chaotic to be trusted. Planning was more rational. Society was best administered by scientifically minded planners. In the years between the two World Wars, planning was generally accepted as a necessary substitute for the disorder of the market. Ironically, the more elaborate proposals for economic planning were based on the general equilibrium theory of Leon Walras, himself a man of deep socialist convictions. I myself heard Oskar Lange say shortly before his death in 1965 at a meeting in the Old Theater of the London School of Economics, that the optimality of the plan for a national economy could be tested by solving a Walrasian system of equations with the new-fangled instrument of the computer—much to the amusement of a skeptical Lionel Robbins who was in the chair.

The onslaught on the market economy in the first half of the 20th century proved difficult to resist. The troops are well known. Arthur Pigou, in his The Economics of Welfare51 demanded the correction of inevitable external effects of the free market. Walras’ disciple, Enrico Barone, wrote “The Ministry of Production in a Collectivist State” (1935). E. H. Chamberlin (1926) and Joan Robinson (1933) characterized the economic market as monopolistically or imperfectly competitive. The main battering ram, of course, was John M. Keynes’sGeneral Theory (1936). The Great Depression had thoroughly undermined the confidence in the free market system. Keynes, by vesting in governments the role of saviors of bourgeois civilization when it was facing utter breakdown, seemed to plant the last nail into the coffin of classical liberalism.

Hayek, Friedman, Coase, and Buchanan

In their different ways these four economists, who, with the exception of Ronald Coase, have now left us, helped reestablish the philosophy of freedom on a more

50 John Stuart Mill,The Collected Works of John Stuart Mill, Volume XIX—Essays on Politics and Society Part II, ed. John M. Robson, Introduction by Alexander Brady (Toronto: University of Toronto Press, London: Routledge and Kegan Paul, 1977). 51 Pigou, Arthur C., The Economics of Welfare. 1932. Library of Economics and Liberty. Accessed 24 July 2013.

solid basis than in classical times. They did not all see eye to eye on everything, but their suggestions are the basis of the reconstruction work carried out in the second part of the 20th century.

The work of this group of "neo-liberal" economists is what, rightly in my view, William Coleman sees as genuine scientific and policy progress. The first contribution I want to note was that of Hayek in the field of knowledge and economics. It came early in the story we are telling. The year was 1934 and the book a collection of essays under the title Collectivist Economic Planning . In 1920, Ludwig von Mises had written a seminal article on the impossibility of centralized economic calculation. Hayek took it up and re-published it with an introduction and a conclusion of his pen. The book also included Barone on the" Ministry of Production," as a foil for the position taken up by the critics of planning. Hayek took up the central idea of this book in his 1945 essay "The Use of Knowledge in Society."52 Hayek's initial object was to rebut Oskar Lange's proposal for a Central Pricing Board to set prices in a planned socialist society. The market was much more efficient than a central board in setting prices because the dynamic of their movements reflected the knowledge of millions of different people, who could only know a minimal fraction of reality individually. What Mises and Hayek had explained theoretically in the 1930s was proven right in fact when the protecting screen of the Berlin Wall was dismantled in 1989.

Hayek always thought that redressing economic history and the history of economic thought was a necessary condition of the re-founding of liberalism. In 1954 he edited Capitalism and the Historians , where he put together a collection of essays purporting to change the accepted picture of the cruelty of the Industrial Revolution. This should have helped to repair the broken relationship between liberals and humanitarians, on the basis of the same logic that should explain why the harsh realities of urbanization in developing countries should not tell against capitalist development.53

Milton Friedman's contribution to "neo-liberalism" was just as important in its own way. People forget that he wrote The Theory of the Consumption Function in 1957, where, in parallel with Albert Ando and Franco Modigliani, he dismantled Keynes's loose "fundamental law" of human psychology that people save proportionally less the greater their income. Keynes' conclusion was based on deficient statistical work; individuals made their consumption decisions on the basis of their perceived long term prospects. There is no need to extol the work of Milton Friedman and Anna Schwartz on the mistakes of the Federal Reserve during the Great Depression. That has spelled the end of Keynes' pretence of having written a general theory of the macro-economy: so much then for the essential impossibility of the market system to self-equilibrate. Also, Friedman and his wife Rose wrote

52 Hayek, Friedrich A., "The Use of Knowledge in Society." 1945. Library of Economics and Liberty. Accessed 24 July 2013. 53 Later work by economic historians on mortality in cities and soldiers' and male prisoners' height in the 1830s in Britain has confirmed the step back in welfare during those ten years. Water sanitation and greater abundance of food after the abolition of the Corn Laws and the reduction of tariffs explains the turn-around towards more prosperity from 1860 onwards.

books and made films to rescue the necessary relationship between freedom and wealth.

For more on these topics, see the EconTalk podcasts Burgin on Hayek, Friedman, and the Great Persuasion, Friedman on Capitalism and Freedom and Coase on Externalities, the Firm, and the State of Economics. See also Art Cardin and Steve Horwitz, Is Market Failure a Sufficient Condition for Government Intervention?, April 1, 2013, Library of Economics and Liberty.

Pigou's case against free markets was they were inefficient due to an endless number of external effects. Ronald Coase effectively turned the tables on Pigou with two arguments: that people and firms in the market often corrected externalities by mutual agreement, and that solutions imposed by government were more often a worse outcome than the starting situation. In the famous 1959 dinner at the home of Aaron Director, where Milton Friedman and George Stigler were present with another seventeen skeptical economists, Coase presented his case that, given low transaction costs, the parties confronting a situation beset by external effects would find an optimal agreement with no need for government intervention. He also showed that the solution imposed by authorities as selfevident could be shown to have little or no justification. Coase overturned a majority of twenty against his theorem at the beginning of the dinner. What is important for the neo-liberal position is that Coase did not take it for granted that markets functioned perfectly. High transaction costs made it difficult to come to effective agreements. So, as Coleman underlines, the neo-liberal renovation does not posit perfect markets. It rather builds on the often unrecognized fact of the imperfections of government. After Coase, the case for liberty came to rest on the high probability of government failure—something that was more often than not overlooked in economics textbooks and political discussion.

There still was the snag of the possible incompatibility of freedom and democracy. The case of Schumpeter is especially telling on this point. He well understood the essence of capitalism but saw it as necessarily bound for self destruction. In his Theory of Economic Development (1912) he had characterized the free market system as moved by "creative destruction," where progress is based on new procedures that bring about the obsolescence of existing modes of production. But in his notorious Capitalism, Socialism and Democracy (1943) he came to the shocking conclusion that creative destruction would come to a grinding halt in a democracy because the people would not willingly bear its cost. Only a more or less hidden socialist dictatorship could force the people to accept the sacrifices demanded by economic progress. His conclusion was: "Can capitalism survive? No, I don't think it can. [...] Can socialism work? Of course it can."54 No great prophesy, but still a pointed formulation of the paradox of democracy.

Buchanan's attempt to solving the conflict between democracy and freedom is a decisive contribution to the neo-liberal reconstruction of the case for freedom. For

54 See Schumpeter, Capitalism, Socialism, and Democracy. (1943, 1976), Part II, Prologue; and Part III ch. xv.

him, political processes cannot be imposed or be judged from the outside. Buchanan especially directed this prohibition to political philosophers, who should never "play at being gods." It is for people themselves to vote and decide how to arrange social matters concerning them. The problem is that often in actual democracies ,the result of collective decisions is wanted by none of the people concerned. So Buchanan proposed that collective decisions should be taken in two separate forms. One is the constitutional mode, when the basic rules of the game should be decided unanimously or nearly so. The other is the political mode, in which decisions would be taken by majority vote. People would be careful to agree to a Constitution that guaranteed their basic rights whatever their future situation in society would be

compared to their present one. The rules of poker should be decided by customary agreement for the long term, whatever the hand one holds at the moment.

Buchanan would not presume to tell voters what they should prefer. In this, he treats the political game as another market where consumers and producers will not be told what to prefer or do. But as in the economic market, he would hope that institutions emerge that better reflect the wishes of voters in the long term. This he tried to attain by separating decisions about the rules of the game from day to day politics; in this way voters would slowly learn to organize their democracies under a Constitution that would protect them even when they were not in power.

The neo-liberal transformation

Whatever one may think of the results obtained by the efforts of those economists that, following William Coleman, I have decided to call "neo-liberals," there is little doubt that a reconstruction of liberalism was need by the middle of the 20th century. The audacity lay in holding that liberalism could only be revived by strictly applied free market economics.

Their achievements should not make one think that all is done. If nothing else we still have fully to understand the reasons and causes of the deep financial crisis from which we are barely emerging.

The Riddle of Schumpeter

September 13, 2013

I have been immersing myself in Joseph A. Schumpeter's History of Economic Analysis. My reason for re-reading this classical work was to find the answer to an enigma: why did Schumpeter call the object of his ambitious work "a history of analysis", when to an unprepared reader it seems to be a straightforward history of economic thought? Whoever looks at the matter covered will find so much more than analysis—page after mesmerizing page on the socio-political background, on the intellectual scenery, on developments in neighboring fields, all adorned with wistful reflections on the vanishing civilization of Europe of which he was such a distinguished product. What did Schumpeter mean by "economic analysis"? With this odd denomination, did he want to signify something important about the whole enterprise of economics? I now think that, in the anti-market atmosphere of the central years of the 20th century, this was the proclamation of contrarian principles rather than the mere affectation of a writer who loved to surprise.

I first studied Schumpeter's History at the behest of the great Lionel Robbins, who had just become my doctoral supervisor. My intention was to write a thesis on John Stuart Mill and I felt I needed to be well versed in economics before approaching Mill's work. Robbins told me to start by reading two books: Alfred Marshall's Principles of Economics55 and Schumpeter's History—two weeks for each, he said. It took me much longer than that! The two books set me on the path to becoming an economist but also left me with an ambivalent attitude to their two authors. Marshall made me impatient with his ploy of banishing difficult theoretical problems to the mathematical appendix, especially his crucial exposition of a general equilibrium model. Not for nothing did Joan Robinson call him "Marshall, the old fox". As to Schumpeter, I did not know what to make of his choice of heroes: François Quesnay extolled for his

Tableau économique, Antoine Cournot placed above David Ricardo, Karl Marx presented as a better economist than Mill, Leon Walras portrayed as the giant above all others—and Adam Smith demoted to being a late mercantilist. Also, I was confused by his constant sniping at free trade. On the other hand, the broad canvas on which he painted his story I found beguiling. Let me leave Marshall for another day and concentrate my attention on 'Schumpeter, the seductive sphinx'.

It is not easy to know what to make of Schumpeter. Devotees of the Austrian School of Economics would classify him as one of their own, on account of his efforts to move beyond perfect competition to a new economic dynamics. His admiration for Karl Marx as economist fits less well with such an affiliation. His rejection of the general validity of laissez faire excludes him altogether from the wider camp of classical liberalism. This has not stopped him from becoming a revered figure in business schools, where his main title to popularity is the choice of the entrepreneur and creative destruction as the defining characteristics of the capitalist system.

55 Marshall, Alfred, Principles of Economics. 1920. Library of Economics and Liberty. 10 September 2013.

The Theory of Economic Development, which he published in German in 1912 at the early age of twenty-nine, did not receive the acclaim it deserved, principally because it did not appear in English until 1934.56 This book was 'Austrian' in that it linked booms and busts to the expansion and subsequent contraction of bank credit. To the explanation of economic growth it incorporated a crucial 'Austrian' actor, the entrepreneur. But he gave a personal twist to both elements. There could not be a dynamic capitalist economy without cycles; excessive credit was not such a bad thing, as it was the way of selectively financing entrepreneurs at the expense of the more staid part of the population. And in capitalist societies entrepreneurs were neither the providers of capital nor the inventors of new techniques but rather innovators who put new ideas in practice and tried to make a profit by exploiting the advantage of their temporary monopoly.

His book appeared in English when John M. Keynes's much simpler theory of depressions (and cycles) was to gain the attention of the profession. In any case, by the time the translation appeared Schumpeter was working on a two volume work on Business Cycles (1938).57 It was not a success and could not have been, for it was virtually unreadable. Also, Schumpeter presented cycles as phenomena occurring at set intervals, when he should have thought of them as the random result of the bunching of entrepreneurial innovations. And his detailed historical exposé was not easily translatable into mathematical models, which is the way growth theory was moving. Thus the positive contributions of these volumes, as those of his youthful book, went underground, so to speak. The central role of innovation driven by entrepreneurs and new firms in the search for profits; the role of bank credit in sustaining the whole process; and the resulting continuous change that endangered the position of existing interests were ideas of Schumpeter's that would take time to move back center stage.58

Creative destruction

Another concept was still to come, that of "the gale of creative destruction" as the center of the capitalist process. With those words he summed up the idea that the economy only progressed by destroying existing modes of production and substituting innovative ones, much to the disarray of those employed in the up to then useful activities. That felicitous phrase appeared in his next book, Capitalism, Socialism and Democracy (1942)—paradoxically a book that described the slow death of the capitalist economy. It was an instant success and is still read today by friends and foes of capitalist society. It was published in 1942, barely two years before Friedrich Hayek's Road to Serfdom. The contrast between those books could not be starker. One is a detached, almost cynical picture of the undoing of

56 Joseph A. Schumpeter's The Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle (translation into English by Redvers Opie). Harvard University Press (Cambridge): 1934. 57 Joseph A. Schumpeter's Business Cycles: A Theoretical, Historical, and Statistical Analysis of the Capitalist Process. McGraw Hill (New York): 1939. 58 See Thomas K. McCraw's perceptive article "Schumpeter's Business Cycles as Business History". Business History Review 80 Summer 2006): 231-261. See also his masterful biography Prophet of Innovation: Joseph Schumpeter and Creative Destruction. Harvard, 2007.

capitalism by its success and its replacement by planned socialism that would discipline the working classes. The other is a heartfelt warning that liberty is in danger because of the slow whittling down of the free market and the mindless drift towards planned welfare.

I find it surprising that Schumpeter should be held in such high esteem precisely because of this book and its one short chapter on "creative destruction". Thus Michael Cox and Richard Alms in their entry in the Concise Encyclopedia of Economics,59 praise Schumpeter for turning a spotlight on the role of new technologies, new markets, and new organizational ideas in transforming the economy. Innovation undercuts old ways of doing things and destroys the jobs linked to them. But it also brings about new employment through the continued (though no doubt irregular) growth we have enjoyed in the West and now in the whole world. One could say that 'creative destruction' is not a new idea.60 However, many years of static analysis had turned the attention of the profession away from the dynamics of capitalism, except for Marx who got this dynamics all wrong. So that it is true that Schumpeter did a signal service to economics when he said that capitalism "is by nature a form or method of economic change and not only never is, but never can be stationary".

But Capitalism, Socialism and Democracy contains much more than the chapter on creative destruction. In fact, one of the curious features of Capitalism, Socialism and Democracy is that the gales of creative destruction of chapter seven disappear from sight as soon as Schumpeter starts discussing the capitalism of his day. Socialism came as the inheritor of a monopolistic kind of capitalism, not the competitive kind (Capitalism, Socialism, and Democracy, page 169). It was needed to rescue "big business capitalism" from its "fetters" (page 179).

What ails the capitalist society?

The rest of the book makes one look askance at the ambivalence of its author. It is no mere coincidence that the 2010 edition was prefaced by fashionable Joseph Stiglitz.61 This is another case where a presenter does not appear to have read the book carefully. Stiglitz says that the threat to capitalism does not come from the

left (as if Schumpeter had said that) but "from the right, from the capitalists themselves": large corporations that lord over markets for long periods and put

59 W. Michael Cox and Richard Alm, "Creative Destruction."The Concise Encyclopedia of Economics. 2008. Library of Economics and Liberty. 60 Ricardo indirectly discussed the effects of commercial and technological advances in his 1815 pamphlet on the free trade in corn and in the chapter on machinery of the 1821 edition of his On the Principles of Political Economy and Taxation. Nassau Senior, in his "Fourth elementary proposition of the science of political economy" foresaw the possibility of increasing returns to the investment of capital. (Political Economy (1850, 1854).) Marshall in the Preface of his Principles of Economics (1890) famously wrote: "The Mecca of the economist lies in economic biology rather than in economic dynamics. But biological conceptions are more complex than those of mechanics; a volume on Foundations must therefore give a relatively large place to mechanical analogies; and frequent use is made of the term "equilibrium," which suggests something of statical analogy. This fact, combined with the predominant attention paid in the present volume to the normal conditions of life in the modern age, has suggested the notion that its central idea is "statical," rather than "dynamical." But in fact it is concerned throughout with the forces that cause movement: and its keynote is that of dynamics, rather than statics." 61 Joseph A. Schumpeter's Capitalism, Socialism, and Democracy. Routledge Classics (Oxford): 2010.

capitalism in jeopardy. As an example he points at the prolonged monopoly of Microsoft over PC operating systems. This does not capture the whole of Schumpeter's view of the decay of capitalism. First, he would have observed that this firm's privileged position is now being undermined by creative destruction. Secondly, he laid the blame of the loss of innovative capacity of the capitalism of his time not only on big business but on idle managers, unionized workers, and disgruntled intellectuals.

The book opens with a long discussion of Marx, whose back Schumpeter pats with paternal indulgence. The real matter of the essay is broached in Part II on Capitalism, with the following shocking answer to a loaded question: "Can capitalism survive? No. I do not think it can." (page 53) For Schumpeter capitalism is being brought down by its very achievements. The monopolies it fosters, the unequal wealth it creates, the seeds of envy it sows in its thrust for growth expose it to destructive criticism, so that different forces conspire to make its walls crumble. When capitalism nears maturity there is a noticeable obsolescence of the entrepreneurial function. Enterprises grow into firms and firms into corporations which then become content to enjoy the advantages of the status quo. The population of mere employees grows steadily and with it a conservative attitude suspicious of any change. Organized labor endangers work discipline. Finally, a swarm of underemployed intellectuals are spawned by an educational system that does everything in its power to rob capitalism of all legitimacy. Dare I place Schumpeter himself in this category? In his discharge I will note that he said, "If a doctor predicts that his patient will die presently, this does not mean that he desires it." But, as we shall see, he did present socialism as a possible rescuer of capitalist society in its death throes.

The pure logic of socialism

Part III starts with another revealing question and answer: "Can socialism work? Of course it can." (page 149) In fact, socialism as Schumpeter conceives it works on the same analytical principle as capitalism, only better. "There is nothing wrong with the pure logic of socialism". This is "so obvious" that "the only authority standing for denial is Professor Ludwig von Mises." It is only a question of discovering individual wants and calculating existing factors of production by a method of approximation that mimics the price system of a free market. The economist who settled the question, said Schumpeter, was Enrico Barone" in his article on "The Minister of Production in a Collectivist State" (1908). The minister would ask consumers about their reactions to price schedules and producers their reactions to intended quantities, see the replies, and by iteration discover the arguments of the general equilibrium at which welfare would be maximized. This method he saw as much more ordered than the fumbling of the free market. Nothing was said of the temptation of demanders and producers to cover up their real utility functions, nothing of the unavoidable ignorance of the central planners due to consumers and producers not knowing their utility functions until they actually contract. As James M. Buchanan remarked more than once, these socialists presume that individuals "carry around with them fully determined utility functions, and [that] in the market

they act always to maximize utilities subject to the constraints they confront." This assumption is wrong.

[... T]here is no means by which even the most idealized omniscient designer could duplicate the results of voluntary exchange. The potential participants do not know until they enter the process what their own choices will be. From this it follows that it is logically impossible for an omniscient designer to know, unless, of course, we are to preclude individual freedom of will.62

More than fifty years had to pass before Ludwig von Mises' depiction of the market as an engine of discovery and Hayek's insistence on the dispersion of knowledge in society were proved true and the free market superior to any socialist mimicry: down went the Berlin wall and up went the true face of real socialism for all to see.

Be that as it may, Schumpeter clearly held socialism a superior type of organization of society. Chapter 17 has a section III, titled "The case for the superiority of the socialist blueprint". There one can read that socialism will perform better "as soon as the capitalist economy permanently slacks down", which seems to indicate that Schumpeter thought the demise of capitalism was at hand.

Socialist management may conceivably prove as superior to big business capitalism as big business capitalism has proved to be to the kind of competitive capitalism [...] of a hundred years ago. (page 174)

In his view, socialist planners could start the process from a desired (and more just) distribution of resources and manage the economy with less disturbance and loss than in the free market. "As a matter of blueprint logic it is undeniable that the socialist blueprint is drawn at a higher level of rationality." (page 175)

How to get from here to there

But before going on to describe the socialist society in its practical functioning rather than as a blueprint, let us take a look at the transition from one system to the other as Schumpeter saw it. "The first thing that must be done is to bring about inflation." Price increases would be inevitable with the new wage claims. "Inflation expropriates the holders of claims in terms of money in a delightfully simple way." Then he went on to paraphrase Lenin: "in order to destroy the bourgeois society you must debauch its money." Thus Schumpeter begins to show ruthlessness unexpected in him.

There would follow an extensive program of nationalizations. Such a program "might [...] accomplish a big step towards socialism": banking, insurance, railroads, mining, electricity, iron and steel, building and building materials, "and for noneconomic reasons armament, movies, shipbuilding, trade in foodstuffs" would be

62 James Buchanan's "Order Defined in the Process of Emergence," in The Logical Foundations of Constitutional Liberty, Volume I of the Collected Works of James M. Buchanan. Liberty Fund (Indianapolis): 1999. This consideration also tells neo-classical economists that they cannot model individuals as reacting mechanically to incentives.

taken over. (pages 208-209) Here Schumpeter was showing an uncommon power of divination of what Clement Attlee in Britain and Charles de Gaulle in France would do after the war, with the results everyone knows.

The great lie of democracy

Among the more interesting chapters of the book are those concerned with democracy. Schumpeter took a realistic view of this great political ideal. "Democracy is a political method." It is simply an arrangement to arrive at political decisions and "not an end in itself". (pages 217-218) It is not a procedure whereby the people take decisions for the common good by choosing the issues and who will carry them out. The reality of democracy is the inverse: some individuals acquire the power to take decisions "by means of a competitive struggle for the peoples' votes." (page 241) He thus drew an interesting parallel between the imperfect competition of the political and the economic world.

Under capitalism democracy could work well given certain conditions, such as good human material, a restricted sphere of political decisions, a competent bureaucracy, democratic self-control and a large measure of tolerance for differing opinions. The achievement of these conditions, however, Schumpeter regarded with some justified skepticism, but that skepticism became Machiavellian expediency when he admitted with equanimity that "as a matter of practical necessity socialist democracy may turn out to be more of a sham than capitalist democracy ever was". (page 269)

The reason for limiting democracy under socialism was that "no responsible person can view with equanimity the consequences of extending the democratic method [...] to all economic affairs." (page 266) His conclusion was stark: "effective management of the socialist economy means dictatorship not of the proletariat but over the proletariat in the factory". (pages 266-269) In effect, popular sovereignty would be reduced to voting in general elections. If the men used this sovereignty to relax the discipline in the factory, a socialist government, having the future of the country at heart, could restrict even this degree of sovereignty. In any case, tools of discipline would be much more powerful under socialism. Dismissal would mean loss of sustenance. The government could be strict in the guidance of the young. The authorities could also forbid strikes and treat shirking as sabotage.

There even are passages in the work extolling the control of workers in Russia after 1932: the voluntary extension of working hours without extra pay; no democratic 'meetingism'; "and nothing more [...] heard of the right to strike". (pages 192-193) Schumpeter was not totally unaware "of the sinister connotations of all this," but he excused this regimentation as being demanded by "the unripeness of the situation" in a country like Russia having just set foot on the path to socialism. (page 194)

Schumpeter's conception of economics

How could Schumpeter go so wrong? The answer, I hold, can be found in The History of Economic Analysis. Of course, there is his personality to be taken into account, a personality that speaks of contradiction, of being pulled in different directions, of living passionately in diverse countries and cultures. People who know central Europe only from hearsay will be confused by this strange man. Some have said that he was a snob trying to feign aristocratic roots; they do not understand what it was to be a traditional Austrian gentleman. Some marvel at the number of languages he spoke, but a central European would be thought uneducated if he did not know many languages, including Latin if he was born before World War I. Some think he tended to show off his intelligence and erudition; in Continental Europe it is not done to hide your light under a bushel. Also, the fastidious gentleman that he was did not hold democracy in high regard and thought that the working class lacked self-discipline. He was one of the more distinguished products of the bourgeoisie that had "put up a splendid fight for heart and home," he said in his very Capitalism, Socialism and Democracy. He even went out of his way to praise "the impressive economic and even more impressive cultural achievements of the capitalist order." (pages 113-144) So there is need for a deeper explanation of why Schumpeter uncharacteristically took the side of socialism and why he was so unnaturally detached from the society that was his heart and home.

Many a writer has seen the same paradox in Schumpeter's History that I saw when I first read it: he proclaimed that "histories of economics should confine themselves to economic analysis" and then proceeded to weave in" intellectual history, biography and economic sociology".63 I now think there is no paradox but a conscious application of a distinctive methodological point of view. There is no contradiction in the History but the result of keeping to the definition of what the task of economists should be: to use the set of neutral instruments discovered by economists through the ages for the analysis of the problems and policies of each time and place. The History focuses on telling how those instruments were slowly fashioned and whence they came. I now also think that deciding to write on the development of economic analysis rather than the history of economic thought is the symptom of a much deeper mistake.

A passage in the methodological introduction to the book will make my thesis clearer. Economic theory, he says, devises 'gadgets' in its study of the manifold phenomena of the real world, with whose help resulting reality may be analyzed. Examples of these gadgets are the

'marginal rate of substitution', 'marginal productivity', 'multiplier', 'accelerator' [...], relations between concepts and methods of handling these relations, all of which have nothing hypothetical about them. And it is the sum total of these gadgets [...] which constitutes economic theory. In Mrs. Robinson's unsurpassably felicitous phrase, economic theory is a box of tools. (History of Economic Analysis, page 15)

63 Thomas C. Leonard's review of McCraw's biography, Prophet of Innovation. PDF file.

One could ask, where have the multiplier and the accelerator gone? The discarding of these two gadgets may indicate that the point of economics is not fashioning of tools but discovering the laws and regularities of society. As I say, Schumpeter saw the advance of economic knowledge as the slow discovery and definition of these neutral analytical instruments, which could then be applied to different problems or situations. In this way,

"... we construct a composite instrument or engine or organon of economic analysis [...] which functions formally in the same way whatever the economic problem to which we may turn. (page 16)

Schumpeter is thus content with analyzing social problems with his box of tools and tries to harbor no preconception as to what the results of given policies or institutional reforms will be. For him, those preconceptions simply constitute the pre-scientific view or Weltanschauung of the different economists and it is not very productive to try to tell one from the other. The consequence of his formal conception of economics is that at bottom he is indifferent to the various ways of organizing social affairs. He congratulates himself for his kind of economics being free from 'ideology'. (See Part I, chapter 4, "The Sociology of Economics".) He even goes as far as to say that Marx "as a matter of fact" was not influenced by his very definite philosophical views when doing his "work of analysis". (page 32)

Now, there is another conception of economics that is not merely formal or instrumental. It sees economics as a systematic effort to discover reality. The knowledge slowly gathered by economists allows us to foresee how individuals react to incentives and how the universal 'laws' of human societies function. In the field of economics the profession has accumulated knowledge that is substantive and allows us to predict with some confidence the effect of certain policies or institutions. It would be easy to give examples in microeconomics: think only of the interesting results of Gary Becker and his followers in the application of economics to social questions, such as the war on drugs, or the size of families, or gains from education. Even in the field of macroeconomics, under a cloud at present because of the late financial crisis, we can with confidence make predictions. For example, we can predict the long term effects of persistent increases in money supply on inflation and the rate of exchange; or the beneficial effects of free trade in the reducing the number of the poor.64

Schumpeter reasons differently. He continuously proclaims his agnosticism as to the truth of economic theorems. Thus, he explains the hostility against classical economics because of "the alliance of economic theory with the liberalism of the nineteenth century". He proceeds to say that "many people hated economic theory because they thought it was just a device for bolstering up a political program of which they disapproved". And he even traduces the professional economists of the

64 It has been calculated that the number of people living with less than $1 a day has been reduced by some 350 million from 1975 to 2000; or by some 783 million if the poverty line is drawn at $2 a day, at the same time as world population was increasing from 3.6 to 6.5 billion. Pinkovskiy and Sala-i-Martin (2009), "Parametric Estimations of the World Distributions of Income." NBER, Working Paper 15433. PDF file. It is not far-fetched to connect this fall in poverty head counts to globalization rather than to foreign aid.

time because "they did all they could to harness their analytic apparatus into the service of their liberal political creed". (page 19) The result of his 'neutral' position can be seen in the distance he repeatedly takes from the doctrine of free trade in many places of his History. But, what if free trade, in inauspicious circumstances and against the expectations of so many, does in fact have the observable results deduced by the classical economists? Is this ideology or science?

Value-free science

There is great confusion about the role of values in science. Of course we should not, in as far as we can, let our values, political or moral, distort our account of the facts. But this does not mean that we cannot observe the effects of a policy in application of a theoretical conclusion. Schumpeter's pronouncements verge on the absurd when he writes:

We may [...] prefer the world of the modern dictatorial socialism to the world of Adam Smith, or vice versa, but any such preference comes within the same category of subjective evaluation as does, to plagiarize Sombart, a man's preference of blondes over brunettes.

For more on Joseph Schumpeter, see the EconTalk podcasts McCraw on Schumpeter, Innovation, and Creative Destruction and Boettke on Mises.

He even perversely applies Robbins' interdict to the observable results of the predictions of economic theory, when he says that, "there is no objective meaning to the term progress in matters of economic or other policy because there is no valid standard for interpersonal comparison." (page 40) Personal evaluation surely refers to our liking or disliking the actual outcome of policies but not to the deriving predictions from an economic theory or to the accuracy of the predictions themselves. Let us take an instance where a theory may have been colored by political valuation, the theory that it is necessary to create 'the new man' for centrally planned economies. The prediction of their failure in achieving their aims and especially the measurement of the effects of such policies on the population are not a matter of personal preference. There will be people who think that the predicted unfeasibility of such a theory and the observation of the death of tens of millions of people of the present generation is a price worth paying for the creation of the future just society but that does not change what the results of real socialism have been in the 20th century: the economic theory with whose help those consequences were predicted by von Mises and Hayek ceases to be 'ideology' if the observed consequences of disregarding those predictions can be linked to the theory. They cease then to be a matter of personal preference.

It should be unnecessary to say that this does not mean that all has been done and discovered in the field of economic research. Even the best established theories can be refuted by facts and turn out to be wrong. But over the centuries economists have accumulated a respectable amount of useful knowledge about the workings of society—quite enough to give the free market the benefit of the doubt. Given the

destructive consequences of the kind of economic philosophy he favored, Schumpeter is a thinker in need of re-evaluation.

Ronald Coase, the Unexpected Economist

October 7, 2013

Even the time of Professor Ronald Coase's demise was unconventional. At the age of 102, he had just published a book with Dr. Ning Wang, an associate professor at Arizona State University, with the alluring title How China Became Capitalist65 . The younger author must of course have brought with him a deep knowledge of China under communism and carried out most of the factual research. Coase's hand however is there, in his refusal to be tied down by preconceived opinion and his ability to recognize 'the consequences of human action but not of human design.' He was a modest man who did not throw his weight about but never gave up trying to draw a true picture of reality. In his quiet way he always challenged received doctrines; not only in Welfare Economics but everything he touched, from the theory of the firm to monopoly regulation. This has made Coase difficult to classify and to interpret. There is always the danger to stay on the surface of his thought and misunderstand his apparently simple ideas. One of the reasons for confusion is that many people forget his idiosyncratic methodology; he was in full neither a neoclassical nor an Austrian economist. The "right economics," he used to say, should study the working of the real world economy: he traduced what he called "blackboard economics"—and that would include much of the current model building in the profession and most of the strict deductivism of the Misesian school.

The firm and the market

Coase's fame was built on two articles, though he wrote a few more of great import. The first famous one was titled "The Nature of the Firm,"66 written when he was twenty-six. There he introduced the idea of 'transaction costs' or as he put it "that there is a cost of using the price mechanism," to explain why there are islands of command organization within a sea of market exchanges. This is illuminating as a general thought but Coase was not content with that. The use of the concept of transaction costs by some economists seemed to him often to be circular. The kind of economics of the firm he wanted to see was along the lines of the research pursued by his disciple Oliver Williamson in The Economic Institutions of Capitalism,67 for example.

Thus, when accepting an honorary doctorate from the University of Missouri, Coase took as his theme "Why Economics Will Change."68 He was unhappy that economists do not study the working of economic systems with all their interrelationships but were content with taking the social system as given. They were incapable of dealing with systemic change. Thus, they were seemingly impotent when trying to predict the size of firms after the great fall in transaction costs brought about by the Internet. On the one hand, cheaper information would help smaller firms prosper in the wide market; on the other hand, easier internal

65 Ronald Coase and Ning Wang, How China Became Capitalist. Palgrave Macmillan (New York): 2012. 66 Ronald Coase, "The Nature of the Firm," in Economica 4(16), November 1937, pages 386-405. 67 Oliver E. Williamson, The Economic Institutions of Capitalism. Free Press (New York): 1998. 68 "Why Economics Will Change", remarks delivered at the University of Missouri, April 4, 2002.

communications would allow large firms to become bigger. This was for him an indication that in such situations mere reasoning would not help. Foreseeing what would actually happen demanded much

detailed empirical work on market structures, on service contracts, and on the internal organization of firms.

The trend of economics was towards applying price theory to explain social questions. The contrary was needed, he thought. Economics "is still the subject that Adam Smith created. It has the same shape, the same set of problems." Empirical work was needed but of the kind that "actually changes the way we look at the problem."

... transaction costs depend, as we learned from the new institutional economics, on the working of the legal system (the system of property rights, the enforcement of property rights, the ability to foresee what the legal decisions will be, and so on). They also depend on the political system, they depend on the educational system, and they are interrelated with other social systems. And in consequence, economists should enlist the support of lawyers, sociologists, anthropologists, and others in our work in order to understand why transaction costs are what they actually are. It's the opposite of economic imperialism.

We shall see Coase apply this kind of vision to the analysis of China's way towards capitalism.

The same down-to-earth kind of analysis he applied to the organization of the radio-electric spectrum. George Stigler once said that an economist justified the earnings of his whole life by delaying a bad law even for one day. Coase was material in undoing a bad law forever with his 1959 article on the Federal Communications Commission monopoly of the airwaves. As he was wont to do, he applied elementary microeconomics to solve an apparently intractable administrative question: how to administer a limited resource 'fairly' through direct state intervention rather than though a defective price system.

The administrative apportionment of the radio-electric spectrum started in 1927 with the "Radio Act." It set up a Federal Commission to share out radio licenses on the basis of "public interest, necessity or convenience." Those licenses were not tradable unless the Commission approved. Later this system was naturally extended to television.

This was the kind of problem he liked to tackle: untying an apparently intractable institutional knot with a piecemeal solution. Political life is riddled with attempts to steer society towards fairness, equality, happiness and leaving it the worse for the attempt—even when those aims are sincerely pursued. The way to sweep those cobwebs away is to free individual action and open the way to healthy self-interest. Coase proposed that licenses should be leased to the highest bidder and be made fully transferable. In the 1980s auctioning of radio waves was finally introduced.

The Coase Theorem

Coase's most famous contribution to economics was his criticism of the idea of market failure caused by pervasive 'externalities.' Arthur Pigou (1877-1959), in his The Economics of Welfare,69 had posited the widespread existence in market economies of indirect effects of economic activity, not reflected in prices. Producers caused harms and consumers obtained benefits they did not pay for. This led to excessive production of 'bads' and too low a demand for 'goods' which distanced the economy from its optimum. The profession took it as an incontrovertible truth that a market economy would normally ail from the proverbial uncontrolled smoke-stacks and unrewarded research laboratory, calling for correction by taxes and subsidies.

In a past column I related the 1959 dinner at the house of Aaron Director where Coase convinced the luminaries of the Economics Department of the University of Chicago that Pigou was wrong.70 The market could be relied on to find a solution for such external effects through spontaneous agreements between the parties concerned. This idea Coase expounded in his other famous article "The Problem of Social Cost,"71 where he dealt with unprovoked harm inflicted on a third party. The case is well known. A doctor in his surgery is disturbed by the installation of an adjoining noisy confectionery workshop. The traditional reaction would be to restrain the late-coming confectioner from disturbing the doctor in his auscultation. But Coase shows that this could be a mistake; the situation should be taken whole and the less valued activity made to give way to the more profitable one—and this could well be the confectioner. A market transaction could solve the externality problem, with the doctor paying for a noise abatement contraption if he did not wish to move.72

The next step in Coase's reasoning is that "the problem would be solved in a completely satisfactory manner when the damaging business [...] has to pay for all the damage caused and the pricing system works smoothly (strictly this means that the operation of the pricing system is without cost)." (Coase, The Problem of Social Cost," page 2.)

First, it is important to understand that who the 'harming' party is may not be evident. The value of both activities "has to be looked at in total and at the margin."

69 Pigou, Arthur C., The Economics of Welfare. 1932. Library of Economics and Liberty. 70 Pedro Schwartz, "In Praise of Neo-Liberalism." August 5, 2013. 71 Ronald Coase, "The Problem of Social Cost," in The Journal of Law and Economics. Volume III, October 1960. PDF file. 72 Of course the same kind of reasoning is applicable to the production of external 'goods.' Coase himself suggested to his disciple Cheung that he should analyze contract innovation between apple growers and hive keepers in the State of Washington. Coase then published the article, in accordance with his policy as editor of The Journal of Law and Economics of commissioning papers rather than waiting for them passively. In this case it was J.E. Meade and not Pigou who made this example popular by assuming that apple growers could not enforce their property rights over apple blossoms; hence the shadow price of nectar was higher than the market price and resources would therefore not be correctly assigned at the margin. After exhaustive fact finding, in keeping with his mentor's methodology, Cheung found that bees provide valuable pollination services to apple trees and draw nectar mostly from other plants and that "contractual arrangements governing nectar and pollination services are consistent with efficient allocation of resources." (page 13) Steve N. Cheung: "The Fable of the Bees: an Economic Investigation", Journal of Law and Economics. 16(1), April 1973. JSTOR.

In the example above, the doctor could be the damaging business if the confectionery contributes most to the aggregate value.

Secondly, we must analyze the condition that 'the pricing system works smoothly' with great care. This clause implies that his reasoning is really applicable only to a perfectly competitive situation, where the contestants quickly come to an agreement because they can easily find alternative outcomes. Absent perfect competition, a game would start where the parties tried not to reveal their preferences, and the optimum, which, according to the received view, is clearly visible to an outside party, could not be reached. If indeed the optimum were clearly visible to an all-seeing arbiter, a Court could adjudicate the optimum outcome.

Thirdly and to confuse matters even more, Coase added in parentheses that another way of saying that the pricing system worked smoothly meant 'that the operation of the price system is costless.' This has generally and wrongly been understood as meaning that market solutions to correct externalities are conditional on transaction costs being zero, which can really never be the case.

Fourthly, textbooks add another condition to there being a market solution to externalities. This is that property rights be well defined previously to the conflict arising. It is assumed that a transaction to solve the externality cannot reach a definite conclusion if the doctor, in the case above, has no title to his surgery of the confectioner is a squatter.

Even Coase was sometimes heard to say that it had taken him years fully to understand his theorem. This must be so, because towards the end of his life, when he wrote his book on how China became capitalist with Ning Wang, he tacitly relied on an interpretation of the Coase theorem which does not assume perfect competition nor zero transaction costs nor well defined property rights!

Enter Buchanan

Before we understand how Coase widened his interpretation of the Coase Theorem, both in his article on light house economics and in his book on China, we must give the floor to James Buchanan. In 1984 he wrote an article titled "Rights, Efficiency and Exchange" with the subtitle "The Irrelevance of Transaction Costs."73 Now, this is a real shocker! What could Buchanan have meant?

He started, as was his wont, by denying that optima were observable. The fallacy in ordinary formulations of the Coase Theorem was that the optimum can be objectively defined. It was wrong to define a situation as beset by externalities because an objective optimum had not been reached. "It is unfortunate [he said] that Coase presented his argument [...] largely in terms of presumably-objectively measurable and independently-determined harm and benefit relationships." It was a mistake to think "that an 'efficient' [...] allocation exists and becomes determinate

73 James M. Buchanan, The Logical Foundations of Constitutional Liberty. The Collected Works of James M. Buchanan, volume 1. Liberty Fund (Indianapolis): 1999, pages 260-277.

conceptually to any external observer." An external observer could not determine whether a trade fell short of an optimum. Each transactor discovered what was an optimum for him or her and accordingly when he came or failed to come to an exchange. Realized trades, whether under conditions of perfect competition or not, must be optimal, though the institutional framework may not be. So that the clause in parentheses criticized above, adds Buchanan, should have been worded as a condition that "the pricing system works without interference," not that "it is without cost." (Note 13) Whether transaction costs are high or low is irrelevant for the decision to execute or not the trade in question: it will be optimal "given the institutional setting." (Buchanan, page 264.)

Now, this seems to be a fiction out of Candide, where everything is for the best in the best of possible worlds. Not so, says Buchanan. When the parties to a transaction discover that they are not satisfied with the agreement reached they will try to change the institutional framework in which they operate, as long as they can negotiate without political interference. "If the initial [institutional] constraints are deemed to be 'inefficient' potential traders will, themselves, find it advantageous to invest resources in efforts to shift them." (Pg. 268)

We must now see whether Coase himself came to see the conditions for the correction of externalities as evolving by agreement and custom when the authorities do not interfere unduly with deals in the market.

External effects illuminated

In his much debated article "The Lighthouse in Economics"74 Coase showed how the market could quite satisfyingly deal with external effects. He started by quoting quite a number of economists starting with John Stuart Mill and proceeding to Sidgwick, Pigou and Paul Samuelson, who considered that lighthouses should be subsidized or operated by Government as they supplied a useful service that went unrewarded because no compensation could be levied on ships at sea. Conclusion: no right thinking entrepreneur would dream of undertaking such a ruinous business. But Samuelson went even further: no toll should ever be charged, for even if they be levied on all ships benefiting from this service, the very fact of charging a price would discourage some ships from sailing in those waters when the marginal cost of sending signals to one more ship is zero.

With typical attention to detail, Coase went back into the history of lighthouses in Britain and showed that they mostly had been built and operated by private adventurers and that, when it was decided to nationalize them all through an institution called Trinity House, a goodly price had to be paid for they were good business pace Samuelson. Thus, in 1820, twenty-four lighthouses belonged to Trinity House and twenty-two were private; but many of those belonging to Trinity House had been originally built by private enterprise.

74 Ronald Coase, "The Lighthouse in Economics.". The Journal of Law and Economics. 17(2) October 1974. JSTOR.

There remains the matter of tolls. How could ships at sea be charged for the service? Even if the marginal cost of serving one more ship was zero, somebody had to pay for the average cost. The answer was found by having the port authorities charge the ships by inspecting their logbooks when they berthed at port. Those that passed without stopping could be safely ignored since the marginal cost of servicing them was zero.

In sum, not all users of a service need be charged for that service to be profitable; and with a little ingenuity all concerned could agree on an institutional arrangement to make it possible to use and to pay for a service crippled by external effects.

Evolution towards capitalism in China

I warmly recommend Coase's and Wang's book for the extraordinary tale they recount. From the outside, China's transformation is astounding; from the inside as told in this book it is nothing short of miraculous. There was not a moment when it could be taken for granted. The freeze after the Tianamen massacre in 1989 seemed to put the whole process in danger. The future is not free of danger, especially in view of the parlous state of Chinese banks—aside from the difficulties of moving towards more personal and political freedom.

From the point of view of this paper, the interest of the book lies in its thesis: that the transformation of China from a socialist tyranny into a sui generis capitalist economy was not planned by the Communist Party and the different Governments that ruled the country after Mao. It was the unintended result of a policy aiming at the preservation of socialism by fostering growth and the consequence of the unexpected expansion of what the authors call "the four marginal forces." The Chinese leaders were content to tolerate a measure of private activity as long as they kept control of state enterprises; and thus "private farming,

township and village enterprises, individual entrepreneurship, and the Special Economic Zones" enjoyed an increasing degree of economic freedom as long as they did not threaten official socialism. (Coase and Wang, page 164.)

The transaction costs for individual entrepreneurs in a communist society must have been almost insurmountable, especially in the beginning, when downright corruption and capitalist business were almost indistinguishable. Market solutions were found by agreements between private people. Also, as the authors underline:

China did not first delineate property rights, specify other relevant institutional rules and then allow market forces to allocate rights to the highest bidder. [...] As economic conditions changed over time [... the] State was thus frequently called to revise and redefine the structure of rights. [...] (Coase and Wang, pages 172-173.)

In sum: there were two parallel tracks of reform in China, both following unexpected paths. It is clear that Coase saw this book as an example of the kind of economics he hoped an increasing number of economists would follow: an open mind as to theory and close attention to real data. Whatever one may think of his

research program there is little doubt that the world of economics is different for the long stay of Ronald Coase in our midst.

Overcoming the Contradictions of Liberal Democracy: Sociobiology and Social

Engineering

November 4, 2013

Democracy is an unstable system that often does disservice to individual liberty. With this stark assertion I want to pose two problems that have been with the friends of democracy from the very earliest times—going back to the Athenian followers of Pericles when traduced by Plato, to Alexis de Tocqueville and John Stuart Mill when concerned with the enlargement of the franchise, down to Friedrich Hayek and James Buchanan when proposing remedies for the demagoguery of our day. The first is that government of the people, by the people, for the people has more than once been on the point of perishing from the Earth. The second is that democracy, though the political corollary of individualism, has in practice often tyrannized the individual. One explanation for the recurring instability and frequent oppressiveness of democratic politics is that they are due to the natural attrition of human arrangements. A better answer is that they are the consequence of systematic flaws in our political systems. Democracy as practiced is flawed. Democratic life is beset by paradox. These imperfections must be brought into the open and remedied if we want liberal democracy to survive.

Let me give two samples of the confusion and contradiction that beset present day political life: the crisis of Welfare and the denial of capitalist growth.

The failure of the Welfare State

The financial crisis that started in 2007 is perceived in Europe as the writing on the wall for the original idea of the Welfare State. Financing pensions, health, and education on egalitarian lines is now seen as a system of social service with all the wrong incentives: demand runs wild, quality of service deteriorates and taxpayers groan under their weight.

The trouble is that a majority of voters seem to want a Welfare State that they now know is unsustainable. For many years they were content to sell their birthright for a mess of potage but suddenly now they fear they will go hungry: their pensions are being cut, the queues before the hospitals grow longer, and an increasing number of their young go uneducated.

These troubles do not affect Europeans only. In the United States, public opinion is divided regarding the unstoppable growth of Government debt. The need to reduce the deficit of the Federal Treasury is widely acknowledged, though there is disagreement about the speed of the consolidation. There is even a plan in the United States to extend entitlements along the lines of the failed European experiment. This does not stop a majority from wanting to put new debt-financed programs in train, be they as expensive as so-called Obamacare. When the minority tries to resist lifting the debt ceiling to fund such new entitlements, the Federal Government is able to bring public opinion on its side by showing that new debt is

needed to cover ordinary expenses such as military pensions or civil servants salaries: the world turned upside down.

People love to hate the market

The hostility to the market always present in democratic politics has become acute with the 2007-2011 financial crisis. How acute can be gauged by the general denial of the positive effects of globalization on poverty. The commonplace assertion is that the expansion of capitalism is making the poor poorer and the rich richer all around the world. This is contrary to fact. If poverty is defined in absolute terms as the state of people living below a certain threshold of consumption, then the story of globalization in the last thirty years is astoundingly positive. In an academic article crowning a long effort to measure world poverty, Xavier Sala-i-Martin, with the help of Maxim Pinkovskiy (2009)75 , shows that, if the poverty threshold is defined as living below $1 a day, "the total number of poor thus defined has fallen from 403 million in 1970 to 152 million in 2006"—a reduction of 251 million poor in thirty-six years. The same trend is revealed for higher thresholds of poverty. That figure is especially telling since the data have been observed in the midst of a growing world population, which should have led to an increase in the number of poor. It cannot be a mere coincidence that those years have been marked by a steady expansion of international trade and foreign direct investment, in other words, by increasing globalization.76 Time has proved Milton and Rose Friedman right when in Capitalism and Freedom (1962, 2002) they pointed at capitalism to explain the prosperity of the free part of the world. Globalization is the spread of liberty and the story of economic freedom is one of falling poverty and inequality, together with a marked progress in welfare.

Despite these observable facts, intellectual opinion and political belief go the other way. Religious leaders, intellectual elites and ordinary people ceaselessly denounce the worsening state of the poor and root for political intervention to control the free market, precisely the institution that makes for the reduction of poverty and the increase in wellbeing.

Why such deliberate blindness to the benefits of economic freedom enjoyed by growing numbers around the world? Again it seems that this is more than a passing fad or a mere coincidence. It shows that liberal democracy suffers from a deep contradiction: people are discontent with our societies while they expect and demand boundless improvement from their progress.

The politics of market control This contradiction between opinion and behavior often turn democrats into collectivists, because it fosters mistrust of trade, rejection of competition, fear of

75 Maxim Pinkovskiy and Xavier Sala-i-Martin: "Parametric Estimations of the World Distribution of Income". Working Paper 15433, October 2009, National Bureau of Economic Research. Other measures of poverty show a similar degree of reduction. They also find that various measures of global inequality have declined substantially and measures of global welfare increased. 76 Of course, there is more than a single cause to such progress, the main additional one being medical advances, but there is no need here to underline the reciprocal relation between freedom and scientific progress.

price changes, aversion to new wealth, in short, general suspicion of the free market. This leads to democracy being proposed as a system to control spontaneous social change politically, rather than as a system to transmit individual choices. When later voters notice the corruption implicit in political logrolling or in the sharing out of 'pork' this view of democracy leads to, they pine for more republican politics where politicians look for the common good, whatever that may be.

Economic competition is based on free agreements for mutual gain; politics (and politically governed markets) are about extracting rents. I shall have something to say later in these three columns about the fundamental distinction between the positive-sum games of the free market and the negative-sum games of rent seeking, a distinction that ordinary voters find difficult to make.

Four paradoxes of modern democracy

Ailments such as those evidenced in the above two examples are no accident or mere coincidence. Their causes may be concealed but they still bear witness to deep contradictions in democratic life and practice.

There are many sources of paradox in our democracies. I will turn my attention to four, which I want to deal with in this and the next few essays.

1. The first one is that the ideals of individualism and citizenship may be discounted as not fully in harmony with our human nature; in fact, they may be rejected as not natural at all.

2. The democratic vote may result in communal decisions that nobody wants, as coming at the expense of personal preferences; the nation, though the natural venue for popular sovereignty, may often be the source of stifling tribalism.

3. Thirdly, the confusion of wealth with freedom and poverty with serfdom will tempt many to portray formal liberties as an in-egalitarian sham.

4. And last, money, which Hayek saw as 'one of the greatest instruments of freedom ever invented by man', repeatedly suffers from financial disorders that endanger liberty, as the crises of the 1930s and the first decade of the present century show.

The paradox of the liar

It is my view that these four contradictions are not incurable. They are in the character of semantic loops one encounters in ordinary discourse and in computer programs. These loops can be solved by separating planes of meaning, so that selfreference is avoided. One of the oldest is the "paradox of the Liar", which runs thus:

"Epimenides the Cretan says that all Cretans are liars."

Many authors solve this contradiction by separating levels of propositions, even visibly with inverted commas, thus:

"Epimenides, the Cretan says: 'all Cretans are liars'."

This sentence is true if in fact Epimenides said as much, whether he was contradicting himself or not.

Each of these four paradoxes of democratic life suffers from a self-reference that has to be cut so that they escape the vicious circle that afflicts them. This is done by moving the discourse to a 'meta-plane'. Let me explain this perhaps obscure expression taken from the discussion of semantic paradoxes at the beginning of the 20th century.77 The solution just proposed for the Liar paradox consists in separating the miscreant proposition into two parts: one within the single marks, couched in what is technically called the 'object language'; and the rest expressed in what is called the 'meta-language'. The meta-language sentence passes judgment on the object sentence and by excluding self-reference avoids the paradox.

The four paradoxes of liberal democracy that I want to discuss in these columns belong to the same class of semantic paradoxes as that of the Liar.

1′. If the modern economy is seen as unnatural or irrational because it breaks with tradition or has not been politically designed, then it will be rejected as undemocratic, though it is the result of the free actions of innumerable individuals.

2′. If whatever the majority decides is right then majoritarian democracy can vote itself out of existence.

3′. If liberal democracy is based on the principle that all men are equal, then the free market, based on the principle of free individual choice, will be rejected as leading to undemocratic inequality.

4′. If by democratic decision money starts to be issued in excess, then its role as a symbol of value may be fundamentally undermined. Semantic paradoxes are not mere logical curios. They often become 'existential', in that they embody a shocking or absurd trait of reality. Living with such paradoxes becomes unbearable. Solving them becomes a way to approach the truth. Hence, the very evolution of social life leads to habits or institutions appearing on a metaplane that help societies escape such vicious circles.

The object of this column and the next ones is to sketch ways to free democratic life of deformities such as the ones listed here. The object is to make democracy more amicable to individual freedom. I shall explore solutions to the four paradoxes based on creating or cultivating meta-planes of meaning to solve deadly contradictions, along the following lines.

1". Our personal instincts as to what is natural should not lead us to disallow unpredictable social evolution on a higher plane because its results feel artificial.

77 These reflections have been inspired by the articles on "Paradoxes", the "Liar paradox" and "Meta-languages" in J. Ferrater Mora (1982): Diccionario de filosofía, vol.3. Alianza Editorial, Madrid.

2". People who use their democratic rights to destroy liberal democracy should not necessarily be given full leeway but be made to abide by the higher rules of a Constitution.

3". The equality demanded by democrats should be limited to equality before the law by a meta-rule.

4". Money creation should be anchored by some well-grounded meta-rule so that credit does not grow excessively by feeding on itself.

I shall note in the conclusion of these essays that ladders onto higher planes allowing democracies to escape from vicious circles tend to develop spontaneously with economic growth and cultural progress. With the passage of time, institutional fire-walls tend to appear that break the loops of democratic life. History shows that people can learn to be democratic in ways that are not inimical to personal freedom.

I. THE ERRORS OF BIOLOGICAL DETERMINISM AND SOCIAL ENGINEERING

Freud on culture as unnatural repression

Late in life, Sigmund Freud published one of his most striking essays, Civilization and its Discontents. 78 I am not the only one to have felt when reading this work that Freud was still under the impression of the cruelty of World War I and the harshness of its aftermath when thus taking stock of human culture in 1930. The legend has it that, when sailing into New York for the first time in 1909 he turned to Jung at his side and said, "They don't realize that we are bringing the plague".79 The plague was the spreading of the belief that civilized repression was to be exorcised if mankind would be rid of its unhappiness. Was he perhaps ruing the day when he let loose the devils of the libido and blamed repression for the neuroses of mankind?

Man's discontent goes deep, says Freud. Humans are perpetually faced with the omnipotence of destiny and the futility of their own striving. In childhood they crucially depend on others and are naturally open to the religious impulse. Their anguish is prolonged in adult years by the unavoidable presence of three sources of human suffering: the supremacy of Nature, the decay of our own body, and deficient human relations in the family, society and the state. The latter are especially painful since we devised those institutions, he says, for our happiness, welfare and protection. Freud was thus questioning even the benefits of arrangements purposely devised by thinking men.

All this, however, does not explain "the strange hostility of so many men against culture". For Freud, a second cause could be found in our disappointment with the technical advances of the age.

78 I am using the 1979 Spanish translation in vol. XXI of Freud's Collected Works, published by Amorrortu Ediciones, Buenos Aires, pages 89-104. 79 The source given in the Wikipedia article on Sigmund Freud is Jacoby, Russell (2009-09-21). "Freud's Visit to Clark University". The Chronicle Review. (Retrieved 25 October 2013).

In the course of the last generations, humanity has realized extraordinary progress in the natural sciences and their technical applications. [...] Man is justly proud of such conquests but has begun to suspect that these recently acquired powers [...] have not made him happier.

Freud coined a cruel expression to describe the continuous dissatisfaction of humans despite extraordinary increases in the power of technology:

Man, so to speak, has come to be a god with artificial limbs, magnificent enough [... when he dons] his prostheses but these do not grow from his body and sometimes cause him considerable distress.

A god with prostheses! Such was the second step in his diagnosis of man's hostility towards culture.

Freud wanted to go deeper, however, in his explanation of the discontents of civilization. The third and more fundamental cause was that man's sexuality and aggressive instincts were savage and violent and had to be repressed for social life to be possible.

Whoever remembers the horrors of the great migrations, the invasions of the Huns, of the moguls under Genghis Khan and Tamerlane, the conquest of Jerusalem by the pious crusaders, and even the cruelties of the last World War must humbly accept the reality [of human aggressiveness].

The necessary repression gave rise to the neurosis of civilized man, who often relieved it by reverting to blind participation in communal life. The aggressive tendencies of mankind could be channeled in defense of the tribe. These small groups had

... the very appreciable advantage of permitting the satisfaction of instinct through the hostility against outsiders [...] thus easing the cohesion of the members of the community.

Echoes of Thomas Hobbes in his extoling of social repression: man was freest before culture, but this natural liberty "had no value because the individual was barely capable of defending it", was Freud's conclusion. It went in the same direction as Hobbes: free institutions were not in harmony with man's primordial nature.

Hayek's three sources of sociability

The Freudian idea that the institutions of the free society inevitably clashed with the true nature of man was subtly changed by Hayek. The text to be read and reread in this regard is his pithy "Epilogue" to Law, Legislation and Liberty,80 titled

80 Friedrich A. Hayek, Law, Legislation, and Liberty Volume 3: The Political Order of a Free People. The University of Chicago Press, 1982.

"The three sources of human values" (1982). It is there Hayek rejected the general view that human institutions were either of biological or of rational origin.

Culture is neither natural nor artificial, neither genetically transmitted nor rationally designed. [...] The structures formed by traditional human practices are neither natural in the strict sense of being genetically determined, nor artificial in the sense of being the product of intelligent design. (Hayek, page 155)

First, he did accept that "man has been civilized much against his wishes" and that there was discontent in our civilization due to a feeling of helplessness of individual men and women to control the forces that shape their lives.

Secondly, he did not rest content with Freud's classification of the sources of civilized discontent into neurotic repression and technical artifice. Even in closed societies of a primitive kind there was control and invention, but these were accepted and welcomed. There was another source of discontent that was felt as impersonal and often sinister. The institutions of civilized life evolved spontaneously through purblind competition. They were opaque and even incomprehensible to the individual.

These new rules were not supported by the awareness that they were more effective. We have never defined our economic system. We were not intelligent enough for that. We have stumbled into it has carried us to unforeseen heights and given rise to ambitions which may yet lead us to destroy it. (page 164)

Thirdly, Hayek did not deplore the emergence of rules that disciplined human nature, much to the contrary: "Freedom was made possible by the gradual evolution of the discipline of civilization which is at the same time the discipline of freedom" (page 163). This is what led Hayek to say that "the morals which maintain the open society do not serve to gratify human emotions" (page 160). The reason why many institutions of the modern world are misunderstood or indeed rejected by modern man is that indeed they are not 'natural', nor are they 'rational' in the sense of being consciously devised for a defined purpose.

One must remember that one of the reasons why Hayek wrote this Epilogue was to correct "the errors of sociobiology". For Hayek, that school was mistaken in believing that the customs and the institutions of human beings could be 'reduced' to their genetic nature, that is to say, biologically deconstructed. Also, one must not forget that the purpose of Volume I of Law, Legislation, and Liberty, titled "Rules and Order" was to reject what he called 'constructivism,' the belief that it was rational and possible to design institutions from scratch as if they were the artificial limbs Freud so tellingly described. In sum, the principle on which Hayek based his analysis of institutions was that encapsulated in Adam Ferguson's famous phrase that "nations stumble upon establishments, which are indeed the result of human action, but not the execution of any human design."[81]

81 Adam Ferguson: An Essay on the History of Civil Society (1767). Available online at the Online Library of Liberty.

All this means that humans do not fully understand the nature and effects of the institutions of civilized life and that attempts to order them from top to bottom are nugatory. The evolution of the economic order in the progress of our civilization goes very much against the grain of the customs and beliefs of the tribal life we have only partially outgrown. Neither does it conform to the demands of Cartesian logic.

[... F]rom the toleration of bartering with the outsider, the recognition of delimited private property, especially in land, the enforcement of contractual obligations, the competition with fellow craftsmen in the same trade, the variability of initially customary prices, the lending of money, particularly at interest, were all initially infringements of customary rules. (page 161)

We live in anguish (or discontent, as Freud would have said) because the rules which "maintain the open society do not serve to gratify human emotions".

The basic tools of civilization—language, morals, law, and money—are the result of spontaneous growth and not of design, and of the last two organized power has got hold and thoroughly corrupted them. (page 163)

Popper and the abstract society[82]

All this Karl Popper had stressed many years before. When discussing Plato's reactionary philosophy in his The Open Society and its Enemies (1945, 1957) he came to the, for him, surprising conclusion that Plato was right in saying that the ancient Greeks "were suffering under a severe strain, and that strain was due to the social revolution which had begun with the rise of democracy and individualism." (1957, page 171). Life in the tribe accords better with our inherited traits. When society moves away from functioning like an organism the result can be unsettling.

An open society may become, by degrees, what I should like to term an 'abstract society'.[...] We could conceive of a society in which men practically never meet face to face—in which all business is conducted by individuals in isolation who communicate by typed letters or telegrams, and who go about in closed motorcars.

True, Popper had added that relationships, which in a closed society were set by accident of birth or place in social hierarchy, changed in an open society to becoming personal objects of choice. But, as Popper concluded,

[A]lthough society has become abstract, the biological make-up of man has not changed much; men have social needs which they cannot satisfy in an abstract society. (pages 174-175)

82 The matter of this and the next paragraph I have expounded in more detail in my chapter titled "Happiness is not within the Government's remit: The philosophical flaw in happiness economics" of the book edited by Philip Booth: ... and the Pursuit of Happiness. Institute of Economic Affairs (London): 2012.

The moral rejection of efficient markets

The instinctive rejection of the ethics of the Open Society has an unexpected effect: it leads ordinary people to fret against the conclusions of economics even when they are well established and tested. This makes the life of the classical economist a frustrating experience. Our science of economics seems to oppose the fond beliefs and moral principles of ordinary people, so that markets go unloved and suffer continuous interference.

In a recent clear-sighted essay, Clark and Lee83 underline the fact that the conclusions of economic analysis are often rejected out of hand because of the ethics seen to sustain it. The political economy of the market, whether right or wrong in its factual conclusions and predictions, is felt to be downright immoral by many. It is said to be based on greed, to be devoid of human feelings, even to undermine the very morality of hard work and self-disciplined calculation that made its success. These misguided beliefs are nourished by the clash between ordinary morality and the impersonal ethics of the market, or what Clark and Lee call 'mundane morality', as distinguished from 'magnanimous morality'. The latter

... can best be defined in terms of helping others in ways that satisfy three characteristics—helping intentionally, doing so at a personal sacrifice, and providing the help to identifiable beneficiaries. (Clark and Lee, page 3)

Mundane morality, on the other hand, while being essential for the existence of society, is much less attractive to ordinary people and in fact often not recognised as morality at all. This is because, contrary to magnanimous morality, it has three characteristics that contrast with the three set out above: it is self-interested, profitable for both sides, and dispersed anonymously.

Now we can see why mundane morality is seen under such an unfavourable light by people who do not recognise that it has much more general and beneficent effects in society than personal magnanimity. In sum,

[i]t is much easier to understand the persistent criticism of markets, and of the invisible hand justification for them, once the strong emotional attachment to magnanimous morality is considered. (pages 7-8)

Moving to a meta-plane

As I said when setting out the first paradox to be considered in liberal democracy, it is a dangerous mistake to limit oneself to holding that the rules of social life must be either natural or rational. This will make the habits and institutions of the modern economy look artificial because designed by nobody and that situations resulting from the free decisions of individuals will be rejected as undemocratic.

83 Clark, J.R. and Lee, Dwight R. (2011): "Markets and Morality". The Cato Journal, vol. 31, no. 1 (Winter), pages 1-25.

The best way to free society from this vicious circle is to place the basic tools of civilization—language, morals, law, and money—on a higher plane, as we did with the propositions of the meta-language in the Liar's paradox. They must not be seen as part of the object language and therefore to be judged according to the rules of our biological makeup. They may be corrected and reformed by reason but very carefully since our reason is itself the result of culture and can with difficulty understand the byways of spontaneous evolution.

In sum, our personal instincts as to what is natural should not lead us to disallow unpredictable social evolution on a higher plane because its results feel artificial, and we should wield the instrument of our reason with some care and diffidence.

The Dangers of Majoritarian Democracy

December 5, 2013

In my previous column, "Overcoming the Contradictions of Liberal Democracy: Sociobiology and Social Engineering," I promised to proceed with the analysis of the paradoxes of liberal democracy. The first one I explained was that the institutions of the Great Society might prove to be neither natural nor rational and could therefore be resisted or even rejected in democratic societies. My conclusion was rather disturbing: in a nutshell, "man has been civilized very much against his wishes", as Friedrich Hayek said.

In this column I will discuss the following paradoxes that also make liberal democracy an unstable system, to wit:

- That the democratic vote may result in communal decisions that nobody wants. - That the confusion of individual liberty with the enjoyment of sufficient means for self-fulfillment leads to the corruption of democracy. - That what is considered the normal venue for popular sovereignty—the nation—may often be the source of stifling tribalism.

I. SOME IMPERFECTIONS OF THE DEMOCRATIC VOTE

The fundamental question of politics

One of the ideas of Plato that Karl Popper most decidedly criticized was that the object of political philosophy consisted in answering the question, who should rule and how to educate those who would govern. For Popper this was the wrong question: one should rather ask, how to control government, how to set up checks and balances to divide power.84 Popper's main argument for this change of focus was the 'paradox of liberty'. If one tried to vest power on whoever was the best and the wisest, as Plato wanted, there was the danger that this person could turn out to be a tyrant. At its extreme, the popular vote could be self-destructive: what if the people democratically willed to be governed by a populist strong-man? This is not as rare as one could wish; remember Austria's vote for Hitler or Argentina's for Perón.

Here we have another paradox of the kind I am grappling with in these columns.85 The starting point of this vicious circle is the realization that a large enough body of men cannot organize itself to govern directly for the good of all. To achieve common aims, power has to be entrusted to a sufficiently small number of people.

84 Popper, Karl R. (1957): The Open Society and its enemies, volume I The Spell of Plato. Routledge and Kegan Paul, London. 85 Readers of my previous column may have noticed that, in this column, I have decided to consider nationalism as a separate source of paradox. For a whole family of political paradoxes, see Popper (1957), volume I, chapter 7, note 4 on page 265.

Even so, disorder would threaten if these rulers fought for power: sovereignty should be undivided. This makes it imperative to choose the sovereign well: hence the Platonic question. But what if the sovereign abused its powers? Long experience tells us how transient the qualities are that may have led to the choice of a sovereign, if choice there was. In the end, whoever exercises undivided sovereignty can impose his or her fickle will on those who selected her, or use power to exploit a minority with the connivance of the majority, or simply indulge in corruption.

It is indeed better to have a good woman or man at the helm, but in politics usually the worst get to the top. The emphasis should be elsewhere; it should lay on establishing strong enough barriers or checks to stop the prince from abusing his power. Contrary to what so many political thinkers and constitutional lawyers have said over the years, sovereignty should be divided. That is the only way to break what one could call 'the Leviathan paradox'.86

Imperfections of democracy

Many modern constitutions proclaim that sovereignty is ultimately vested on the people. In that case, the power of the people must also be divided if liberty is to endure. Democracy can therefore not be defined as the rule by majority vote. Neither does it imply that the vote of the majority is "an authoritative expression of what is right". 87 Fundamental to our living under a democratic constitution is that we accept the result of votes because we want our free institutions to function in their own limited way, even though we may not agree with this or that decision.

Collective choices are subject to fundamental imperfections that are less present in market choices. This is because goods bought, sold, or hired in the economic market are divisible and they are so along two dimensions: they need not be acquired in large bundles; and their effects are mostly reduced to the people using them. Political goods, on the other hand, are indivisible in both dimensions: citizens have to acquire them in bulk; and political choices have huge external effects on third parties. Imagine us having to choose all the goods we may want to consume for the next four years in one go on the date of the general or the

presidential election—food, housing, entertainment, holidays, education, health, whatnot, in one huge shopping cart; and that our choice should be fundamentally conditioned by that of all other consumers. This is what we inevitably must do in elections at the political market. The only reason for our participating in such awkward decisions is that some goods that we find indispensable, such as defense or justice, are by their very nature indivisible or too costly to divide.

So that when some economists speak of the defects of the market while forgetting the defects of the State they are giving a distorted picture of social life. We may need to take political decisions by democratic vote but should not be under any illusion that the result will ever be perfect or reflect our several preferences fairly.

86 See Popper (1957), volume I, chapter 7: "The principle of leadership" 87 Popper (1957), volume I, chapter 7, page 125.

Electoral systems

Not only does the indivisibility of the goods produced in the political sphere make choice haphazard but the procedures to come to a choice are necessarily faulty. There are no perfect electoral systems.

Majoritarian systems magnify the results of the largest minority. When the winner takes all, as is the case in English Parliamentary elections or Presidential elections in the United States, the person chosen may have received a minority of the votes expressed. When the agent is chosen in successive ballots and choice reduced to the two candidates having topped the first, as in French Presidential elections, the strategic alliance of the smaller groups may win over the plurality.

Proportional systems give power to coalitions, which then apply none of the programs presented for the election Also, pure proportionality, as in Israel, magnifies the power of single-issue groups; corrected proportionality either excludes parties not having reached a preset minimum, as with the Liberals in Germany recently, or arbitrarily increases the representation of local Mafias, as in Sicily, or of regional nationalists, as in Spain.

The defects of electoral systems go much deeper than skewed weighting of the results. As Condorcet discovered in 1785, voters can come to different conclusions depending on the starting point.88 This makes the person setting the agenda decisive, as is shown practically by the disputes that surround the wording of the question in referenda. Kenneth Arrow went further in 1951. He generalized Condorcet's result by actually proving that it is impossible for an electoral body to choose the best possible social arrangement for all situations and all conceivable preferences democratically!89 So that if a people were asked to choose the kind of society they would want to establish, they just could not do so without somebody dictating the result.

If this were not enough, public choice theorists have pointed out a number of quirks in democratic decisions: such as whether it is rational to vote at all, given the minimal influence of each single vote on the final result; or how deforming the use of 'left', 'right' and 'center' is to characterize opinions and programs, or how demeaning the use of slogans in electoral campaigns. All these are consequences of the high relative cost for voters of informing themselves on political issues.

Rent seeking and agency problems

Two other kinds of shortcomings afflict democracy. Political rent-seeking is a destructive activity engaged in by groups of electors looking for favors or protection from governments in exchange for votes. Principal-agent problems

88 Condorcet, Jean Marie Antoine de Caritat, marquis de, (1785): Discours préliminaire de l'Essai sur l'application de l'analyse ... la probabilité des décisions rendues ... la pluralité des voix. Imprimerie Royale, Paris. 89 Arrow, Kenneth J. (1951, 1963): Social Choice and Individual Values. Wiley, New York.

arise because the elected often abuse their positions for their own profit at the expense of the people they are supposed to represent.

Rent-seeking is usually consequent on some government intervention in the market but not always so. For example, let us suppose that a municipal authority decides to restrict the number of taxi-cabs in the city. If the limited licenses were then auctioned or chosen by lot, the free market would have been interfered with but no unfair favor bestowed on anyone. However, if the license were to be assigned at will by the authority on whomever it pleased, the favored holder would receive a political rent. Other candidates would then be ready to lobby and misuse resources which otherwise could be applied to produce value. There could be a second round to rent-seeking if the authority in turn expected to receive a political rent, in the form of increased importance of the post, or even irregular gain in the form of bribes.90

The amount of political rents in modern societies can be gauged from the ever increasing number of regulations. Modern economies increasingly look like a Gulliver tied down by innumerable threads on the shores of Lilliput!

Most regulations favor incumbents and become barriers to entry in an industry. This is the case even with well-meaning impositions, such as the original allocation of broadcasting bands by the Federal Communications Commission on the basis of "public interest, necessity or convenience" and the prohibition to resell broadcasting licenses. Ronald Coase proposed to take the rent-seeking sting away by having licenses leased to the highest bidder and made fully transferable. In the 1980s the auctioning of radio waves was finally introduced.

Politicians wanting to protect large firms tend to prefer regulation to subsidies because subsidies attract new entrants into a market while regulation erects barriers to entry. George Stigler studied the demand for regulation in a 1971 article, where he argued that regulation is only apparently called for by public opinion; in fact it benefits incumbent companies.91 In other words, it is acquired by the regulated industry and "is designed and operated primarily for its benefit".

Sam Peltzman completed Stigler's study by looking at the supply side and the equilibrium of the regulation market.92 He opened the black box of the politicianregulators' motives and how far they dare go in unnecessarily increasing costs through legislation: costs and benefits in term of votes gained and lost by the supplier put limit (or set an optimum, as we economists say) to regulators' interference.

90 Buchanan, James M. (1980, 1999): "Rent Seeking and Profit Seeking", in The Logical Foundations of Constitutional Liberty in The Collected Works of James M. Buchanan", volume 1, pages 103-115. Liberty Fund, Indianapolis. 91 Stigler, George J. (1971): "The Theory of Economic Regulation", The Bell Journal of Economics and Management, volume 2, number 1 (Spring). 92 Peltzman, Sam (1976):" Toward a More General Theory of Regulation", Journal of Law and Economics, Number 19.

The principal-agent problem arises through asymmetric information, when the person who proffers the service knows better than the one receiving it, thereby inducing the better informed to cheat. Arrow was one of the first economists to study the effect of information on market performance and the appearance of new market structures to correct its shortfall.93 The trouble is that correcting structures mostly fail to emerge in the political sphere. The asymmetry of information appears in all forms of government and is acute even in democracies, where periodic elections allow citizens to take agents to task. This is because the several regulations cost the generality of electors very little and they lack the incentive to inform themselves fully on the details of their effects.94

Preventing abuses of majoritarian democracy

These functional defects of democracy tell us that decisions by majority vote often lead to results that the majority did not want, either because the voters could not be bothered to understand the issues involved or because the results were hijacked by special interests at the expense of general welfare. But the trouble goes deeper. Unless checked and counterbalanced, majority decisions may result in the exploitation of minorities. As John Stuart Mill said in On Liberty in 1859:

The "people" who exercise the power are not always the same people with those over whom it is exercised; and the "self-government" spoken of is not the government of each by himself, but of each by all the rest. (Chapter I, paragraph 4.)

In a way, the defects just recounted should be taken as symptoms of deeper trouble. Democratic votes must always be examined in the light of their effects on individual liberty. The remedy must have two dimensions. One is to exclude fundamental freedoms—habeas corpus, freedom of thought and expression, property rights, freedom of association, and all the others—from invasion by majority decision. The other is to have majorities come as near as possible to unanimity, at least in what concerns the Constitution. These two limitations of majority decision could be interpreted as veto powers granted to individuals, an absolute veto of invasions of personal freedoms, and a modified veto in Constitutional matters.

II. NEGATIVE AND POSITIVE PREEDOM

Concepts of liberty

It was Isaiah Berlin who, in his deservedly famous essay "Two Concepts of Liberty",95 most clearly drew the difference between 'liberty from' and 'liberty to'.

93 Arrow (1963) studied the emergence of institutional structures and professional mores as spontaneous corrections of information asymmetries that helped approximate the medical service market to one free of principal-agent problems. 94 Arrow, Kenneth J. (1963): "Uncertainty and the Welfare Economics of Medical Care", American Economic Review, vol. LIII, no. 5 (December). 95 Berlin, Isaiah (1958, 1969): "Two Concepts of Liberty", in Four Essays on Liberty. Oxford University Press.

If one studies the essay carefully it soon becomes clear that Berlin added a third kind of liberty to the first two. For him there was first 'liberty from', what unfortunately goes under the name of 'negative liberty' and should be called 'formal liberty'. Then came 'liberty to' or 'possessive liberty'; and thirdly 'status liberty' or 'national identity'. We will first examine the clash between liberty and wealth; and then, under a

separate heading, that between liberty and identity. In sum, three kinds of liberty best summed up under the motto of the French Revolution: Liberté, Égalité, Fraternité. We want the first.

Formal freedom versus possessive freedom

I am formally free, says Berlin, "to the degree that no man or body of men interferes with my activity". I am unduly coerced when other human beings deliberately interfere with me within the area "in which I could otherwise act". Whenever I am prevented by human agency from attaining a goal I am deprived of some political freedom. There are some inabilities that do not imply political coercion. With slight irony he adds:

If I say that I am unable to jump ten feet in the air, or cannot read because I am blind, or cannot understand the darker pages of Hegel, it would be eccentric to say that I am to that degree enslaved or coerced. (Berlin, page 122)

Now, the process of moving from enjoying formal rights to wanting to be my own master is quite natural. The next step is more romantic: I will claim the need to discover my better self, to realize myself. Berlin quotes a passage of 1881 by the Hegelian philosopher T. H. Green:

The ideal of true freedom is the maximum power for all the members of human society alike to make the best of themselves. (page 133, note 1)

Ah! But for this I need to have resources at my disposal. If am desperately poor I am not free, most people believe. This is why I want 'possessive freedom' to be called 'freedom to'.

Wealth and liberty

If only the wealthy are really free and the poor are in fact slaves, then a free society must right the inequalities of wealth and income so that its members enjoy substantively equal freedom. If we do not have enough possessions to be 'free' to realize ourselves then society should supply us with the necessary means. This leads directly to the European Welfare State or to American benefits.

Some authors go further down this path. For Amartya Sen it is not the means or resources but what he calls "functionings" that should be as far as possible equalized: these include to be sufficiently fed, be in good health, avoid premature death, reduce infant mortality, even be happy, be recognized with dignity, and

participate in the life of the community.96 As was to be expected, Sen goes even further, as far as to say that true liberty can be imposed on the individual:

The social-choice characterization of liberty compares whet emerges with what a person would have chosen, whether or not he actually does the choosing.97 (Sen, Rationality and Freedom, page 397)

Why should the persons enjoying those 'rights' give anything in exchange? And as to who has the duty to make those rights effective, the answer is not clear. If it is 'society' then it is nobody in particular.

Formal or procedural liberty, on the other hand, can be posited universally. Formal rights can easily be expressed as well defined duties that personally oblige all and sundry. The rule 'thou shalt not kill' imposes on all the duty to abstain from murder. Property rights can be expressed as the duty for everyone not to steal, swindle or deceive. Negative rights can be easily expressed as concrete obligations of welldefined people.

The Universal Declaration of Human Rights

These procedural liberties are the individual freedoms defined in the first part of the 1948 Universal Declaration of the United Nations, articles 1 to 21: life, liberty and security of person; presumption of innocence; respect of property, agreements and contracts; freedom of thought, conscience and religion; freedom of association, and so on. These are liberties that impose on all a clear duty to abstain from contrary actions.

Articles 22 to 30, however, proclaim social rights to Social Security, periodic holidays with pay, no less, an adequate standard of living, free elementary education, security in the event of unemployment or ill-health. The list is crowned with the declaration that "everyone is entitled to a social and international order in which the rights and freedoms set forth in this Declaration can be fully realized." The 'rights' to adequate social services and good working conditions are no doubt a desirable development for Humanity but they are very different from the 'liberties' defining a personal space free from undue interference.98

III. THE DEMAND FOR IDENTITY

Trade Unions

96 Sen, Amartya K. (1992): Inequality Reexamined. Clarendon Press, Oxford. 97 Sen, Amartya K. (2002) "Liberty and Social Choice," in Rationality and Freedom. Harvard University Press, Cambridge. 98 The inclusion of these rights must have been in part due to the influence of Eleanor Roosevelt, who was a member of the Drafting Committee. Another delegate who did not see his proposals accepted was the member for the USSR, Andrej Vychinsky, the prosecutor of the Moscow Trials of 1936 and 1938. He abstained in the final vote because the text included no measures to protect workers from hunger, did not guarantee media independent of the capitalist press and did not protect the rights of minority nationalities.

Additionally, Berlin distinguished a third kind of freedom often demanded: group dignity and self-rule.

I may be seeking not for [...] security from coercion, arbitrary arrest, tyranny, deprivation of certain opportunities. [...] What I may seek is to avoid simply being ignored, or patronized or despised [...]—in short, not being treated as an individual, having my uniqueness insufficiently recognized. [...] This is hankering after status and recognition. (Berlin, pages 157-158)

In the 19th and 20th centuries the demand for status at the expense of individual liberty took at least two forms: privileges for trade unions and the right of national self-government.

As to trade unions, in Britain they slowly gained privileges that made them special kinds of association. Unions were legalized in 1851 and gained exemption from liability for strike action with the Trade Disputes Act of 1906. This Act also legalized closed-shop clauses, whereby workers could be forced to join the shop union under pain of dismissal. The 1992 Trade Union and Labor Relations Act passed at the behest of Margaret Thatcher forbade closed shop arrangements, demanded a ballot before a union called a strike, and made 'sympathy strikes' illegal.

In the United States, under the inspiration of Franklin Delano Roosevelt, the 1935 Wagner Act legalized collective bargaining and closed shops, and set up the National Labor Relations Board. The worst anti-competitive features of this Act were corrected by the Taft-Hartley Act of 1947 allowing States to pass Right to Work Laws, whereby nearly half of American states are union free.

The paradox of nationalism

The presumption that there is an irrebutable right for nations to form their own state deserves a more extended consideration. Nationalism is a case of abuse of the principle of majoritarian democracy. Nationalists usually claim to be democratic or at least claim to be answering the wish of the sovereign people. However, nationalism is not freedom-loving by nature. At birth, nations have to be created out of disparate elements. In the course of their lives, nations must be maintained against centrifugal forces, since the principle of nationhood can be claimed by regions in the nation.

However, political self-government, which ideally is a communal corollary of individual self-government, can normally only be organized within a nation-state. Liberal democracy and nationalism are antithetical but citizenship needs a nation to function politically. Here is a contradiction, if there ever was one!

The spread of nationalism

That people, not least free people, are naturally organized in nations is a relatively modern concept. There are three special moments when the idea of a nation

bloomed. The first moment was during the French Revolution, when a people in arms pushed back the armies of Europe and then victoriously invaded the Continent. The second was at the end of the World War I, when at the behest of President Wilson, the right of each nation to become a state was proclaimed. The third was on the occasion of the Bandung Conference of 1955, when the idea was launched that the countries of the Third World had a right to become independent states on a par with the older nations of Europe that had lorded over them. At each of these three moments the idea of the nation and the right of a people to become a nation-state was presented as self-evident but soon showed deep contradictions. The French revolutionaries worshiped at the altar of Universal Reason but then tried to impose French civilization on the peoples they allegedly freed. The European nations born of the splitting of the Austrian, Russian, Ottoman and German Empires discovered that they were multinational themselves and were soon at war within their own borders and with their multifarious neighbors. The new Third World States had no compunction to stamp out all freedoms within their new and somewhat artificial borders in the name of national liberty. As Isaiah Berlin noted:

It is this desire for reciprocal recognition that leads the most authoritarian democracies to be, at times, consciously preferred by its members to the most enlightened oligarchies. (Berlin, page 157)

Kedourie and Gellner

An outright rejection or a melancholy understanding of nationalism has characterized the writings many an enlightened thinker, especially after the shambles brought by the Wilson doctrine between the two World Wars. Those who have most deeply lamented the havoc brought by nationalism in Europe and later in the world at large usually come from countries that used to be a part of 19th century multinational Empires. Joseph Schumpeter was an old style Austrian gentleman who never really felt at home in America. I have heard the Hungarian Anthony de Jasay suspend his condemnation of the State when I extolled the Hapsburg Empire in his presence. The nostalgia for non-nationalistic days was especially keen in assimilated Jews, such as the Viennese Karl Popper and the Estonian Isaiah Berlin, as also the two writers whose views I want to consider now.

Elie Kedourie was an Iraqi Jew who found it impossible to live in the post-Ottoman Middle East. Ernst Gellner was the son of German speaking Jews who had fled Bohemia. Both writers found a home in Britain, then a land free of nationalistic fever though undoubtedly patriotic. I attended their classes at the London School of Economics and had many a conversation with them when writing my thesis on Mill. They both wanted to find an explanation for the phenomenon of unbridled nationalism, which had so impacted their lives.

Kedourie considered nationalism a venomous ideology born of the philosophy of the Enlightenment.99

99 Kedourie, Elie (1960. 1961): Nationalism. Hutchinson University Library

Nationalism is a doctrine invented in Europe at the beginning of the nineteenth century. It pretends to supply a criterion for the determination of the unit of population proper to enjoy a government exclusively of its own, for the legitimate exercise of power in the state, and for the right organization of a society of states. (Kedourie, page 9)

This doctrine had its roots in Kant's idea that the individual was free only when moved by her own conception of the good, with no regard to consequences and impervious to rewards. Self-determination justified all actions in search of the moral life, both of the individual and the nation. This doctrine, he added, became a part of the political rhetoric of the West and then of the whole world.

Gellner thought that nationalism was more than an ideology. He thought that the kind of society created by industrialization was fertile ground for the spread of nationalism, which was not a contingent intellectual development but a necessary consequence of the new mode of production: the population became mobile, literacy spread, individuals lost their local ties, expectations became egalitarian, Government became centralized, the State was able to mould their peoples and regiment them. The role of ideology was only to help stateless intellectuals and politicians exploit those conditions.100

Gellner did not want to deny that "humanity has always lived in groups" and that "a certain amount of patriotism is a perpetual part of human life". But for him nationalism was a very concrete kind of patriotism transformed by the social conditions of the industrial world. Nationalism transformed a constant trait of humanity, to live in groups, in a powerful political force taken over by the State.

Nationalism and patriotism

Now, the fact that we may reject the excesses of nationalism from the point of view of individual freedom does not mean that we overlook the existence and force of patriotic feelings. It is one thing to give in to aggressive uses of power to form nations or increase their territory and quite another to feel a deep attachment for one's country. I personally do not think that Spain is superior in its past history or present state to other countries in the world or in Europe, but if I were asked whether I would be ready to take up arms to defend her from an unwarranted attack my answer would be Yes.

It is the artificial creation of national states that lays the ground for the invasion of personal liberties. Moving borders often leads to the shedding of blood, as Europe discovered to its cost during the 20th century. Attempts to build new nations by carving up or forcefully joining old and settled societies, gives rise to the kind of tensions we are today witnessing in the European Union.

Provisional conclusion

100 Gellner, Ernst (1983): Nations and Nationalism. Blackwell, Oxford.

In my next column, after analyzing the contradictions brought by money and finance in democratic societies, I will try and outline the barriers we could set up to limit the negative effects of the paradoxes I have been studying on liberal democracies.

How to reconcile our peoples to living in open societies; how to make our citizens accept constitutional barriers to majoritarian votes; how to limit the power of envy in market economies; how to tame nationalism when it deforms natural patriotic feelings; how to create stable moneys: such is the task that lies before me in concluding this study of the paradoxes that continuously unsettle our liberal democracies.

The Paradox of Money

June 6, 2014

In this third of my columns on the contradictions of liberal democracy, I want to consider a worrying source of disorder in democracies: money and credit. This is a topic I necessarily had to deal with before closing the series. The financial upheaval which the world has suffered has dealt a body blow to liberty. I could not pass it over with a few general comments.

Let me state from the very beginning the paradox of money: that money, one of the greatest instruments of individual freedom ever invented by man should have become an instrument of political exploitation in the hands of government. The effects of this abuse go further than upsetting the financial equilibrium of market economies and reducing their productive progress. It undermines the whole philosophy of liberty. If laissez faire has to be suspended in the field of money and credit and if the most important institution for trade, contract, saving and investment cannot be left to be managed by individuals and firms, then what is left of our personal self-government? We shall have to slip through the nooks and crannies of State control to attain our goals, untiringly hounded by the henchmen of "that insidious and crafty animal, vulgarly called a statesman or politician."101 And the pretexts for public intervention in all spheres of life will be ready at hand for those who never believed in a free economy as the foundation of a free society. As David Laidler has recently said on the causes of the Great Recession:

More than competing ideas about the proper conduct of counter-cyclical economic policy were at stake here [...]. Profound and ideologically loaded questions about the capacity of the market economy to function smoothly without the benefit of constant attention from government, and hence about the appropriate political framework that should underpin macro-economic policy, were also getting renewed attention in 2008.102

I must confess that I did not expect the depth of the Great Recession that hit our world from 2008 to 2011 (to 2013 for the Eurozone). I discounted the warnings those few economists who said that another Great Depression like that of the thirties was coming. I thought central banks had the instruments to contain the recession, without having recourse to extraordinary monetary and fiscal measures. There must have been something wrong in my understanding of our financial world when I underrated the danger of the turmoil

getting out of hand and paralyzing banks, stock exchanges, Treasuries and firms. I was not seeing the whole picture.

101 Adam Smith (1776): Book IV, Chapter II, paragraph 39 from An Inquiry into the Nature and Causes of the Wealth of Nations. 102 David Laidler (2013): "Reassessing the Thesis of the Monetary History". Paper presented at the IEA Conference "The causes of the Great Recession", November, 26, 2013. The Monetary History is that of Friedman and Schwartz (1963).

I am not alone in having failed to foresee what was coming.103 When one reads the policy declarations and academic papers of central bank officials and monetary economists when they found themselves in the middle of the maelstrom, the impression is one of improvisation and of desperately reaching for whatever tools were at hand: interest rates brought down virtually to zero, quantitative easing through central banks hugely increasing their balance sheets, governments coming to the rescue of banks before having to be rescued themselves, a helping hand proffered to quasi-banks; in the United States things went as far as rescuing GMAC and nationalizing AIG and General Motors. I understand the urgency but must point out how light-weight the explanations were of why the whole thing had happened; at most one finds allusions to imprudent deregulation, excessively low interest rates, loose money creation, disruptive speculation, financial innovations—and greed, especially bankers' greed. There was no real attempt to understand what had gone wrong with the financial and indeed economic system as a whole.

First conclusion: Government, the primary cause of the financial crisis

I will now marshal the arguments that lead me to maintain that the present financial crisis was primarily caused by defects of the State. In my view, it is contrary to fact to say that the Great Recession was due to a failure of the free market. I concur with George Selgin, Larry White, John Allison and other authors who have for many years been charging governments with the same wrong, that of being the principal cause of the Great Recession.

How did we get there?

A. The Fed and other central banks

To take a broad and fundamental view of what has happened to our advanced market economies we need to go back some years: first, to 1913, the year of the creation of the Federal Reserve. The explanation for the setting up of a nationalized central bank was that the financial system of the United States had been subject to excessive volatility and repeated crises, in the absence of a central institution in charge of monetary policy. The record of the Fed, however, has been dismal, both from the point of view of financial stability and of inflation. As to stability, Selgin, Lastrapes and White (2010) find that the record before World War II is much worse than the National Banking System that existed before 1913; and though they see some merit to the performance of the Fed in recent years, I wonder what they think now after the Great Recession.104 And as to defending the value of the dollar over the years, the performance is even worse: by some reckonings one 1913 dollar would be worth only four cents today. The trouble with this 2,250% cumulative rate of inflation is that it is not and cannot be smooth, thus making long

103 For a rare early warning that monetary policy cannot be decoupled from State finance, see BIS Working Papers No 147 by Borio, Claudio and White, William (2004) "Whither monetary and financial stability? The implications of evolving policy regimes", February. 104 Selgin, George, Lastrapes, William D. and White, Lawrence H. (2010): Has the Fed been a Failure? CATO Institute Working Paper.

term investment calculations very difficult. The task of the Fed was made especially difficult by Congress in 1977: it was assigned three statutory objectives for monetary policy: maximum employment, stable prices,

and moderate long-term interest rates—three goals with one instrument, an impossible task if these goals are placed on the same level.105

In recent years and under the chairmanship of Alan Greenspan, the Fed's policy was not to intervene when bubbles appeared to be forming but, after they burst, minimize asset corrections at any cost by 'printing' more money. The Fed would always be there to prevent significant market corrections. This became known as the 'Greenspan put'. Greenspan served from mid-1987 to the end of 2006, under four Presidents: Reagan, George H. W. Bush, Clinton, and George W. Bush. Before coming to that exalted post he had been an admirer of Ayn Rand and had written an essay in Rand's Capitalism: the Unknown Ideal (1966, New American Library), where he said that the dollar should return to the gold standard and the Federal Reserve abolished.106 Not bad for a free marketeer who then would head the Fed for eighteen and a half years!107

Paul Volcker, the preceding Fed Chairman, had expunged inflation from the United States' financial system with the hardest of medicines. Under the newly appointed Greenspan, the Fed faced the 1987 crash with a "readiness to serve as a source of liquidity to support the economic and financial system".108 This readiness was evident whenever the economy tried a small correction: in the hiccup of 1990 the Federal Funds Rate was reduced from above 8% to below 3%. The bursting of the dotcom bubble and the attack on the World Trade Center led in 2001 to 2004 to a reduction of the interest rate from above 6% to 1%, resulting in negative real interest rates. Greenspan then had no qualms about pushing it back to 4.5% before he left office. Over the whole period, the Greenspan Fed oversaw a massive (though highly irregular) increase in the money supply.

On his appointment, Bernanke proceeded along the same lines, placing the Federal Funds Rate at a peak of 5.25 % and inverting the yield curve. John Allison is at his most instructive when writing on the destructive effects of inverted yields on banking business. Bernanke held the inverted yield curve (with long term interest rates below short) for more than a year, up to January 2008.

105 The Tinbergen Rule states that for each and every policy target there must be at least one policy tool. If there are fewer tools than targets, then some policy goals will not be achieved. Wikipedia article on Jan Tinbergen, accessed 18xiii3. 106 John A. Allison (2013): The Financial Crisis and the Free Market Cure. Why Pure Capitalism is the World's Only Hope, McGraw Hill. Since this is not a column for specialists in monetary economics, I recommend John Allison's book. He led his bank BB&T through the crisis without showing a single quarter loss, which gives his words some authority. The book is notable for the clarity with which he explains the complicated details of the current financial crisis. This notwithstanding, may I say that I consider Adam Smith's The Theory of Moral Sentiments (1759) more encompassing than Ayn Rand's writings favored by Allison. 107 I have not found the strength yet to read Greenspan's memoir, The Age of Turbulence (2007), Penguin, or his answers to the Financial Crisis Panel in 2010. 108 The aim to keep inflation low was coupled with the firm resolution of avoiding deflation like the plague. However, there are benign deflations when it is productivity gains that would lead to falls in prices, if money supply is kept under control. See Selgin (1987): Less than Zero. The Case for a Falling Price Level in a Growing Economy. IEA, London.

If you are managing [...] a commercial bank [...], an inverted yield curve is a disaster. Banks borrow short (at lower interest rates) and lend long (at higher interest rates). If short term rates are higher than long term rates, banks are faced with negative margins. (Allison, page 29)

This kind of policy has two effects: it moves lending out of the regulated banking industry, and it starts a recession.

Two remarks are pertinent here. One is that I have come to agree with Allison that if the market had been allowed to set interest rates in the way it did before 1913, these rates would not have been as low as Greenspan drove them, nor would they have grown as fast as in the first years of Bernanke's tenure. The second is that such irregular and volatile moves, coupled with drastic changes in money creation must have been destructive for the economy.109

This is not the moment to go round the world and see what central banks have done in other places. In any case, the ructions started in the United States. Most other issuers of money, with the notable exception of the Central Bank of Canada, to which I have given some attention in my courses, followed suit in pursuing lenient and irregular monetary policies. The European Central Bank is especially interesting, since it issues a currency, the euro, which has tried to stay above politics and to mimic the gold standard: the ECB is not being too successful, whatever their officials may hope to achieve.110 It will have to be for another day.

My provisional conclusion at the sight of this sorry spectacle is that, despite all the arguments presented by writers of a monetarist persuasion for an active monetary policy, continuous and systematic intervention by central banks is in the end counterproductive.

B. Deposit insurance and regulation

Another controversial element of the monetary arrangements of the advanced world is the institution of bank deposit insurance. It was started by President Franklin Delano Roosevelt in 1934, after the widespread failure of United States commercial banks in 1931-34. Its compass has been widened continuously, especially during the current crisis. It has been imitated around the world.

109 The reason given for such wild changes of interest rates is that they are demanded by the so-called 'Taylor rule'. Central bankers who believe they can micromanage the monetary economy apply this rule by continuously comparing: (a) their forecast of the rate of inflation with the actual rate; and (b) the potential rate of growth (and unemployment) of the economy with the actual rate. (These forecasts are made on the basis of Dynamic Stochastic General Equilibrium models that have signally failed to forewarn the late crisis.) If the actual rate of inflation is above the desired rate; and if the economy is growing faster than its long term potential central bankers raise the interest rate; and they do the contrary if a deflation is looming and unemployment is high. No allowance is made for the possibility of a benign deflation, as per footnote 8 above. And no consideration is given to the possibility of 'stagflation'—high inflation with high unemployment. It would be better if central bankers did not micromanage and kept the money supply constant. 110 In my view, the ECB has not been successful in this task, whatever its officials may say. The contortions that the ECB authorities go through to preserve the independence of the bank and stop Member States from abusing the euro for their own political purposes I have touched upon in a previous column titled "The ECB Changes its Spots".

This scheme has two negative consequences on the banking sector. The first is that it reduces the perceived need for discrimination by investors as to where to place their money. This allows more adventurous or less scrupulous bankers to solicit funds less wisely than if their clients felt less secure. This unfair competition often pushes solid banks further up the risk curve than they would like. The second is that all deposit

insurance schemes are usually financed by the banking sector itself, so that solid banks have to face the cost of guaranteeing the deposits left hanging by failed banks.

This apparent security for investors is enhanced by the belief that financial corporations included in the deposit insurance schemes are overseen by regulators whose task it is to find badly run banks. The general failure of commercial banks around the world shows that in most cases regulation is no guarantee against business failure. Inspectors and regulators usually are civil servants, who are not very savvy about banking business and who tend to be more indulgent in times of boom. In this crisis, regulation has proved to be pro-cyclical, since new and stricter rules are usually applied in a reactive manner, at the bottom of the cycle: this is the case with the Basel III capital ratios for commercial banks, who are asked to increase their capital at the same time as they are told to lend more to businesses.

C. Housing programs

The tradition of Congress wanting to foster home ownership as a fulfillment of the American dream has also been replicated in many countries. The whole crisis started with subprime mortgages being securitized and placed around the world. A number of measures had been passed to make housing affordable for people who in the end should not have committed to home ownership but been content with renting. Remember the Fair Housing Act of 1968, the Community Reinvestment Act of 1977, and the Equal Credit and Opportunity Act of 1979. As one can see, the programs go back a long way. The Federal Housing Administration was launched in 1934 and Fannie Mae in 1938 by President Roosevelt, and Freddie Mac in 1970 by President Clinton.

The Farm Credit Administration was an insurer of home mortgages. But Fannie Mae started with the purpose of taking middle class mortgages contracted by banks on their books; and Freddie to buy mortgages on the secondary market, pool them, and sell them as a mortgage-backed security to investors on the open market. So, who started the practice of selling mortgage-backed securities on financial markets? They were both Government Sponsored Enterprises, so they enjoyed an implicit government guarantee, which in fact became explicit when they had to be nationalized. In the beginning these two GSEs pushed commercial banks away from the prime market. Private banks then took to unloading mortgages on those two instead of keeping them on their books. In 1990, Clinton set Fannie and Freddie on the path to grant subprime loans, as part of the effort to make the mortgage market racially fair. This kind of competition led many commercial banks to follow suit. Interest rates were low, banks had to look for more rewarding investments, and mortgages seemed cheap to prospective

homeowners. The housing market had been mined by politicians. When nationalization came, Fannie and Freddie held a $2 trillion subprime portfolio.[111]

The disaster I know best is that of Spain. There was a deadly combination of the constructivist introduction of the euro and politically governed local savings banks. By joining the Eurozone, Spain saw its rate of interest (government bond yields) fall from double digits to under 4%. Half the banking market was made up of savings banks that were credit cooperatives with no shareholders. They were under the direct influence trade unions, political parties, and autonomous (or state) governments. When the crash came Spain was building 850,000 homes a year for a demand reckoned to have been in the 400 thousands at most.

D. Rating Agencies and Mark-to-Market

Again in the case of rating agencies, the State is to blame for their malfunction. Early on Standard and Poor's, Moody's, and Fitch were granted an oligopoly by the United States Securities and Exchange Commission, as being the only institutions allowed to provide bond ratings for public pension plans. In 1975 they were designated as "nationally recognized statistical rating organizations", whose ratings would allow institutional investors and investment banks to comply with regulatory and capital requirement norms. If we add to this that they take refuge under the First Amendment of the United States Constitution, whereby their opinions are protected under the freedom of the press, their status constitutes an unwarranted interference with the market, which in the end has blown up in the face of the United States government. Why the supply of such services cannot be left to the competition of the market is a mystery. I am sure that freedom would supply a better service, especially if the managers of pension funds and other public investment vehicles were made responsible for their investment mistakes, be they based or not on agency ratings. A further intervention of the SEC changed the mode of compensation of these agencies: they were to be paid by the issuers of bonds and not, as was natural until the 1970s, by the acquirers. This made for dangerous conflicts of interest.112

European authorities and Eurozone member states have complained of the unfairness of such ratings and the danger negative ratings imply in moments of market instability. European Union legislation in the pipe-line will open credit rating agencies to civil liability for intentional or negligent damages; and, in the framework of a fixed calendar for issuing sovereign ratings, governments will be able to react to a change in their rating before it is made public.113 Shooting the messenger!

Another rule imposed by the SEC and generally adopted across the stock exchanges of the first world is that of forcing public companies and especially finance corporations to value their assets at their market price at the end of each

111 Wallison and Calomiris (2008): The Last Trillion-Dollar Commitment. 112 Allison (2013), pp. 82-83. 113 Riet, Ad van (2013): "Financial Repression to Ease Fiscal Stress: Turning Back the Clock in the Eurozone?" An ECB Draft Document. Page 20. See below for fuller attention to van Riet's paper.

year. This is contrary to the accounting assumption that companies are rated as going concerns. It is wrong to impose such a rule, especially in times of turmoil when there is no market for those assets and the company intends to keep them to maturity. I have myself as a company director in a publicly quoted group experienced the unfairness of this rule when there is no price in the market, which caused a destruction of the worth of the group.

E. Too big to fail

The question of systemic risk has been the main reason for massive public intervention in financial markets put forward during the crisis. My first remark is that the excessive size of some financial institutions may be due to mistaken public policies of the kind we have examined above. A financial market without deposit insurance and GSEs and the rest would lead to less risk-taking on the part of private bank directors and officials. The confidence that central banks and governments will save you if you are big enough gives rise to extensive moral hazard. John Allison's remark that Citigroup has been saved by the government three times in his lifetime is quite telling. (Allison, page 173)

The severity of the turmoil can confidently be traced back to the haphazard behavior of the US authorities in the matter of who can be allowed to fail without endangering the world financial system. Citigroup was saved by the Fed but not Wachovia. Bear Sterns and Goldman Sachs were saved by the Fed but not Lehman Bros. (Lehman would have found a buyer had not Dick Fuld been confident of a last moment rescue.) The United States government saved AIG, Fannie Mae, Freddie Mac, GMAC, and General Motors, but left countless other firms to go bust without compunction. No surprise that such erratic behavior led to a general seizure of financial markets round the world.

Thirdly, there are well known ways to prepare for, and put in effect, bankruptcies, and they were simply not considered. Assets do not disappear when their owners fail: they are revalued and redeployed. One of the welcome reforms made after the crisis is the obligation of large financial institutions to prepare a last will and testament for the possibility of failure.

The question of how to deal with 'too big to fail' corporations is certainly a complicated one, about which I have not totally made my mind up. But surely John Allison's remark is to the point:

The reward for running a good business is to have your worst competitors bailed out by the US government and then to have massive new regulations that punish your company for sins it did not commit. (Allison, page 130)

F. Derivatives and shadow banking

When Alan Greenspan became the chairman of the Fed, he declared himself in favor of deregulating derivatives, the OTC or Over-The-Counter market, and the shadow banking sector. And he thought this a positive move towards market

freedom. But in a system so hemmed in with politically immoveable constraints as Western economies are, 'doing a Greenspan' can land the financial system in 'third best land', and often lead to catastrophe. When things did not work the way he wanted, Greenspan simply took the evasive way out. "It is not that humans have become any more greedy than in generations past. It is that the avenues to express greed had grown so enormously." He then went on to contradict earlier pronouncements of his and suggest that financial markets need to be regulated.

This change of direction is the result of trying to reform without descending to fundamentals and being surprised by the results. Of course banks took refuge in mortgage-backed securities, collateralized debt obligations, or structured investment vehicles. They did so to restore their profitability eroded by low interest rates or by privileged competition from Government Sponsored Enterprises. All those were efforts to dis-intermediate deposits, that is, to invest clients' money where it could earn a little more. In origin mortgage-backed securities were a way of shifting mortgage risk to outside investors; and collateralized debt obligations were simply a form of insurance. The face value of these derivatives looks enormous but the actual money exchanged and risked is small, just as in an insurance contract, where the principal can be huge but the premiums minimal. So the real size of the derivatives market is smaller than usually held.

The call for more transparency in the issue of derivatives and of more publicity in the OTC market deserves consideration. But this should not deflect our conclusion that the fundamental flaws of this 'shadow' banking market come from fleeing the public policy interventions we have analyzed above.

Second conclusion: A spending State will not control the cycle I studied macroeconomics under the inspiration of the great monetarists of the last quarter of the 20th century: Milton Friedman and Anna Schwartz in their explanation of the Great Depression in their Monetary History of the United States (1963), Harry J. Johnson with his monetary explanation of the balance of payments, David Laidler and his analysis of the demand and supply of money, Brunner and Meltzer when they finally codified monetarism. As I lived through Lady Thatcher's reforms in the United Kingdom in the seventies and eighties, I came to see the fight against inflation as part of the battle for economic freedom. My inclination, therefore, was to explain the late Great Recession through the inability to maintain the money supply steadily—in the belief that the transmission mechanism between the currency created by banks and the money used in the economy at large still functioned.

My studies as a young man incline me to defend monetary measures, rather than fiscal, to relieve the recession. We must not forget, however, that I now see this kind of monetary interpretation as fundamentally incomplete. I now feel that attempts to devise anti-cyclical monetary policies removing restrictions of the kind we have studied in the first part of this essay are condemned from the start.114

114 Moves towards a better monetary and financial market cannot be achieved by simply removing interventions piecemeal with no regard to indirect effects and feedbacks. When immoveable constraints

The debate about remedies

The debate is still raging about the relative merits of monetary measures versus fiscal remedies when fighting a recession such as the one we have gone through; and also as to the role of real and institutional variables in the bringing about and the deepening of crises. As Laidler relates in his distinguished (2013) article, the controversy today is again between the monetarists, represented by the figure of Milton Friedman, and the Keynesians headed by Paul Krugman: the first holding to the monetary explanation of the Great Depression, blaming the drastic fall in base and banking money; the latter, returning to John Maynard Keynes' skepticism regarding the power of the Bank of England and proposing a program of public investment.

The evidence of the slow exit from the present crisis seems to point at the superiority of monetary measures, says Laidler in his conclusions. Tim Congdon principally has for years maintained the close connection between broad money supply and nominal GDP, as a guide for monetary policy.115 This poses two questions. The first one is, is the connection reliable between nominal GDP and GDP corrected for prices, between a higher money value of a country's production and the real goods and services it supplies to its own and foreign populations? The second is, if monetary expansion is not a reliable source of real growth, can the continuous (and hopefully steady) expansion of money in the end avoid inflation? After all, real growth does not come from money but from increases in primary goods, population, capital, technology and productivity. Making the supply of broad money grow at a steady pace may be a good anti-cyclical recipe. But what will it do to real growth? And can the modern State carry out this well designed anti-cyclical policy?

The growth of the State

All the meddling by the authorities in the financial markets is no coincidence. Our democracies seem to want goods and services, if possible for free, that seemingly cannot be supplied by the free market. Whether voters know, or pay sufficient attention to, what their representatives promise them, they seem to accept the gifts without counting the cost. For a time, such largesse can be paid for by taxes. But there comes a point when individuals and firms consider taxes too heavy and try to avoid them or even to evade them. The present situation of all advanced nations is that the Welfare or Entitlement State is unsustainable. The demands it makes on the taxpayers are simply too large and without end.

Enter "financial repression", Dr. van Riet's (2013) felicitous expression, culled from many a contribution by students of public policy. He thus characterizes the

make it impossible to reach the free market first best, the second best solution is much more complicated than omitting this or that intervention. One might find oneself in 'third best land', far removed from what one intended. This is what Lipsey, R.G. and Lancaster, Kevin showed in their famous 1956-7 paper on "The General Theory of the Second Best." Review of Economic Studies, 24(1), pp. 11-32. 115 Congdon, Tim (2011): Money in a Free Society. Encounter Books.

financial stratagems used by authorities in the Eurozone to get over any limits to the growth of public expenditure.116 It seems that taxpayer resistance makes it difficult for States to make their total expenditure go over 40% of GDP in the United States and 50% in Europe. Policy makers then resort to regulation.117

The term "financial repression" is generally used to describe a comprehensive policy regime put in place by the government to manage the domestic financial system—with assistance from the regulator—by imposing tight restrictions on financial markets, intermediaries and services, often complemented by capital account and foreign exchange controls to prevent evasion or currency speculation. (Riet, page 4)

Van Riet, being a good mainstream economist, makes a distinction in public financial intervention that I would question. He distinguishes between "interventions in the public interest" and interventions that "privilege governments and unduly restrain market-based fiscal discipline, especially in times of funding stress". (Riet, page 3)

Against the background of these two alternative views, one may distinguish between beneficial and harmful forms of financial repression. Financial repression can be seen as a "public service" in the interest of society if the interventions are introduced with the strict objective of correcting market and regulatory failures and for financial and monetary stability as well as distributional purposes.

The clause "distributional purposes" in that passage betrays a lack of realism. The Welfare or Entitlements State is a system designed to interfere with market mechanisms in a way that spills over mere redistribution and necessarily leads to abuse of public finances. Also, the interventions under the guise of "correcting market and regulatory failures" that we have just reviewed suggest that 'justified' public policy interventions may be few and far between. Van Riet's whole purpose in his paper is to warn about the pervasive vicious interventions that take place

... when regulatory distortions undermine the ability of financial markets to send disciplinary signals about economic fundamentals and, in particular, the soundness of fiscal positions.

The list of possibly repressive interventions presented by van Riet is interesting in view of what we have been saying about the causes of the Great Recession:

- Coerce banks to fund the public sector or state companies; - Use pension reserves to cover the budget deficit, be that of the pension system itself or the State; - Confiscate private wealth to deal with the public debt overhang;

116 Riet, Ad van (2013): "Financial Repression to Ease Fiscal Stress: Turning Back the Clock in the Eurozone?" An ECB Draft Document. 117 See my references to Stigler (1971) and Peltzman (1976) in my previous column on "The Dangers of Majoritarian Democracy".

- Make central banks change their monetary policy or cap interest rates or buy sovereign bonds; - Create excess inflation to expand nominal GDP; - Control the free movement of capital to stop investors from taking refuge abroad. (Riet, page 6) - If you happened to live in Greece or Cyprus during the euro crisis this list would not surprise you.

Summary conclusion: the rape of money Money was not invented by States or central banks. As Carl Menger said, "Money has not been generated by law. In its origin it is a social, and not a state institution." It was a discovery of merchants who found that they could get a better price or pay a lower one if they used a highly saleable good as a medium of exchange. So they specialized in accumulating these acceptable tokens for their own sake.118

Sovereigns soon discovered that they could get a cut of the value supplied by money by coining these tokens for themselves: they could thus extract seignorage or the difference between the face value and the social or intrinsic value of the coin. Today seignorage or the tax on the use of money takes innumerable other forms: the inflation tax, or the finance of State activities, or the increased satisfaction among the citizenry from more jobs. It is thus that the authorities can extract income or votes with the help of money creation—for a time.

All these returns to the State from having nationalized money and determining its price (the interest rate) are difficult to turn into a steady stream of economic or political income. They are temporary and volatile because the users of money soon discover ways to minimize this underhand extraction of value by the sovereign issuer.

This is why I am now skeptical of attempts to design monetary policies that will forestall ballooning excitement or correct irrational panics among money users. When money was based on gold there were cyclical ups and downs but, as issuing money was not in the hands of the State, their span was narrow and they soon came to a halt. The evidence of the present crisis indicates that the idea of independent central banks committed to defending the value of their currency is a pipe dream, unless we go back to an automatic limit to money supply. Today's governments cannot resist the temptation to 'print' money and place bonds to finance the insatiable needs of welfare and entitlements—until they are hit by a financial crisis.

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Conclusion to the Three columns: Can the paradoxes of liberal democracy be overcome?

118 Menger did add that the State could help the general use of money by sanctioning and regulating it. This last concession to administrative views of money was unfortunately laden with dangerous implications. Commercial money needs no other sanction than its general acceptance. See Menger, Carl (1892): "On the Origin of Money", Economic Journal, Volume 2 (1892), pp. 239-55.

The review of the paradoxes of liberal democracy in my three columns poses many questions that should not be answered in a hurry. Since individual freedom is our principal and most endangered value and since democracy is ideally the expression of the self-government of individuals when they are pursuing

communal goods, the study of how to avoid contradictions between freedom and democracy must have a high place in our concerns. Finding ways of containment of, or escape from, these contradictions merits long consideration.

1. The unnatural market

It seems there is little one can do to change the deep feeling in all societies that individualism and the free market are at bottom immoral and that democrats should get together to agree on political interventions to make it more just. No matter that the capitalist system has had a beneficial effect on our standards of living. No matter that the poor, for whose fate so many bleeding hearts grieve, are moving in millions out of destitution by their own efforts. No matter that our welfare systems and our entitlements end by enslaving those who are said to be favored by them. Calls for forced redistribution rear their ugly heads as soon as the market system suffers a hiccup, mainly caused by previous State interventions.

2. The vices of democracy

The malfunctions of our electoral systems are difficult to cure. There is no perfect electoral law. One way that voter rational ignorance could be defused and principal-agent problems be contained would be reducing the scope of politics in society. A tall order!

Smaller States making votes as local as possible is a solution worth considering. However, we must remember that Mancur Olson underlined the fact that large and inclusive constituencies, such as that for the presidency of the United States, weaken the force of interest groups.119 Still, smaller states are often in danger of invasion. Remember the fate of Italian merchant states in the 1400s: they could not put up significant resistance to invasion by France and Spain and in the end were (badly) governed by the Spanish for almost two centuries.

A traditional remedy is that of the separation of powers. Proposed by Montesquieu, it was enshrined in the United States Constitution. It had two dimensions: horizontal, the need to govern with the concurrence of the Presidency, Congress, and the Supreme Court; vertical, the retention by the constituent states of powers "not delegated to the United States by the Constitution" (Article X). The first one has had a little more effect than the second.

3. Patriotism and nationalism

119 U.S. Presidents are always more favorable to free trade than Congressmen. More generally, see Olson, Mancur (1965, 1998): The Logic of Collective Action: Public goods and the Theory of Groups. Harvard. Chapter I, sections D and E.

Again, though the natural love for one's country has too often been deformed and exaggerated during the 20th century, this is an inclination that cannot well be ignored. When trying to set up new 'rational' constructs, such as the European Union, it has to be taken into account under pain of conflict. Different languages, alphabets, traditions, religions, will be so many obstacles to be met by the constructivists. The attempt to create a European national feeling is not being very successful and it is not enough to lament a 'democratic deficit' in the European Union and try to correct it by granting more powers to an artificial European Parliament. Just using the crisis of the euro as a pretext to increase the speed of integration bodes conflict. Political integration there and in other prospective unions should not be rushed.

4. The confusion of liberty with wealth

The hatred of markets intensifies when philosophers define freedom as having abundant means to live the life one prefers. Liberty is not freedom from want. Granting minimum incomes, free education, state pensions, and other entitlements to every person in the population does not free the recipients and often makes more dependent. Formal liberties, such as habeas corpus or the respect of private property are especially important to the poor and downtrodden, so that they are allowed to find their own way out of destitution. Free choice must include the responsibility for the consequences of one's acts. The Welfare State corrupts those who live at the expense of public funds.

5. The role of money in a free society

As we have just seen, the financial crisis in the advanced world has increased demands for more control and regulation. Many have said that the Great Recession has shown that the free market does not work in the field of money and that it was a mistake to deregulate banking activities. One may ask two simple questions: What deregulation? What free market?

At bottom, money is not allowed to function untrammeled because the modern State has needs that cannot be covered with taxes, so that it has recourse to legal money and public finance. Some radical solutions could be considered: renouncing legal tender on the part of State Treasuries; going back to the gold standard; allowing true monetary competition, opening the door to private moneys; not interfering with the creation of new forms of money and electronic payment modes.

In sum?

Much research is needed to help strengthen economic liberty as a necessary basis for individual liberty. I hope the answer to all these questions will not be 'when freedom dies'.

The Scandal of Machiavelli or The Iron Law of Politics

February 3, 2014

For historians of political thought, the year 2013 was the 500th anniversary of the writing of The Prince by Niccolò Machiavelli. It was an occasion to fight it out with the great Florentine. I still have not got over the shock of reading The Prince as a student in Franco's Spain. The idealistic young man that I was did not know how to counter Machiavelli's implacable logic. True, times had changed and the crimes of a Borgia were not countenanced. But what if the spirit of politics, even democratic politics, was as Machiavelli had described? Was there nothing else to be said about competition for power but that it was the kind of savage game he described? When democracy was restored in Spain I was elected to Parliament as a lonely libertarian in a conservative ticket. I was not cut out for the job and did not stay long. Does this mean that I had not understood and digested the lessons of The Prince?

I. An eventful life and a complex personality Niccolò Machiavelli was born in Florence on May 3, 1469, in a family of the lower nobility and modest means. His father Bernard Machiavelli was a natural son, a condition which weighed on our author's political career. Little is known about Niccolò's education and early life in Republican Florence, except that he became a distinguished civil servant when he was thirty.

His means were always modest: his salary while employed at the Signoria and a house and some land in the village of Sant' Andrea di Percussina in the borough of San Cassiano.

The situation of relative isolation of the affairs of central Italy changed in 1494, when the King Charles III of France came over the Alps with his army to claim the Kingdom of Naples for himself. The Medici were forced to leave Florence for a long exile of almost twenty years. In the wake of the French, the traditional allies of democratic Florence, the Republic was restored. For a period the acetic priest Savonarola lorded over the populace. He ended by being burnt at the stake. The institutions of the Republic were thus restored in 1498 and Machiavelli, at the age of 29, was made the head of the Second Chancellery of the Signoria, in charge of military and foreign affairs. It is not known why he was offered such a high post. This was the beginning of a distinguished diplomatic and military career.

In 1500 he took part in the first of his many missions to the court of the King of France. He met Cesare Borgia in 1502, again as part of the mission the Signoria sent to deflect the ambitions of the Duke of Valentinois or "il Valentino", as he was generally called, from carving a dukedom for himself in Romagna at the expense of Florence among other cities. It is when following Valentino that Machiavelli came to distinguish two factors in attaining and maintaining supreme power in a new kingdom: Fortuna and Virtù—on the one hand luck and on the other what the Romans called virtus, courage, decisiveness, ambition, and ruthlessness. Machiavelli's admiration for the Duke was born during those negotiations—an admiration that grew when he witnessed how ruthless he was towards his enemies and how attentive to the needs of the cities he acquired. Thus, his lieutenant in Romagna, Ramiro de Lorca had proved himself efficient but cruel. To distance

himself from such an unpopular strongman he had him beheaded and left in the public square of Cesena, carved like an ox. Machiavelli also recounted Cesare's revenge at Sinigallia with admiration, in a piece of 1503 he had titled "Description of the way that Duke Valentino killed Vitellozzo Vitelli, Oliverotto da Fermo, Paolo Orsisni and the Duke of Gravina-Orsini" the gist of which he inserted in The Prince. Borgia attracted the four plotters to the castle of Senigallia under false pretenses and had them strangled. Machiavelli in The Prince drew the moral of this story with the following words: "And because this part is worthy of notice and of being imitated by others, I do not want to pass it over" (The Prince, Chapter VII). What he was implying is that, in relations among states and princes force was decisive, in contrast with private life.

In that very year of 1503 Cesare's father, Pope Alexander VI, died. Borgia later told Machiavelli that he had worked out in detail what to do if this happened before he had consolidated his conquests: he had a remedy for everything, "except that he never thought that, on top of his [father's] death, he himself would also be a death's door". Machiavelli adds that, apart from the misfortune of his illness, his mistake was not to oppose the election of Julius II to the Papal See. Machiavelli added in The Prince that, finding nothing else amiss in his deeds, he "proposes him [...] as a model to be imitated by all those who by chance have been raised to political dominion".

Later missions of Machiavelli in an increasingly senior role led him to visit France again and to sound the intentions of the indecisive German Emperor Maximillian and to negotiate with the irascible Pope Julius II. In 1508 he took part in the submission of rebellious Pisa by force of arms. In between missions he was intent on creating and funding a citizen army for Florence, along the lines of the Roman legions. He did not trust mercenary forces led by condottieri that were the fashion at the time. These ideas he would later

expound in his 1521 book La Arte della Guerra, or The Art of War. However, the troops he raised and organized proved to be useless in the defense of the town of Prato, overrun and sacked by the Spanish troops under the command of Viceroy Raimundo de Cardona. This rout marked the end of the free Florentine Republic whose servant he was and the Medici returned to take their place in the city.

Machiavelli was immediately dismissed from the Signoria and confined to his village, except for being called in to have the accounts of his citizen army closely scrutinized: he was found exact and honest. He had restarted writing his Discourses on Livy when a thunderbolt struck: his name was found on a list in possession of a young hothead intent on killing Giuliano de Medici. Locked up in the Bargello, the horrendous Florentine jail, he was interrogated under torture,120 but escaped execution by refusing to confess. He was lucky that, on the death of Julius II, Leon X, a Medici Pope, was elected and there was a general pardon. His services to the state ended there though, with the exception of a few minimal missions and

120 Machiavelli was submitted to "strappato" or Stretching, a method of interrogation that consisted in tying the suspect's hands with a rope behind his back, pulling the rope through a pulley fixed to the ceiling, and letting the man fall short of the floor. Machiavelli resisted six disjointing falls.

the commission of Istorie fiorentine, a history of Florence. In the last year of his life, democracy returned to Florence and Machiavelli joined in organizing the participation of his city in the Holy Alliance against the Spanish. The Alliance was unable to stop the Landsknechte and Tercios of Emperor Charles V, which famously went on to sack Rome in 1527.

Let me return to 1513. When he was released from the Bargello in March, he set aside the Discourses on Livy and started writing The Prince. By December the work was finished. In a letter of December 13 to his friend Francesco Vettori, the Florentine Orator or Ambassador to Leo X, he wrote that he had finished "uno opuscolo de Principatibus" , an opuscule on principalities. The question remains of when and why he wrote chapter XXVI, the eloquent, passionate call to some young scion of the Medici family to free Italy from the barbarians who had invaded it, and composed the dedication of the work to the young man who was to rule Florence as Lorenzo II Medici. Was this simply self-serving? Of course he wanted to be back in public service. And we know from his letters to Francesco Vettori that he had toyed with the idea of a dedication Lorenzo's uncle Giuliano, the effective ruler of Florence for a short period after the fall of the Republic. But Giuliano, busy and surrounded by courtiers as he was, might not give his pamphlet full attention. In the end the dedication went to Lorenzo, who had just been made captain general of Florence. When one reads the dedication together with chapter XXVI, the patriotic passion in both texts justifies their insertion on their own merits. Machiavelli did want some great man to redeem Italy.

He bore his forcible retirement in Sant' Andrea di Percussina for nearly fifteen years with some bitterness but, we are sure, with the famous sardonic Machiavelli smile. In those years he wrote The Prince and the Discorsi, published La arte della Guerra (1521), looked after his family, managed his house and land and loved the beautiful women who crossed his path. On December 10, 1513 he wrote a dignified letter to Vettori where he describes one day of life he lives. Early in the morning he catches some thrushes with bird-lime. Then he oversees the cut of some wood to sell for he fears he is being cheated. Later he sits himself by a fountain and takes to reading some book by Dante, Petrarch, Ovid or some minor poet: "I read their passions of love, and those loves remind me of mine, and I enjoy myself with these thoughts." He then repairs to Sant' Andrea to chat with passers-by and hear their stories and complaints, as he had done

with the wood-cutters in the morning. After a Spartan meal with his "brigade", as he calls his family, he goes to the village tavern for a noisy game of cards.

When evening comes, I go back home, and go to my study. On the threshold, I take off my work clothes, covered in mud and filth, and I put on my royal and courtly dress. Thus decently attired, I enter the ancient courts of rulers who have long since died. There, I am warmly welcomed, and I feed on the only food I find nourishing and was born to savor. I am not ashamed to talk to them and ask them to explain their actions and they, out of kindness, answer me. Four hours go by without my feeling any anxiety. I forget every worry. I am no longer afraid of poverty or frightened of death. I live entirely through them. (Inglese,1989, letter 19)

II. Machiavellian politics

Though the Discorsi and The Prince should be read together I will mainly pay attention to the latter and more celebrated work.

The effective truth of the matter

"It seems to me more convenient to go straight to the effective truth of the matter than to the imagination of it", says Machiavelli at the start of chapter XV of The Prince. He proceeds: "How one lives is so far away from how one should live, that he who forgoes what is done for what should be done learns rather his ruin than his preservation." In The Prince Machiavelli wants to discover the kind of behavior necessary to keep and govern a new principality, that is to say, one where the lord cannot rely on the peaceful enjoyment of a tradition. That kind of behavior can be very distant from what is demanded by ordinary morality.

In an interesting passage of his correspondence with Vettori he had rejected the efforts of his friend to interpret reality with the help of the great classical philosophers. His friend had used Aristotle's Politics to deny the capacity of federated republics like Switzerland to expand their territory, despite the present lording of the Swiss over Milan. That is as may be, replied Machiavelli. He did not know what Aristotle had to say about the subject but he remembered that the Etruscans were a federation and governed the whole of northern Italy in their time. He was only interested in "what could reasonably come to be, in what is and has been". (Viroli, page 141)

Back to The Prince. In chapter XVII, one of the most notorious, he asks himself whether it is better for a new prince to be cruel or merciful. If he has to choose one or the other, he concludes, "it is much safer to be feared rather than loved". Men "are ungrateful, simulate and dissemble, run away from danger and are greedy for profit". He adds a phrase that still echoes under the vaults of political philosophy: "men forget more easily the death of a father than the loss of their patrimony", he argues when recommending that the prince should take the possessions of his subjects quickly and in one swoop.

The object of political action is the increase of territory and the enjoyment of power. It is "very natural and ordinary to want to acquire". A republican constitution with its liberties is desirable but runs the danger of invasion by outside barbarians. The only way to stay independent is strong political and military power.

The dangers for a new prince come from two sources: outside enemies and inside disorder. He quotes from Virgil's Aeneas:

Res dura , et regni novitas me talia cogunt

moliri, et late fines custode tueri.

"Hard necessity and the novelty of the kingdom compel me to use these ways, and to defend its borders with ample guard". The new prince must be ready to wage war against his neighbors and should "not mind the ill repute of cruelty, as long as he keeps his subjects united and loyal".

Still there are limits, such as those he studies in chapter VIII, "Of Principalities Acquired by Crimes". Lowly Agathocles, who became the undisputed King of Sicily amply exceeded his limits. Agathocles, relates Machiavelli, one day summoned the people of Syracuse to the agora and had all the senators and well-to-do of Syracuse put to the sword. He thus "held the principality without any civil controversy". However, concedes Machiavelli, "one cannot call virtù to kill ones citizens, betray ones friends, have no faith, mercy nor religion". He adds that this kind of behavior can "make one acquire an empire, but not glory". (chapter VIII)

In chapter XVIII he discourses on what should be the qualities of a prince. Everyone understands that it is "praiseworthy for a prince to keep faith, to live with integrity and not cunningly". But "in our time, the princes who have done great things have not kept faith with their promises [...] and in the end have overcome those who founded themselves on being loyal". Nor should a prudent ruler "keep his faith, when keeping it turns against him, and the reasons that made him promise are spent".

Does one see a soupçon of Machiavelli's famous smile when he advances these thoughts, which in another would suggest cynicism? The chapter is titled "How should princes keep faith" and is full of examples of rulers who promised what they never kept but always found someone to inveigle—the supreme example in the art of deception being Pope Alexander VI. "A prince, then, does not need to have all these qualities, but it is very necessary that he should seem to have them."

The more encompassing reflections of the Discorsi

The Discorsi, whose composition was interrupted by his arrest and then by the writing of De principatibus, is a work of wider scope. It considers the general principles sustaining states of all forms, not only new principalities: city states, popular republics, monarchies old and new. When both works are read together the scandalous nature of the reflections on new principalities is somewhat diluted. What is confirmed is Machiavelli's conception of politics as an autonomous field, subject in its functioning to its own natural laws, where morality and ethics confuse rather than clarify the principles of action.

In the Discorsi Machiavelli asks himself what it means "to govern well"; how one establishes a free state and orders it over the years; what is the best military organization of a republic, a principality or a monarchy; what are the ethical and republican virtues that maintain a free constitution; or what it means for the citizen to love his country. Machiavelli's is a scientific and empirical research rather than a study in political ethics.

He does bring in experiences from many lands and past and present times: Mesopotamia, Ancient Greece, Macedonia, Carthage, Persia, and the Italian Republics of his time and experience. However, his main laboratory is the history of the Roman Republic and Empire. Curiously enough, nobody then and even today seems to have noticed that it was only the Latin Empire that disappeared in the fifth century A.D. This narrow vision may explain the shock across Europe when Constantinople fell to the Ottomans in 1458,

as if that state had totally slipped from the memory of the West. That year also marked the beginning of the end of Venice as a trading Republic and its transformation into a mainly Italian power, which Machiavelli should have noticed. But this is not the place to find fault with the scope of Machiavelli's historical and political analysis. My object is different. I want to ask two rather more important questions: is politics as self-contained as Machiavelli assumes? Has the nature of power changed with the slow expansion of commerce and contract?

Fortuna foretells of the unexpected consequences of political action

At this point one may ask whether there is some element in Machiavelli's conceptions that could be taken to allude to all those conditions and restrictions falling outside the control of the ambitious—the social developments alluded to by Ferguson in the quote at the frontispiece of this essay. I think there is: for him political success for new princes depended not only on virtù but on fortuna also and in equal proportions.

Commentaries of the role of fortuna in Machiavelli's thought could fill a volume. It means more than luck. Fortuna is not simply the rag-bag of all those random elements that can undo the best plans or crown the less prepared intrigue. It includes the misreading of circumstances by an unhappy prince, as was the case for Cesare Borgia. Some princes were able to sail into contrary winds, which was the case for Ferdinand the Catholic of Spain, so admired by Machiavelli. It also includes how well the fundamental character of a ruler fitted with each circumstance.

The locus classicus on this question is chapter XXV, titled "quantum fortuna in rebus humanis posit", how much fortune can do in human affairs. His explanation of success or failure is more complex than simply summing under fortuna all the random elements of a situation or even saying that "human affairs are governed by luck and God" and personal will had little to do with our fate. In troubled times, as those when he writes, it almost seems that the will of individuals counts for nothing, even he has been tempted to think so. He uses a telling metaphor. It is as with one of those untamed rivers that flood lands, fell trees, topple houses, and there is no other remedy but fleeing them. But in quieter times, people can repair banks, dig channels and otherwise tame the future force of the waters. So it is with fortune: one can prepare for calamitous times, rather than simply leaving the land open to flooding. So it is with Italy, a land without river-banks and dykes: other would her fate be if she was "repaired with convenient virtue, as are Magna [Graecia], Spain and France."

The mix of fortuna and virtù is not simply half and half. Some characters are more suited to different circumstances. Princes cannot really change the character they were born with. To triumph it is important to "proceed with the quality of the times". Some man reacts to circumstances "with caution, another with impetuosity; one with violence, another with art; some with patience, [...] some with design." He gives the example of violent Pope Julius II, who took Bologna with sheer audacity, while the differing interests of Venetians, Spanish and French stopped them from intervening. In the end, then, Machiavelli "thinks it is better to be impetuous than cautious, because Fortune is a woman; so that, when wanting to vanquish her, it is necessary to beat her and hurt her."

True, the concept of fortuna is not analytical enough to structure the unwilled consequences of human action. Napoleon was an avid reader of The Prince but despite his cunning and his violence he did not build the Europe he wanted. What is it that made Mussolini and Hitler fail, at huge cost for their nations and the world? Was Stalin successful in building a Soviet empire? Mao Dse Dong unified China but he

wasted the suffering he imposed on his people if what he wanted was a proletarian revolution. It is not merely lack of fortuna that explains these unexpected outcomes.

The Iron Law of Politics

When reading The Prince many of us feel that Machiavelli overlooked an essential part of reality, he who was such a realist. He saw politics as governed by an internal iron law that conferred success on he who lied, cheated, used force on his enemies, and cowed his people cruelly hoping they would appreciate the order he imposed on society.

He discounted, or was blind to, the importance of respect for property, of honored contracts and of mutually beneficial exchange. This is still the case today with students and practitioners of international relations, who see agricultural, industrial and financial activity merely as instruments of state power. The cowardly, greedy, overbearing humans described by Machiavelli are not incapable of rational foresight and of pursuing their own interest in unplanned harmony with those of others. "It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner but from their regard to their own interest", noted Adam Smith.121 And this space for "positive sum games", as we economists call them, is getting larger and wider by the day.

In sum, Machiavelli's method is suited to studying some aspects of politics as an autonomous activity governed by its own logic but it is an incomplete method.

IV. Leaving the state of nature

121 Adam Smith's Book I, Chapter 2 of An Inquiry Into the Nature and Causes of the Wealth of Nations. Library of Economics and Liberty.

Machiavelli was certainly not the only philosopher to think that the world of politics was governed by an iron law. Thomas Hobbes is the first one that jumps to mind.

The state of nature in Leviathan and The Prince

Hobbes started from an even more exclusively materialist conception of human nature to defend absolute power as a condition for a well-functioning Commonwealth (Leviathan, 1651). The concept of "the state of nature" of humanity in Hobbes is not very different from Machiavelli's implicit starting point when speaking of the political world. For Hobbes, men have very similar physical and mental capacities. They are moved by the passion for "power, worth, dignity, honour and worthiness" (Leviathan, I.10). With such human material, the war of all against all is served. In the state of nature "men live without other security than what their own strength, and their own invention shall furnish them withal".

In such condition, there is no place for Industry; because the fruit thereof is uncertain; and consequently no culture of the Earth; no Navigation, nor use of the commodities that may be imported by Sea; no commodious Building; no Instruments of moving, and removing such things as require much force; no Knowledge of the face of the Earth; no account of Time; no Arts; no Letters; and which is the worst of all, continuall feare, and danger of violent death; And the life of man, solitary, poore, nasty, brutish, and short. (I.13)

Again, these words like some of Machiavelli's have echoed warningly in the halls of political philosophy ever since they were written.

For the Florentine "the state of nature" or "the warre of all against all", to use two Hobbesian expressions, was as between princes and states: the private life of the people flourished when there was peace, and private life was subject to and governed by ordinary morality. The biography of Machiavelli presents us with a better kind of man than his satanic legend. As a person he was not Machiavellian. At the time it was generally accepted that men had trysts outside marriage; but apart from that, he was an attentive husband, a loving father, an honest public administrator, and a great servant of the state. For him, the three spheres of life were governed by different rules: family and friends by love and attention; public service, by professionalism and faithfulness; but politics by the desire for preeminence and the need for survival. Only in politics was there need for leaving ethics aside.122

The escape route proposed by Hobbes was more completely detailed than in The Prince and the Discorsi. In Leviathan he proposed a social contract.

122 This was also the case for Hobbes, in all that the Sovereign deigned not to interfere with. "The Liberty of a Subject, lyeth therefore only in those things, which in regulating their actions, the Sovereign hath praetermitted: such as the Liberty to buy, and sell, and otherwise contract with one another; to choose their own aboad, their own diet, their own trade of life, and institute their children as they themselves think fit; &the like." (II.21)

> The only way to erect such a Common Power, as may be able to defend them from the invasion of Forraigners, and the injuries of one another, and thereby to secure them in such sort, as that by their own industrie, and by the fruits of the Earth, they may nourish themselves and live contentedly; is to confer all their power and strength upon one Man, or upon one Assembly of men, that may reduce all their Wills, by plurality of voices, unto one Will. (Leviathan, II.17)

Both The Prince and Leviathan are incomplete in two dimensions. On the one hand, the idea is missing that the part of social life that follows the paths of free agreements in mutual benefit is much larger than the realm of politics, something that is missed by many Machiavellians today who can only see economic and social life in terms of struggle for power, instead of spontaneous cooperation by free competition. On the other hand, the analysis is also missing the slow learning and diffusion in large parts of the world of freer institutional arrangements with a lesser degree of sovereign interference. Liberal democracy and globalization may seem fragile but they still seem to be forging ahead.

We have not progressed much compared with Renaissance Italy in what concerns international relations, which are still very Hobbesian. Internal political life in the more civilized countries has been tamed in its methods though not in the spirit in which they are carried on. However, economic activities and exchanges are extending their sphere of action and helping individuals to be freer. States and governments still interfere but communication technologies and economic globalization multiply escape routes.

Trades in the state of nature according to Buchanan

Even in a state of nature, "during the time when men live without a common Power to keep them all in awe" and therefore are "in that condition which is called Warre" (Leviathan, I.13), a spontaneous equilibrium could appear. It is not an optimum equilibrium but it can be stable and open to contracts, agreements, and individual exchanges. I am saying two things here: one, that hostile competition has a natural limit; and two, that there are spontaneous avenues out of the state of war of all against all. If this were not so, how could we have made such relative progress as we call civilization? The problem is not to explain tribal poverty but the "Wealth of Nations".

James Buchanan published a seminal study in 1975, titled The Limits of Liberty: Between Anarchy and Leviathan123, where he studied the operation of a state of nature as a theoretical model. He reasoned that there is a moment when the disorder of anarchy touches bottom, so to speak. In the Hobbesian natural state there appears an equilibrium distribution of resources. Each individual or family only stretches its aggressive resources to the point that what they obtain at the margin with those efforts equals the marginal cost of securing and defending shares. This initial state looks like Hobbes's natural state, but a way out appears which is different from a grand social contract to appoint an absolute ruler: the

123 Available online at: The Limits of Liberty: Between Anarchy and Leviathan, by James M. Buchanan. Library of Economist and Liberty.

agreement to trade, barter and exchange Adam Smith spoke of. There will often be repeated trades that are enforced without a central authority. (Buchanan, The Limits if Liberty, chapter 2). It is enough that the cheated party plays "tit-for-tat", by answering in kind until the other party mends his ways.

Possible ways out of the state of nature

Such an escape from Hobbesian equilibrium will be helped by the emergence of the institution of private property, whereby the limits between "mine and thine" are traced and areas of friction reduced. All parties to the recognition of such demarcation profit from the reduction in the use of resources for defense and aggression. Subsequently agreements take place in two steps: one is the initial demarcation of rights, which may be unequal according to the relative strength and ability of the parties—really a sort of constitutional arrangement; the other is trades and exchanges in specific goods acquired according to the rules originally defined. Measures to curb shirkers and free-riders may appear spontaneously or be agreed at the constitutional level.

This kind of development is the one described by Adam Ferguson. That is the way to explain why and how the great majority of us human beings has emerged from the Hobbesian war of all against all. We individuals are in a large measure autonomous and sufficiently rational to come to favorable agreements. Over time, individuals determine the evolution of the rules of society. This evolution is mostly immanent and the result of individual decisions. Democracy can slowly be learnt through the hard lessons of reality. In some parts of the world people know that to fight inflation with price controls is an added source of conflict. In other parts experience has shown that the nationalization of services, such as health or education, wastes resources and worsens quality; and also that political intervention in labor markets reduces productivity and increases natural unemployment. And so on.124 In Latin America people may someday begin to compare the results attained by the Bolivarian ALBA block, led by Cuba and Venezuela, and those enjoyed by the countries in FTAA, the Free Trade Area of the Americas. In Europe we have seen the Swiss in two referenda of 2010 reject increased taxes on the income and assets of the wealthiest, as well as the extension of paid holidays to six weeks.

V. Conclusion

The search for "the effective truth of the matter" can often confuse. It is true, as Machiavelli saw, that political competition has an element of oppression typical of zero or even negative sum games. It confers on it an essential cruelty that is quite the opposite of the cooperation brought by economic competition. But democratic civilization precisely consists of taming and limiting power. Only the future will tell

124 Of course the record is mixed, so to speak. A Swiss referendum of November 2013 has set a limit to bankers' bonuses and golden parachutes. In that same referendum a proposal to limit the difference between the best and the worst paid in corporations to 12:1 was rejected by 62.5% of the votes.

whether the widening of commercial exchanges will at least in part take some of the weight of sovereignty from our shoulders.

My thesis is that Machiavelli can be shocking or even sound cynical in many of his pronouncements because he cuts off the field of politics from the rest of social life and presents it as governed by what I have called "the Iron Law of Politics". There are other social regularities and they soften or counteract the cruel realities of politics. They are bringing prosperity and civilization to an increasing number of people. Machiavelli could not see them for lack of the requisite analytical instruments, which were invented in the latter part of the 18th century.

Calls for Hobbesian centralization may be the worst solution when there is conflict and disagreement. The instinct of politicians and administrators is often to increase regulation and extend prohibition in their own interest. This is what we see in the reactions to the recent financial crisis with calls of the European officials and national politicians for a united or federal Europe.125 The idea of reducing the size of government and widening the scope of the free economy is something few of them consider.

However, one should not be over-confident about the future taming of politics by spontaneous social action. Governments, trade unions, crony capitalists, and rentseekers in general do not tire in their efforts to engross what others produce. True, the methods of politics in the civilized world are not those of Sinigallia but the spirit of politics is still the same. In The Road to Serfdom (1944) Friedrich Hayek wondered "Why the worst get on top". The only way to soften the iron law of politics is to reduce the field in which it obtains, through economic competition and globalization. In a way, The Prince is as useful a warning as Hayek's war-book for those who, whenever a crisis befalls, think of no other remedy but increasing the control of governments over economic and social life.

125 In a previous piece, I lay out my case for the causes of the financial crisis. See "The Paradox of Money." January 6, 2014, Library of Economics and Liberty.

Poverty and Inequality

April 7, 2014

The stagnation of the incomes of the white and blue collar middle class in advanced economies can be explained in part by Third World competition; another part must be due to changes in technology. From the point of view of the welfare of humanity, the news is good. Those who refuse to see how much globalization is doing for the poor may be wearing their anti-capitalism as a fig leaf to cover their short run appetites. World poverty is not increasing nor is inequality widening. The number of the poor, especially among the most destitute, is reducing steeply which, of course, means that world inequality is diminishing. All this is happening within the framework of secular economic growth temporarily suspended by the late economic crisis. The stagnation of the incomes of the white and blue collar middle class in advanced economies can be explained in part by Third World competition; another part must be due to changes in technology. From the point of view of the welfare of humanity, the news is good. Those who refuse to see how much globalization is doing for the poor may be wearing their anti-capitalism as a fig leaf to cover their short run appetites.

The United Nations proclaimed their Millennium Development Goals (MDGs) in 1990: the first one was "halving the proportion of people with an income level below $1/day between 1990 and 2015". The goal has been met ahead of schedule (United Nations, 2013) and the consensus in the economics profession now is that indeed world poverty has been on the retreat for more than forty years. One of the first champions of this view was Xavier Sala-i-Martin, of Columbia University and Pompeu Fabra School of Economics in Barcelona. For more than a decade, he has been fighting to make the United Nations and the World Bank admit that poverty was falling much more quickly than expected and the facts have borne him out.

Sala's latest paper written with Maxim Pinkovskyi (2009) has broken new ground for me from the very start. I used to study poverty, inequality, and growth (or the lack of it) as separate phenomena, often locked in a diabolical trade-off. I now see that their mutually reinforcing effect comes to light when studied together under the conceptual umbrella of the distribution of income: far from being inimical to one another they are complementary factors in the evolution of human welfare126. So, let me start by paying attention to Sala-i-Martin and Pinkovskyi (P&S).

The evolution of world poverty 1970-2006 With the MDGs, studies of the evolution of world poverty have been coming hard and fast.

126 "Although poverty, inequality, and growth are three different ways of looking at the same object (the distribution of income), researchers traditionally analyzed the three separately. Growth (of per capita GDP) usually relates to the percentage change of the mean of the distribution. Poverty relates to the integral of the distribution to the left of a particular poverty line. Inequality refers to the dispersion of the distribution." (page 2) The three questions should therefore be seen as components of the central question of the improvement of human welfare. Let me say that reading this passage was a Eureka moment for me.

They could be classified into two groups: those that use direct surveys of income distribution and those, like P&S, who use per capita national income figures.127 Whatever the source of the data, the profession normally applies a conventional definition of absolute poverty as a per capita income or consumption below $1 or $1.50 or $2 a day.128 From any civilized point of view these levels of income or consumption are pretty basic and unsatisfactory, so that people above the different lines so defined must still be considered very poor. The point of the exercise is another, however: it is to measure how fast, in what numbers, and by what means the poor are emerging from dire destitution.

The dividing lines mentioned above try to measure absolute poverty and whether it is shrinking. Many people in the scientific community and among practical political economists would prefer us to focus on relative poverty.129 In my view, however, relative poverty is a less defensible notion than absolute, since it tries to count the number of people whose consumption is some percentage below the median income, usually 60% of the income of the person exactly in the middle of the population, income-wise. Now this is not so much a definition of poverty as a controversial indicator of inequality: by definition, there will always be people below the median and this relative poverty will only shrink in as far as the population clusters around the center. Also by definition, relative poverty will never disappear, so that there will always be a part of the population claiming the right to have their income supplemented by society, no account taken of their capacity to better their own condition. Who is 'society', anyway? Better leave the discussion of the presumed claim of all to become 'full participants of what society has to offer' or to aspire to 'full citizenship' for another day. Here I will simply note what this has meant in practice in advanced societies: the creation of a dependency culture in a self-perpetuating under-class, a development not attributable to

the free market but to policies fostered by the social liberalism of intellectual élites.130 My intent will be narrower and more modest. I will be content with measuring the number of those who have emerged from absolute poverty through economic growth and have thus made the world more equal.

Now, measuring world poverty and equality is a difficult exercise demanding the use of a wide range of statistical methods. Let me concentrate on Pinkovkiy and Sala-i-Martin (2009), who address world poverty figures by calculating GDP per

127 Though Sala-i-Martin inclines to income per capita as a measure of poverty, he does check his results with a number of other methods, among them those that rely on surveys. And the overall picture is not so different. 128 These notional amounts of $1, $1.50 or $2 a day are of course corrected for inflation and purchasing power across different societies. 129 Thus Deaton (2013), page 184: poverty in an advanced country "is about not having enough to participate fully in society, about families and their children not being able to live decent lives alongside neighbors and friends." The conclusion for Professor Deaton is that "it is very hard to justify anything other than a relative poverty line" in wealthy countries like the United States. I beg to differ. 130 See Dalrymple (1990).

capita in 191 countries during the years 1970 to 2006.131 I will go straight to three of their graphs from their (2009) article, which I reproduce with due permission.

Figure 1 shows how the distribution of income in the world has changed over those thirty-six years. The two red vertical lines show the yearly income of people getting $1 and $2 per capita a day: the latter being $730 a year.132 The blue curve for 1970 encompasses a large number of people under it and to the left of the red vertical lines and therefore in dreadful poverty. It also shows two humps of inequality around $1,000 and $4,000. Add to this that the curve is widely spread, in itself another sign of inequality. The further we move down the years, the fewer the people to the left of the red lines and the higher the concentration around the median: people are getting better off and wide divergences in income are getting compressed.

Now, for the head counts. From 1970 to 2006 world population increased by some 2.88 billion, so that the number of poor should have increased even if their personal situation had improved overall. However P&S calculate that the number on $1 a day fell by 617,100 and those on $2 fell by 782,900. Some fall!133 What Figure 2 shows is how many people are left whose income is equal to or less than $1 a day. According to P&S there are 350,400: the fall is precipitous. The numbers for $2/day are 847,000 and on $3/day, 1.39 billion. These are still large numbers and they suggest the very stark conditions under which so many people live from the point of view of well-being. Still, progress has been unexpected and huge.

131 Pinkovskiy and Sala-i-Martin approximate the population by fitting the data with a normal or 'parametric' distribution bell curve—which is not too far-fetched an assumption when the sample is so large. Sala compares these results with the 'non parametric' kernel method after dividing the population in quintiles and finds them very similar. 132 This is a semi-logarithmic graph, in that it compresses the whole gamut of yearly incomes per head on the x-axis so that the distance between $50 and $500 a year is the same as between $500 and $5,000. 133 If we reckon that from 1970 to 2006, 617 thousand in the $1a day group must have moved up to the $2 a day group, and that this group was smaller in 2006 by 783 thousand, the gross reduction of the $2 a day must have been nearly 1.4 billion, despite the growth of the world population by nearly 6.5 billion.

For those who are not content with measuring poverty with per capita income or consumption, the above results appear woefully incomplete. In 1990 the United Nations launched a new index under the inspiration of Mahbub ul-Haq and Amartya Sen, the Human Development Index (HDI). This index, now published yearly under the auspices of the United Nations Development Program, tries to give a more accurate picture of what it means to be poor and what one should pay attention to if the poor are to progress to a better life. The HDI is a combination of three indices: (1) Life expectancy at birth as an indication of a long and healthy life; (2) Mean years of schooling at a given moment plus mean expected years of schooling as a representation of the acquisition of knowledge; and (3) Gross National Income per capita as an indication of a decent standard of living.134

A number of critics have wanted to add a fourth dimension to the HDI and call it IHDI (for 'Inequality HDI') on the grounds that inequality reduces the welfare of the poor. Now, in as far as inequality grows from barriers to equal treatment before the law, the addition is fair, but would better be included in an economic liberty index of the sort compiled by the Fraser Institute in Canada or the Heritage Foundation in the United States. However, if the new index is used to enjoin public intervention to undo existing income differences flowing from the operation of the free market, then the aspiration, though understandable, is better achieved by more growth.

The case of India has starkly revealed the difference between the two approaches, one stressing human development, the other economic growth. The polemic has centered around two recent books: one by Amartya Sen and his long-time collaborator Jean Drèze (2013) on India and its contradictions; and the other, Jagdish Bhagwati and Arvind Panagariya (2013) on how much growth matters for the poor and how important deregulation is for growth. Sen, when commenting on his book with Drèze, has underlined the need for more public services in India:

134 Before its reform in 2010 the HDI was a rough measure of the 'functionings' of the poor (to use an Amartya Sen concept) or the kind of life they lead at present. The new HDI includes indices of the possibility of a better life for the poor in the future, thus trying to approach what Sen calls the 'capabilities' that the poor have. For 'functionings' and 'capabilities' see Sen's somewhat different approach in his Nobel Prize lecture (1998, 2002), pages 86-90 and passim.

> The lack of health care, tolerably good schools and other basic facilities important for human well-being and elementary freedoms, keeps a majority of Indians shackled to their deprived lives in a way quite rarely seen in other self-respecting countries that are trying to move ahead in the world.

He extolled the good effects of a program of public intervention in Kérala and even in Bangladesh, a country whose income per capita is markedly lower than India's but whose index of human development is higher.

Bhagwati, on the contrary, has lamented that the spirit of 1991, the deregulation program of the Indian Government that set India on a much needed growth path, seems to have been lost. Only some states, such as Gujarat, are placing their bets on freeing business and reigning in bureaucracy, with positive results. In his book with Panagariya, Bhagwati called for toppling the 'Regulation Raj', the allencompassing administrative empire left behind by the British.

We cannot emphasize enough that our analysis, while it is addressed to India's development experience and underlines the centrality of growth in reducing poverty, has clear lessons for aid and development agencies, as well as NGOs that continually work to affect poverty all over the world.

Bhagwati has loudly complained that Sen will not join in battle with him, which is a pity given that the question at stake is so important. In view of Sala-i-Martin's results recounted above, I think that growth is the strategic variable. International aid, both public and private, can help when it is aimed at the grass-roots, not directed to governments, when it often becomes aid to Switzerland. Wholesale intervention by local officials, even when they are not corrupt, is usually a hindrance to doing business and to supplying public services.135

Sen and Drèze underline what public authorities could do but often don't. Growth has positive effects but does not address all or most of the needs of the poor. But what if human development proves to be highly correlated with GDP per capita? There is evidence that this may be the case. It seems to me that Sen should acknowledge that freeing the economy and opening it to foreign trade and investment is more effective in the fight against poverty than the administrative remedies he proposes. As the saying goes, 'better trade than aid'.

The evolution of world inequality 1970–2006

The other statistic we should make explicit in our discussion is the measure of inequality (though it is implied in that of poverty). There are many different ways of measuring this dimension of income distribution and P&S go down a number of them. I shall choose to focus on the Gini coefficient, which is the classical one. When the Gini number is 0 the situation is said to be one of perfect equality; and when 1,

135 The disastrous state of public schooling in many states of Africa, India, and China is a sad example of the inefficiency of nationalized services, as witnessed by Tooley (2009).

perfect inequality.136 Figure 3 shows a steep fall of the Gini coefficient from 1970 to 2006 and therefore reflects a dramatic reduction of inequality in the world. The line shows a hiccup at the end of the 1990s but then steady progress. The authors see this improvement mainly as the effect of the movement of the Chinese population from low productivity agriculture to high productivity cities, a less pronounced rural-urban migration within India, and decided growth in Latin America and Sub-Saharan Africa.

Incorporating information about the within-country distribution is problematic, however, because data are only readily available in the advanced world. Political circumstances can also affect the trend. Thus there was a large increase in poverty and in inequality when the Soviet Union dissolved and became the Russian Federation. An example of a different kind is that of Nigeria, where for many years the rich got richer while the population in general retreated but recent political reform now seems to have inverted the trend.

It is a well known result in growth economics that countries at different moments of their progress tend to converge onto the rate of growth of the more advanced ones. Nobel Prize laureate Robert Lucas (2009) plotted forty years of growth on the 1960 per capita income of 112 countries. Countries that were poor in that year showed widely scattered subsequent growth rates, from miraculous progress in East Asia to stagnation or negative growth in Africa and Latin America; and countries that were rich in that year showed average rates of growth from 1960- 2000 of only around 2%. The resulting picture was a triangle on its side converging on the United State and European Union vertex.137

Lucas then proceeded to relate that convergence with the 'openness' of the backward countries. The definition of openness he used is undemanding but still shows up in the growth rates of the most backward of the 112 countries: the closed

136 The Gini coefficient is a probability distribution showing the difference between the line of perfect equality and the observed percentage of total income cumulatively assigned to each percentage of the population, starting from the lowest: as when one says that 5% of total income is received by the lowest 20% of the population and so on upwards. Princeton demographer Angus Deaton (2013, page 187) uses the mathematical equivalent: half the mean difference between two items selected randomly, relative to the average income. 137 See figure 1 in Lucas (2009 page 2): a "triangular pattern [...] familiar to students of growth" reflecting the convergence of the extremes of high and low growth in developing countries towards the US and the EU.

ones tended to stay put at their 1960 income levels while the open ones grew faster.138

The obsession with inequality in the advanced world

The question of inequality is the source of much confusion among well-meaning critics of the capitalist system. What I have described of the consequences of the free market up to this point is rather positive, I should say. But capitalism is a system that intellectuals love to hate, among salt-water economists, in Ivy League universities of the United States, in the Departments of English, Sociology and Economics of British Universities, not to mention most economists of Continental Europe.

An example of the myopia that affects some of the most distinguished social scientists is the book recently published by Angus Deaton (2013). This Princeton professor is a world famous demographer who has made the measurement of poverty one of his specialties. His new book shows him at his best, especially his use of clear graphs to elucidate complicated concepts and discover hidden realities. It is a story of how large swathes of humanity have escaped poverty, hunger, illness, premature death, and unjust discrimination—and how medical and economic progress is slowly pulling up the whole of mankind so that they can escape a life that is 'solitary, poor, nasty, brutish, and short'. The world is decidedly a better place to live in than it was in the past, and Deaton's analysis of why it is so and how we got here makes his book decidedly worth reading.

The subtitle however is bewildering: "Health, Wealth, and the Origins of Inequality". Why is inequality always to be deplored? Fair enough if he was dealing only with exploitation, of which there is still a great deal in the world, insofar as the powerful use politics to gain unfair advantages; but not if he is descrying the very force that is materially helping people to become more equal. "Today's global inequality was, to a large extent, created by the success of modern economic growth" (page 4); and the progress of medicine, he could have added, since it is "not just income, but health too" that is creating inequalities (page 6). Now comes a phrase that indicates a certain confusion of thought: "health inequalities are one of the great injustices of the world today" (page 7). If it is an injustice, what would be just? If it is an injustice, who is to blame? Medical advances cannot be extended immediately to everyone. I still remember that in my youth vitally needed antibiotics had to be purchased on the black market in Spain. It may be the rich who benefit first, but not always. Deaton himself admits that it would be absurd to stop the use of new medical knowledge until it was at the disposal of everyone. The idea that medical services should be free at the point of service, as they are in the United Kingdom, is not self-evidently good for the progress of good health.

138 Lucas uses the definition of openness of Sachs and Warner (1995): the country must show effective protection rates of less than 40%; less than 40% of imports must be limited by quotas; no controls or black markets in currency; no export marketing boards of the kind left in place in Africa by the colonial powers; and not be socialist of the East European type. Lucas (2009), page 3.

Under the influence of Amartya Sen, Deaton defines liberty in the broadest of terms, so that any obstacle to the full realization of individual capacities is an instance of oppression. Individual liberty is "the freedom to live a good life and to do the things that make life worth living". And he adds, thus unnecessarily stretching the meaning of liberty: "The absence of freedom is poverty, deprivation, and poor health". (page 2) Should wellbeing be seen as a part of individual freedom? I doubt it. It was Isaiah Berlin who in 1958 memorably said that liberty is to be free from coercion; and he added: "Liberty is liberty, not equality or fairness or justice or culture, or human happiness or a quiet conscience" (page 125)

I would not like to stop anyone from reading Deaton's last book, full of interesting thoughts and facts on the great escape of humanity from the clutches of poverty, but Deaton, apart from lamenting the persistence of some inequalities, does not make it quite clear when inequalities are to be welcome as being the stepping stones of progress.

The top one percent

The object of the present column is to show what the free market system, in as far as it is allowed to be free, has done for the poor of the world, from the point of view of income, welfare, and equality. When speaking of equality Deaton mainly and mercifully deals with the world as a whole. This leads him to a nuanced view of what the medical and industrial revolutions have done for the poor.

However, the fashion among people of the left in the United States, and in Europe, among the rich with bad consciences gathered in Davos, is of a different hue: they worry about what the market grants the rich and denies the middle classes. So despite anything the defenders of a better life for the poor may say, the topic of the day is spreading inequality.

Proof of this is the Summer 2013 number Journal of Economic Perspectives: it leads with a symposium on inequality inside the nations of the advanced world. That symposium is worth reading to get a feeling for the state of professional opinion among economists.

The articles fall into two camps. The more numerous is the side that demands political redistribution mainly through taxes to correct increasing inequality, especially in favor of the top one percent or top 0.1 percent of the population. The minority defends the distribution thrown up by the market as being acceptably efficient and just.

The interventionists not only point to the increasing income of the very rich but also to the stationary real income of the middle class and the lack of upward mobility, in the United States in particular. Their main argument is that it is unfair to see such a small group of 'privileged' people making good; that they really are rent-seekers favored by their political friends; that this inequality creates a danger of instability in advanced democracies; or even that it carries the seeds of the demise of the capitalist system. On this last point, there is a representation in the

symposium of the so-named 'School of Paris'. They maintain, in a Marxist fashion with a dash of Keynesianism, that the dynamics of capitalism condemn it to selfdestruction. The head of the school is Professor Thomas Piketty, who with the help of boundless erudition tries to show that under unregulated capitalism the return on capital tends to exceed the rate of economic growth and therefore leads to a reenter economy; and such an economy is condemned to stagnation and decay. The only solution is to tax the rich.139

On the side of those who write in defense of the large gains of the one percent we principally find Gregory Mankiw (2013). He does recount the striking evidence of the growing share of national income obtained by the top percent from 1973 to 2010. Some of it may be due to successful rent seeking, as Bivens and Mishel (2013) say happened in the financial sector. But, says Mankiw, "the key issue is the extent to which the high incomes of the top 1 percent reflect high productivity rather than some market imperfection" (page 35). He underlines the effect of digital technologies leveraging the talent of entertainment stars and service entrepreneurs in multiplying their gains.140 The difficulty of great numbers of the population adapting to new production systems or acquiring the necessary human capital to do well in them must also be part of the explanation; and the competition of the poor of the Third World is a fact but should be generously accepted.

A fitting conclusion to these polemics appeared in the Correspondence section of the December 2014 number of the same review: Robert Solow published a letter criticizing Mankiw, who replied rather sharply but with much good sense.

Conclusion

As long as the improvement of the situation of a member of a society is not at the cost of any other member, I do not in principle see any reason to complain or interfere. In any free society it is crucial to separate the vice of envy from the virtue of emulation.

139 See Alvaredo, Atkinson, Piketty and Saez (2013). Also of funereal interest is Branco Milanovic's (2013) review of Piketty's Capitalism in the 21st Century. 140 This is also the argument of Steve Kaplan and Joshua Rahu (2013).

Ideas Matter

May 5, 2014

Let me start on a personal note and ask myself the question, why have I given much of my life to dealing in ideas? I did at different moments play practical roles both in business and politics, but I somehow I drifted away. This is not an essay in sour grapes: I am happy that life led me into being an academic specializing in policy innovation. So let me put it another way. Why have I often found my engagement with ideas an obstacle to getting on with people who wanted my advice or my collaboration and did not get what they expected? It is as if my scruples made me difficult to accommodate. Well do I remember one of my kinder adversaries in Parliament telling my political friends on my side of the aisle: "Pedro is not dumb: it's simply that he has convictions".

Intellectuals who in Europe extol competition, descry big government, defend free trade, and criticize state subsidies are felt to be a nuisance: if one wants to be accepted as a thoughtful and agreeable companion one has to defend the national film industry in France or praise Mittbestimmung in Germany or love the euro in Brussels. Equally in the United States, one should not oppose lifting the debt ceiling every so many years to pay public salaries and veterans' pensions, on pain of being classified as some kind of Mad Hatter at an Alice in Wonderland Tea Party. As Friedrich A. Hayek said in an essay I will return to:141

There can be few more thankless tasks at present than the essential one of developing the philosophical foundations on which the further development of a free society must be based. ("The Intellectuals and Socialism," page 191)

The mystery is why those of us who defend the free market, the rule of law, private property, and the rights of minorities go on with our efforts when we seem to be so ineffectual? Milton Friedman used to say that the influence of pro-market economists on political decisions was only seen in times of crisis. For years, proposals of reform went unheeded. But when a crisis struck, politicians started looking around desperately for some kind of solution to the problems that baffled them. There was the opportunity to influence economic policy and break through the wall of interests.142

So the first question for anybody who believes in the importance of ideas is why our beliefs and proposals seem to have so little influence on governments, politicians, civil servants, lobbyists and trade representatives. We do not even seem to have business people on our side: speak to them of creating a pro-market intellectual climate of opinion and a quizzical look comes over their faces.

141 Hayek, Friedrich A. (1949): "The Intellectuals and Socialism", in Studies in Philosophy, Politics and Economics, Routledge and Kegan Paul, London, 1967. 142 This is what Acemoglu and Robinson (2012) call "critical junctures". The recent crisis may be one of those junctures: look at Martin Wolf of the Financial Times, that most Establishment of economic journalists, wanting to do away with bank money ("Strip Private Banks of their Power to Create Money", FT April 24, 2014).

Politicians are afraid they will lose votes if they apply the policies we recommend. Civil servants prefer their complicated interventions to making a clean sweep of gratuitous regulation. The egregious example is international trade: the overwhelming majority of economists defend free trade but protectionism in one form or another seems to be here to stay. A first question, then, is what keeps us going if a wall of interests thwarts all our efforts? How often will we have to trumpet our way round Jericho?

The second question is why ordinary voters close their minds to considering the long term progress of society and only care about how moves towards freer markets affect their immediate interests. Should one assume that they are ruled exclusively by their pocket-books? One of the main contributions of economics as a social science is the mileage one gets from explaining individual actions by personal interests. In the field of politics, public choice theory has clarified many questions starting from the assumption that voters try to maximize a narrow view of their utility, and so do politicians and civil servants, all under the constraint of their costs in terms of jobs, taxes, chances of re-election and bureau size.

There is a third and deeper question which may undercut the economist's pretense to authority. Are we not members of the species homo oeconomicus? Remember the famous passage by Adam Smith in The Wealth of Nations:

It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity, but to their self-love, and never talk to them of our own necessities but of their advantages. [Book I, Chapter 2, paragraph 2]

Do we serve our intellectual fare out of a regard to anything but our personal interest? The question is not an easy one to answer. There may be "a tension between doing well and doing good".143 Of course, scientific economists try to prosper by their pen. Those who have no faith in the market, having been

trained to think and to calculate, cannot understand why nobody offers them the possibility of ruling society or at least ruling the rulers. This leads some intellectuals to react in two ways: subservience to the powers that be or unrequited discontent. Many will tell the powerful only what they want to hear. Most will want to nibble and cavil at the market system. Are we of that crowd?

In sum and as regards the importance and influence of liberal144ideas on public policy, there are three questions to be answered.145 One, why do our ideas have so little influence on political practice; two, whether it is true that revealed preferences show ordinary people only too ready to consider their personal

143 Klein, David (1999): Introduction to What Do Economists Contribute, edited by D. Klein. Cato and New York University Press. Washington, page 2. 144 Note that since I write from Europe I give the words 'liberal' and 'liberalism' a different meaning from that in North America, where I would use 'libertarian' or 'conservative', depending on the context. 145 "Science aims at the stability of belief by cultivating doubt." Philbrook, Clarence. "'Realism' in Policy Espousal", American Economic Review, 43(5), December, 1953, pages 846-859.

interests only; and three, whether we economists are so keen on truth as we pretend to be and are not in fact ruled by our personal interests just like anyone else.

Originality in the search for truth

Let me start with the last of our three questions. There is little doubt that even the most incorruptible of us 'scribblers' (as John Maynard Keynes called us) is moved by the wish to prosper in his career and obtain the favor of his peers and the learned public. This may explain our eagerness to stake precedence in scientific discoveries. Even so philosophical a character as Adam Smith felt he had to write a note in 1755 in which he claimed with "honest and indignant warmth" his exclusive right to "his leading principles, both political and literary".146

However, one should remark that the interest in claiming to be the first in a field of research is ancillary to the discovery of truth. Originality of ideas matters because truth matters—on the understanding that truth in science is unattainable and functions as a regulating ideal.147 In some cases dedication to truth goes well beyond personal interest. At the risk of his peace, Galileo insisted in showing the moons of Jupiter through his new glass to skeptical cardinals of the Church, because he wanted to show them that those moons were truly there. A less dramatic instance of an intellectual not obeying his narrow self-interest is shown in F. A. Hayek's preface to The Road to Serfdom. Let me quote him in full.148

I am as certain as anyone can be that the beliefs set out in it are not determined by my personal interests. I can discover no reason why the kind of society which seems to me desirable should offer greater advantages to me than to the great majority of the people of this country. In fact, I am always told by my socialist colleagues that as an economist I should occupy a much more important position in the kind of society to which I am opposed—provided, of course, that I could bring myself to accept their views.

At bottom, what has moved these and many other scientists and economists is not so much a hankering after fame or a wish for martyrdom but a commitment to work well done and error undone.

Whence the power of rhetoric

It is a matter of observation that interests clothe their pleas in the language of ethics or patriotism to win over voters. If you propose a new tariff it has to be in the name of jobs for the unemployed. State education will be funded to increase equality of opportunity. Higher pensions will be proposed to save pensioners from

146 Stewart, Dugald (1793). "Account of the Life and Writings of Adam Smith LL.D. from the Transactions of the Royal Society of Edinburgh, in Biographical Memoir of Adam Smith. Augustus M. Kelley, New York, 1966, page 67. 147 Philbrook, page 846. 148 Hayek, Friedrich A. (1944): The Road to Serfdom. 1976 edition. Routledge and Kegan Paul. London.

poverty. Health insurance will be imposed in the name of fairness. When you double taxes on the rich it will be for equality or justice—rarely will a Chancellor say directly that he will "tax the rich until their pips squeak".149 Scribblers who blatantly teach their political pupils the art of deceit would have incurred the wrath that Socrates directed at the sophists.

In countries with a strong tradition of respect for freedom, ordinary people may be mistaken in their demands, but they are on the side of the angels. In an uncharacteristically disorganized paper, Karl Popper150 tried to define the limitations of public opinion:

[It] is very powerful. It may change governments, even non-democratic governments. Liberals ought to regards any such power with some degree of suspicion.

Public opinion, then, should not be implicitly trusted, for "truth is never manifest", not even to ordinary men and women in the street. Still it has to be respected. In countries with proper values,

... it is not so much the truth of an assertion or the wisdom of a proposal that is likely to win for a policy the support of public opinion, as is the feeling that injustice is being done which can and must be rectified. (Popper, page 349)

Public opinion is characterized by "moral sensitivity". On condition that ordinary people do not countenance their lower political passions,

... in spite of the limited information at their disposal, many simple men are often wiser than their governments; and if not wiser, then inspired by better or more generous intentions. (page 348)

So there may be occasions when cynicism is counterproductive and when for some unaccountable reason the rhetoric of truth and justice is de rigueur if one wants to make any headway in open political disputes.

Ideas and interests

John Maynard Keynes has been endlessly quoted on the influence of ideas in society.

[The] ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else.

149 Wrongly attributed to Denis Healey, Labour Chancellor of the Exchequer (Treasury Secretary) in 1976, but in the spirit of his policies. He was never allowed to forget the quote even though he never actually said it. 150 Popper, Karl (1954): "Public Opinion and Liberal Principles", in Conjectures and Refutations: The Growth of Scientific Knowledge. Routledge and Kegan Paul, London, 1963.

This pronouncement is too imprecise to be really useful and the explanation which followed was characteristically frivolous.

Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.151

I can agree, as will be seen, with his conclusion that "the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas". But by speaking of 'voices in the air' and 'madmen in authority', he is doing little favor to himself and the influence he would exert on generations of intellectuals and politicians. Also, I wonder if it is at all useful to think of politicians as mad, even when speaking of the bloodiest dictator, be he a Lenin, a Hitler or a Stalin: such men do what they think is best for themselves, given their views on how the world functions. Assuming their madness, one is deprived of the possibility of understanding their motives and devising ways to stop them in good time.

Joseph Schumpeter wrote about the role of intellectuals in capitalist society in even harsher terms than Keynes. He did so in a chapter in Capitalism, Socialism, and Democracy on "The sociology of the intellectual". We can expect intellectuals to form "groups to whose interest it is to work up and organize resentment, to nurse it, to voice it and to lead it". They are, he says, what the Duke of Wellington called "the scribbling set"—a curious coincidence of Keynes and Schumpeter using the same turn of phrase when speaking of intellectuals. These intellectuals write and speak without direct responsibility for practical affairs. The intellectual, Schumpeter could say as World War II was ending, has the paperback, the masscirculation newspaper, and "now, the radio" at his disposal. The finishing touch of his portrait of the scribbler was to see him as the product of an undue expansion of higher education: it created the large group of "unemployed or unsatisfactorily employed or unemployable" graduates, who "swell the host of intellectuals [...] in a thoroughly discontented frame of mind". And, adds Schumpeter, "this hostility increases, instead of diminishing with every achievement of capitalist evolution".152

Hayek is, I feel, somewhat richer and more interesting than Schumpeter or Keynes on the social role of 'intellectuals' (for good or for bad). As Wayne Leighton and Edward López point out in their fascinating new book, Madmen, Intellectuals, and Academic Scribblers153, Hayek distinguishes three different groups of people when he studies the influence of ideas: these are first discovered by the real scholars or experts; then, twisted and warped, they are diffused by the 'intellectuals'; finally, they are applied (properly or not) by businessmen and politicians. Two essays of

151 Keynes, John Maynard. The General Theory of Employment, Interest, and Money. 1965. Harcourt, Brace, and World, chapter 24. 152 Schumpeter, Joseph A. (1943): Capitalism, Socialism and Democracy. Fifth edition, 1976. George Allen and Unwin. London, pages 150-153. 153 Leighton, Wayne and López, Edward J. (2013): Madmen, Intellectuals, and Academic Scribblers: the Economic Engine of Political Change. Stanford University Press, Stanford.

Hayek's touch on this question: "The Intellectuals and Socialism" and "The Transmission of the Ideals of Economic Freedom"154. The first of these is downbeat and pessimistic. He there separates the contribution of the original thinker or the true expert from that of the 'intellectual', whose usual inclination towards socialism or protectionism he laments. The typical intellectual need be neither an original thinker nor a scholar or expert in a particular field of thought: "he need not possess special knowledge of anything in particular, nor need he even be particularly intelligent, to perform his role as intermediary in the spreading

of ideas". ("The Intellectuals and Socialism," page 179) With few exceptions, these vulgarizers follow the latest intellectual fashion, for instance, the fashion of equality, which sets beyond criticism any measure promoting it. Further, Hayek complains that practical men will listen to little else.

[T]he main task of those who believe in the basic principles of the capitalist system must frequently be to defend this system against the capitalists. (page 192)

Though one must remember that that this essay was written in 1949, when liberal ideas were at low ebb, its tone may strike one as despairing in excess. The second essay is more hopeful. In it Hayek traces the story of the survival of liberal ideas in Europe in the interwar years and during and after World War II—surprisingly in Germany under Hitler or by thinkers having fled the Nazi and Communist menace for England or the United States. For those of us who are familiar with the history of the Mont Pèlerin Society, Hayek is in fact recounting what led him to found the Society in 1947 and how he helped rescue a distinguished band of original thinkers and specialists from loneliness and how successful that group was in passing on the torch of freedom to younger generations. On reading the list of some of its founders,155 one may think that these scholars did win some of the battles of ideas and thus have had more influence than could be foreseen in 1947.156

Modeling the influence of ideas

Professor Dani Rodrik of Princeton's Institute for Advanced Studies has just published an essay in the Journal of Economic Perspectives (2014) whose title concerns precisely the problem in hand: "When Ideas Trump Interests"157. He makes two crucial points: (1) that ideas and ideologies seem to be absent from current political economy models; and (2) that ideas observably influence policy decisions much more than is believed. What is usually forgotten, he adds, is that the pursuit of interests is mediated by the views held by the different actors on: (a) what they are maximizing; (b) their beliefs on how the world and society function;

154 Hayek, Friedrich A. (1951): "The Transmission of the Ideals of Economic Freedom", in Studies in Philosophy, Politics and Economics, Ch. 13. Routledge and Kegan Paul, London, 1967. 155 Participants at this first meeting included Hayek, Milton Friedman, Maurice Allais, Henry Hazlitt, Bertrand de Jouvenel, Frank Knight, Fritz Machlup, Ludwig von Mises, Michael Polanyi, Karl Popper, Leonard Read, Lionel Robbins, Wilhelm Roepke, and George Stigler. 156 Hartwell, Max (1995): A History of the Mont Pelerin Society. Liberty Fund. Indianapolis, pages 40- 46. 157 Rodrik, Dani (2014): "When Ideas Trump Interests: Preferences, Worldviews, and Policy Innovations". Journal of Economic Perspectives, 28(1) Winter, pages 189-208.

and (c) what means they have to achieve their ends. All three are relevant for us scribblers because on all three can we say something with effect.

As to the (a) aims to be maximized, we should analyze those other objects of political endeavor beside pecuniary interest, such as honor, glory, reputation, respect, wealth, power, durability in office, and the good of the country. They can be especially relevant in political economy. Rodrik adds a telling phrase: "... this is a point that should not be controversial in an age of suicide bombings". (Rodrik, page 191)

Of greater importance or perhaps more susceptible to influence by applied economists are the other two. As regards (b) the beliefs, wrong views about the functioning of society harbored by the powerful are

difficult to unmake, since reality and the models thereof are ambiguous: Rodrik underlines the conflicting interpretations of the 2007-2010 Great Recession by new-Keynesians and Austrian Schoolmen, with no clear way to decide between them: the first demanding more regulation, the latter blaming public interventionism. However, from time to time the consequences of interested action are so clearly counterproductive that critics may finally be heard by the powerful. An outstanding instance is how 'stagflation' in the 1970s contributed to the demise of folk-Keynesianism at the hand of the 'monetarists'. Another has been the effect on hard-left economists of the evidence of the true nature of the Soviet empire after the Berlin Wall was pulled down.

However, the immediate possibility for political economists of the reformist kind to influence reality is (c), to supply new ideas and methods that will help society sidestep seemingly insurmountable obstacles to reaching the economic possibility frontier. Their function would be to explain and correct inefficient policy options. This is what Rodrik calls "ideas as policy innovation", which he sees as parallel to technological innovations routinely included in microeconomic models. "New ideas about what can be done—innovative policies—can unlock what otherwise might seem like the iron grip of vested interests." (page 194)

Even attaining ends that favor some without harming the rest can encounter resistance in a world where people care about unequal distribution. And when there are losers, there may be no fiscal instrument at hand to compensate them. At worst, in a democracy, the case for reform must be so convincing that force can be applied legally. I am thinking of Lady Thatcher's trade union reform and her fight with the coal miners. The better way is political entrepreneurship. Leighton and López give a number of instances when ingenious reforms helped break the deadlock: Ronald Coase's 1959 piece which led the FCC to auction spectrum license from 1994; President Carter's airline deregulation in 1995, under the inspiration of Alfred Kahn; or Clinton's 1996 Workfare Act, pushed by Newt Gingrich.

Think tanks

In the history of the diffusion of ideas the 'think tank' is a new development. It has come to complete the work of the university departments, of quasi-universities like the Hoover Institution or the National Bureau of Economic Research (NBER), of the unaffiliated essayist, the specialized review or magazine, the research department of a central or private bank, the aides of members of Congress, or the study groups of political parties. Whatever the political affiliation of the think tank, if any, its business is institutional innovation, i.e., presenting new practical ideas to make social and economic change possible by taking a shortcut round the thicket of entrenched interests. I remember Edwin Feulner, the successful begetter of the Heritage Foundation, explaining the need for organizers to apply the lessons of the great thinkers in practice—he compared them with engineers applying scientific theories. Think tanks are ideas factories whose inputs are the thoughts of economists and political philosophers and whose outputs are new ingenious devices to sidestep obstacles. The reason for the success and spread of the think tank is that wealth enhancing policies often need the right vehicle to get an effective coalition on board.

The voice of the people The worst case is when the rent-profiting elites feel they may be in danger of losing power if the economy is made more efficient. Here Rodrik reminds us of two different effects: "the goose that lays the golden eggs effect" and the "the replacement effect". The first one alludes to a situation when the elites are happy with the country undergoing a period of growth, for that allows them to extract more for themselves.

Elites behave here like Mancur Olson's (1993) "stationary bandits," brigands who stay long enough with the farmers from whom they steal that they have an incentive to encourage a degree of prosperity. (Rodrik, page 198)

The "replacement effect" has been analyzed in Acemoglu and Robinson18. Elites fear that making the ruled more prosperous will make them restive and so makes them resist innovation and progress, as they did in pre-revolutionary France or in Metternich's Austria.

The 'replacement' issue may solved by a revolution. There are many instances in history when the scribblers prepared or started one, as in America in 1776 or in France in 1789, with harsh results in the short run but a clear improvement in economic productivity thereafter158. There also are instances when the revolution made matters much worse, as happened in Russia after 1917. The pen can be mightier than we think!

As Rodrik underlines, the right sort of institutions to help with the undoing of special interests are mainly to be found in democracies, with the rivalry of political parties, the possibility of exercising opposition, the organization of trade unions, and the existence of an independent judiciary. (page 198) These encompassing

158 Acemoglu, Daron and Robinson, James A. (2012): Why Nations Fail: the Origins of Power, Prosperity, and Poverty. Crown Publishers, New York, chapter 10.

institutions have helped to overcome the obstacles built by ancien régime ruling elites.

However, democracy does not guarantee that new coalitions of rent-seekers are not formed. One must not assume that majorities will not abuse their powers or indeed that those majorities will not go down dead ends. And the worst kind of political failure comes from voters who, by ignoring opportunity costs, contrive to disappoint their own expectations.

Political Failure by Agreement

The evident preference for the welfare state shown by a majority of voters in democracies poses a substantive problem for defenders of democracy. Political representatives are caught in a prisoners' dilemma: they dare not reduce or abandon unsustainable entitlements for fear of handing government to their rivals and seeing them undo their reforms when they are in power. To escape the dilemma, an agreement might be reached to change the Constitution, as the result of a sort of repeated prisoners' dilemma, after the players have been dealt harsh lessons by reality. These reforms can be formal, such as changes in the electoral system, or substantial, such as forbidding budget deficits and setting a maximum to public spending. Electoral arrangements do make a difference, as in Switzerland where decentralization and referenda have on the whole resulted in less intrusive public policies. But would people in other nations when they saw their entitlements constrained vote for such a liberal Constitution or once approved, refrain from watering it down? The preference for the welfare state is ingrained even in Switzerland. And not even Lady Thatcher dared touch Britain's National Health Service when she was Prime Minister. The Great Recession has led to some cuts being imposed in western countries but they have been justified by the need to 'make the welfare state sustainable' and the general feeling is that the cuts are provisional. As Gerhard Wegner159 says, this is "Political failure by agreement".

Abstract reasoning by itself will not move or convince the majority who, even in the United States, show a preference for welfare policies. Imposing free market rules over an unwilling people would be liberal paternalism—a contradiction in terms. People have to be convinced that there is a better way before we can

expect a change in social policies. Here is an opportunity for helping ideas prevail over interests.To find ways out of this kind of deadlock, Wegner draws an interesting distinction between preferences, which change very slowly if at all, and choices, which will be constrained by the experience of unexpected consequences. In a democracy, many people will harbor preferences for an expansive state. Thus conservative clerics and sentimental socialists will say that the market is ruled by money, that it treats human beings as merchandise and it therefore is immoral. But these and other preferences may turn out to impose huge costs when applied. In few words, the welfare state may prove inimical to growth. In that case, voters may not be able to choose the policies they prefer because they do not work. The role of us dealers in ideas, then, is to discover and denounce the contradictions of

159 Wegner, Gerhard (2008): Political Failure by Agreement: Learning Liberalism and the Welfare State. Edward Elgar. Cheltenham.

collectivist arrangements, explain how things would work if left to the free market, and suggest ways to move from constructivism to spontaneous order.

Unfortunately these kinds of lessons take time to be learnt. As Hayek stressed, we live in a radically uncertain world. Societies and their institutions will evolve in unpredictable ways. Hence, the effects of public interventions and the consequences of freeing markets may not be foreseeable in detail. In that case, "citizens will not instantaneously become confronted with the loss of private autonomy which results the enlargement of public activities".160Scholars will only be able to describe in general terms what will happen if an economy is planned or if the welfare state continues to expand. It took from 1920 to 1989 for the failure of central planning to become evident.161 And the effect of the welfare state on civilization, forewarned by Hayek in 1944, is still not fully deployed.

Though the great scholars may have warned of the consequences of contradictory or unworkable preferences, a task is now laid out for us the intermediaries in the application of ideas: to discover and suggest ways to move society nearer an economic optimum. We can criticize ideologies by pointing out the opportunity costs of political preferences and propose alternative solutions to actual failures of the political market.

Political innovators may even have an effect on the basic political preferences of citizens.

An additional part of political learning concerns the revision of preferences after individuals as political agents ascertain that policies have failed to put their preferences into practice. (Wegner, page 74)

In that way, democracy can be bettered and liberalism learnt.

In conclusion

We dealers in the ideas of liberty and the free market must not quite despair. There are reasons why we may think that interests have the upper hand: economists appear to be governed by personal interest; ordinary people, especially when they vote, seem to think only of their personal interests; and when we look at politics it seems that liberal thinkers and intellectuals wield very little influence.

Despite this pessimistic view of the usefulness of our work we can go much further than Keynes did with his famous phrase, "madmen in authority hear the voices of some academic scribbler in the air". What scholars say may be nearer the truth than well intentioned people imagine; interests are not so easy to define. Politicians and voters are often unsure of what they are maximizing. Their ideas about how the world functions may be wrong. They must discover what means they have to

160 See chapter 5 of Wegner (2008): "Learning liberalism in the Welfare State". 161 Oskar Lange (1936-7) and Abba Lerner (1938) twisted economic theory to show that Mises and Hayek by their criticism had in fact helped to make centralized planning workable. The reality of the Soviet economy proved spectacularly wrong.

further their interests. On all these points the help of thinkers and intellectuals is needed and could be for good.

The defenders of the ideas of liberty and free markets then have two different roles to play. Scholars and specialists will review and criticize ideologies in general terms. Given the point from where the founders in Mont Pèlerin started in 1947, we should stop being despondent about the effect of our philosophy on present day society. But social life is shot through with uncertainty: to be able to speak to citizens who unknowingly vote against their interests we must study the unintended consequences of political decisions and propose alternative solutions and institutions. With this kind of detailed work we shall be able to go on working for the good of our fellow men.

Pikkety Fever

June 5, 2014

Thomas Piketty has intentionally given his latest book the title of Capital in the 21st Century,162 echoing that of Karl Marx's Das Capital.163 It has caught the attention of American liberals as no other economic book since John Kenneth Galbraith's historical effusions. Also, as anything the American left enthuses about is sure to be eagerly picked up by European socialists, Piketty is now all the rage this side of the Atlantic. Paul Krugman has helped with his fervid plug of the tome in the New York Review of Books,164 now reproduced by high circulation newspapers, such as Le Monde in Paris and El País in Madrid. The "Piketty tsunami", as Martin Wolf of the Financial Times has called it, will not recede soon. The book is attractively written, with an abundance of historical and literary references that leaven its lengthy pages. Its very physical weight gives it authority. The statistical apparatus enshrined in its tables and graphs adorns it with a scientific aura. Its watered down Marxism chimes in well with egalitarians of all hues in the developed world. Despite some Piketty fatigue having set in, the book deserves serious examination as its arguments will be an essential part of the armory of left-leaning liberals and anti-market conservatives both in America and in Europe for a long time to come.

Professor Piketty is no newcomer to the economics profession. After obtaining a doctorate in Paris at the age of twenty-two with an abstract mathematical thesis, he was hired by MIT, where he taught for three years. MIT disappointed him. He found the "childish passion for mathematics and purely theoretical speculation" off-putting and dreamed only of coming back to Paris to work in the tradition of the great sociological and historical intellectuals such as Braudel, Levy-Strauss, and Godelier. He may have been unjust in overlooking the practical bent of economists in the United States; to be sure, if he had gone to Chicago or Madison he would have seen economics applied to real problems in society. However, his interests lay elsewhere, in the great questions of "the historical dynamics of the distribution of wealth and the structure of social classes". Here one sees the longa manus of Marx in the universities of continental Europe. The young Piketty took that hand after it had been roughly manicured by history: at the age of eighteen he "belonged to that generation who came of age hearing of the fall of the Berlin Wall over the radio". Marxism was not infallible but always remained an inspiration.

Back in France, he applied himself to gathering and interpreting the facts and statistics on the distribution of income and wealth. The French government helped him start the Paris School of Economics. With the backing of a bevy of research

162 Thomas Piketty, Capital in the 21st Century. Belknap Press, 2014. 163 Karl Marx, Capital: A Critique of Political Economy, Vol. I. The Process of Capitalist Production, Charles H. Kerr and Co., 1906. [Available online at: http://www.econlib.org/library/YPDBooks/Marx/mrxCpA.html.] 164 Paul Krugman, "Why We're in a New Gilded Age," in The New York Review of Books. May 8, 2014. [Available online at: http://www.nybooks.com/articles/archives/2014/may/08/thomaspiketty-new-gilded-age/.]

assistants and in collaboration with economists in his country and also in Britain, Italy and America, he started to write on the need to correct income inequalities and to redistribute riches. The attention and ingenuity he has applied to teasing out the realities of economic inequality from hidden data deserves strong praise. One of the distinguishing characteristics of Piketty's research is that he is not content with observing income inequalities but has added a new dimension to social studies: the collection of previously overlooked data about heritage and patrimony. His first publication was in 1994, precisely on redistribution. In 2007 and 2010 Oxford University Press published two joint efforts of his dealing with the evolution of top incomes. In 2010 the School of Economics of Paris published his On the Long-Run Evolution of Inheritance, 1820-2050. Notice the long span of this study, an indication of his ambition and laboriousness, for he prized open previously ignored notary and estate tax records to try and give a true picture of this important element of social differences. I was certainly interested when I first read him in the Journal of Economic Perspectives of the summer 2013, for my previous Econlib column on "Poverty and Equality".165 Little did I know that I would have to come back to Piketty so soon!

I have read the book that has so shaken the English speaking world in its original French. I am told the English translation is excellent, but I wanted to see how agile and seductive Piketty is in his mother tongue. He is both. Here we have a worthy rival of classical liberalism.

Finders keepers

The first thing to note is a quotation from the 1789 "Declaration of Rights of Man and the Citizen" on the frontispiece of the book: "Social distinctions can only be based on common utility". This principle is generally misunderstood. What the French Revolutionists meant is that legal privileges, such as those of aristocrats or churchmen of that time, should be abolished, so that people would be equal before the law. But the way they worded it has induced later egalitarians such as Piketty to demand that wealth should accrue only to those who have striven for it. Being well-off by inheritance through no merit of the lucky person is seen as wrong, as not derived from useful service to society by the legatee and quite unrelated with merit. This has led egalitarians to suspend the principle of equality before the law by forcibly taking from the well-off to give to the poor.

The question is, should we base the right of private property on labor, as John Locke argued? Locke's justification of property is incomplete. Much of what the self-made man or woman has put into his endeavors is inherited, such as innate intelligence, will-power, beauty, strength or sheer luck—and in the United States the right to resources underground. An egalitarian could say that such windfalls are undeserved and therefore belong to 'society', whose caretaker is the government. Governments always attempt to take away such unearned elements of fortune with taxes on income or property, but the

essential question is who has the ultimate right to these assets. John Stuart Mill found himself in a quandary when

165 "Poverty and Inequality," by Pedro Schwartz. Library of Economics and Liberty, Apr. 7, 2014. [Available online at: http://www.econlib.org/library/Columns/y2014/Schwartzpoverty.html.]

trying to apply the justification by labor to bequest. The person of fortune should be able to leave her accumulated wealth to whoever she wanted, thought Mill; but, as he saw the good luck of the legatee as unfair, he proposed to limit the amount that any single person should be able to receive by bequest.

These questions pose themselves with urgency at present, for example, in the fracking industry. In some states in America, the owner of the land is free to contract the exploitation of locked up gas and oil underground because the underground is his. This explains the vibrancy of innovation in this new gold rush in Texas or Oklahoma, in contrast with other states, such as California and New York, or locations in Europe, where the right to fracking is suspended by mere precaution or where the underground is deemed to belong to the government.

The right of property should be vested on the first occupant or subsequent acquirer by lawful transmission or contract with no interference or eminent domain by the State. This is the principle of "finders keepers", which young children apply instinctively. However, Locke saw this as unfair in a fully cultivated Earth: would there be any land left to occupy? The crucial answer is that, in a progressive society where new products and services are invented or 'found' all the time, the property should devolve on the inventor, who should be able to exploit the new asset, though not with a monopolistic patent in the case of ideas.166

Success in an open economy comes from serving the public, not from hard work or personal virtue. Egalitarians see inherited fortune as unjust. Many also criticize large salaries and generous bonuses as 'obscene', especially when people who receive them are not sportsmen or famous actresses but are occupied in mysterious and underhanded activities such as banking or speculation. Their basic principle is wrong or at least woefully incomplete.

The future inequality

What I have noted about the convenience of the 'finders keepers' principle for progressive societies goes to the heart of Piketty's thesis. He does not see the twoway connection between the accumulation of wealth and the reward of labor, on the one hand, and economic growth and development on the other. In other words, he has no theory of growth. He is content with extrapolating negative trends— often only very recent trends. Not having a theory of growth is a surprising deficiency in such a passionate egalitarian, who above all should concentrate on discovering ways to make the progress of the poor sustainable.

Piketty mentions two factors that lead him to predict an increase in inequality of wealth and incomes in the 21st century: weak demography and stalling production. First, he stresses that when families have many offspring, there will be more children to partake in the assets bequeathed by the previous generation and so less

166 The American Constitution makes a clear distinction between property in material things and rights to ideas. Article 8: "To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." Notice the clause "for a limited time".

concentration of property. But fertility, notes Piketty, seems to be on the way down all round the world. The United Nations is even predicting negative population growth around the end of the present century.

He concludes that inherited wealth will therefore increase its weight in determining the class structure of society.

Second, Piketty takes it as given that the rate of growth of the world economy will slowly subside as the century proceeds. The reasonable way in which he puts this is a revealing example of his beguiling rhetoric. After observing that the per capita rate of growth of world production went up from 0.1% in the 17th century to 2.5% in the middle of the 20th (as summarized in his table 2.5), he contends that such a rate cannot be sustained. He is not a person to exaggerate his forebodings, though. His next step is to discount a forecast by Robert Gordon167 of a 0.5% rate of growth for the second half of the present century as too pessimistic: Piketty predicts a growth rate in the region of 1% to 1.5%. He adds that such a rate of growth, though apparently small, is a compound rate and therefore a huge force for social change. His conclusion, however, is carefully downbeat and ends with a question mark: "the end of growth?" Though he willingly admits that he cannot predict the future with any certainty, he still forecasts that, as population and production will probably stall, the wealth of the upper reaches of society (or classes, as he calls them) will grow both absolutely and relatively. Q.E.D.

Piketty□s laws of capitalism

Why all this should be so, Piketty explains with his "three laws of capitalism". Calling them 'laws' is disingenuous, because at bottom they are only accounting tautologies. Tautologies tell us nothing about reality. They simply define the meaning of words and as such assist us in organizing our discourse, but they cannot help us predict or refute our predictions about the world. However, for people who hanker after certainty, they create a comforting feeling of inevitability, since they bear no connection with observations of fact. They are 'true' by their logical form. Let me now explain these so-called laws, as they are an essential part of the hocuspocus of Piketty.

The first of these □laws□ is:

(1) □ = r · □

where α is the share of total income accrued by the owners of capital out of total national income and r the return on capital. The second of these 'laws' is:

(2) □ = s / g

where s is the rate of savings and g the rate of growth of the economy. Let us see what these first two steps mean, starting with (2).

167 Robert J. Gordon, "Is US economic growth over? Faltering innovation confronts the six headwinds". NBER Working Paper no. 18315, August, 2012. [Available online at: http://www.nber.org/papers/w18315.pdf.]

β is simply a symbol for the proportion of savings over growth. If in (2) savings are very high compared to the rate of economic growth, this will make β very large. Going back to (1), if a large β is multiplied by a high r, or rate of return on capital, then large savings multiplied by a high rate of return will give you a very large α and capitalist fat cats will grow ever fatter.

This is why Piketty needs a high β to clinch his prediction for capitalism in the 21st century. He needs the numerator of (2) on the right-hand side to be consistently larger than the denominator. He needs the inequality in (3) to hold. This is his third 'law':

(3) r > g

To wit, that for long stretches in history and certainly for the coming century, the rate of return on capital will in all probability be greater than the rate of growth. This third law is his principal 'law' of capitalism. To get his results, Piketty needs savings to grow a little more quickly than growth.

For Piketty (per capita) growth is not brought about by increasing returns from globalization, investment in physical and human capital, new discoveries, or better institutions. It follows on the diminishing returns of faltering population expansion and dead-end technology. If both of these lose speed, growth, which started to reduce after 1970, will follow the same diminishing trend during the present century. As we have seen, he does predict that g, the denominator in (2), will only be in the region of 1 to 1.5%. Piketty also needs r in (1), the rate of return on capital, to be large, so that α, the share of capital in GDP, will displace the share of labor. Does he give any economic reason why r would be consistently large in the 21st century? He does not, that I can see.

For him savings, or the accumulation of capital, are determined by social institutions and not governed by economic incentives. The large salaries of the managers of public companies are the result of collusion among company directors. The fortunes inherited and capital gains obtained by the upper one per cent or five per cent of the population are due to the wealth that the previous generation could not help accumulating over their lifetime. Also, the larger the return on capital r at a given time, the greater the amount that is bequeathed to the following generation, says Piketty after looking at the statistics of mid-19th century and present-day United States and United Kingdom data. No economic explanation is given for this irrational bent to look after the welfare of the next generation. The final conclusion of this analysis is that capitalist societies will become ever more unequal and more fractured. The only remedy is to do what Piketty told the Socialist Party of France to propose in the previous two general elections: a marginal rate of income tax of 85% and confiscatory taxes on inheritance.

No theory of population, of life-time consumption, or growth

To be able to say something about this predicted increase in inequality in 21st century capitalism, Piketty needs to be sure that world population will stabilize or even start to reduce, and that savings and the accumulation of capital will become less and less productive.

What Piketty says about the effect of weak demography on economic growth is really beside the point when the problem is per capita income, unless you have a theory to show that population density by itself fosters growth. As somebody with aspirations to be a social scientist, Piketty should propose (and falsify or verify) a hypothesis or model about the relationship between population and growth, not simply posit that population growth per se is a cause of economic growth and the lack of it, of economic decline. With the right sort of institutional arrangements, a stable number of people who live longer and live in cities can enjoy growing wealth and welfare.

Similarly, Piketty's assertion that the greater wealth of a country will lead the rich to leave larger and larger bequests needs to be backed by a refutation of the established theory of saving and consumption: by a rejection of the theory that, when acting rationally, individuals and families one with another will tend to increase their debts when young, accumulate wealth in middle age and, in retirement, spend the greater part of what they saved. Milton Friedman's The Theory of the Consumption Function (1957), for example, shows that there is no necessary connection between the rate of return on capital being greater than the rate

of growth of the economy, on the one hand, and inherited wealth growing apace, on the other. The two may coincide or not.168

Piketty cannot be content with basing his prediction of a fall in the rate of economic growth simply on observation of recent trends. One needs to present a theory or model of economic growth and to try to falsify it if with the kind of data Piketty so sedulously collects. Proximate causes such as physical capital accumulation and technological advance are not enough to explain growth. And even among these proximate causes, Piketty astonishingly discards human capital. "When we speak of capital we exclude human capital". Why does he take such a controversial step? Because for him, capital is only the sum of assets that can be purchased in the market, such as stocks and shares and real estate and does not include assets without a quoted price: only the capital value of slaves can be included in the stock of capital of a capitalist economy.169 However, in a footnote of chapter one on "Income and Output" Piketty does admit that it has been well known since the fifties and sixties that physical capital only explains a small part of the long term increase in productivity and that the essential part of this increase comes from the accumulation of human capital and new knowledge. This idea of defining capital only as something that can be owned by capitalists after having been extracted or

168 This is also a result reached by Modigliani, F. and Brumberg, R. (1954): "Utility and the Consumption Function". As Sala-i-Martin rightly notes in "Piketty y 'Capital en el Siglo XXI'", the fact that r > g in a given society does not imply that inherited wealth increases in that society, because inherited wealth could be zero in such a society. 169 Piketty, "What is capital" in Chapter 1 on "Income and Output".

expropriated from workers is an indication of how deeply the threads Piketty's thought are dyed Marxist red.

A theory of growth must not only pay attention to proximate causes of growth, such as physical and human capital accumulation, technological progress, international trade, and globalization, but also to fundamental causes of development. One must model these different factors and change the weights of each in the model to explain the different paths followed by nations in their progress or lack of it: lucky or unlucky coincidences in history; geographic differences and natural resources; laws, regulations, and institutions that frame individual and collective action; cultural and religious differences.170 All these cannot be subsumed under simplified Marxist 'modes of production' governed by physical capital.

Piketty takes refuge in the fact that he has accumulated a huge quantity of data, some from sources previously ignored by the profession. A number of critics have concentrated on checking his figures and correcting statistical mistakes. All this is well taken. However, the central criticism of his book and previous writings is that he seems to move around his evidence like a headless chicken. No reliable results can come of induction without theory.

Krugman's backhanded compliments

This is why Paul Krugman, despite the enthusiasm of his review, gives a nuanced view of Piketty's achievement. Over the long run, says Krugman, "the stock of capital and total income must grow at roughly the same rate". He adds that one side or the other can pull ahead for decades at a time. To translate Krugman's remark into Piketty's notation s = g, the secular rate of return r must go hand in hand with the secular rate of growth g although r can be larger than g for quite long periods. Krugman adds:

Just about all economic models tell us that if g falls—which it has since 1970, a decline that is likely to continue due to slower growth in the working-age population and slower technological progress—r will fall too. But Piketty asserts that r will fall less than g.

Now, watch Krugman's next step:

This doesn't have to be true. However, if it's sufficiently easy to replace workers with machines [...], slow growth, and the resulting rise in the ratio of capital to income, will indeed widen the gap between r and g. And Piketty argues that this is what the historical record shows will happen.

A wonderful Krugman contortion! So many questions are left hanging in the air. Is there a watertight causal connection between savings and the return on capital? Piketty does not say. What part of saving goes into productive investment? For

170 Daron Acemoglu. An Introduction to Modern Economic Growth. Oxford and Princeton, 2009.

Piketty, most of it is poured into speculation and real estate. Why does the secular rate of growth tend to fall more than the return on capital? Because that was the case in mid-19th century and what has been happening again from around 1970. It is all induction without theory.

Marx's laws of capitalism

Marx is ever present in Piketty's book and at the Paris School of Economics but in a suitably modified form to take account of the failure of the predictions of Das Kapital. Piketty admits that Marx's prophesies did not quite pan out. The Marxian model was mechanical in a way that Piketty is careful to avoid. For Marx, the return on capital is inversely proportional to the quantity of fixed capital per worker. Since in Das Kapital the productivity of capital inexorably diminishes with the years because technology does not progress, the only way out for the besieged capitalists is to go on increasing fixed investment and taking over failed rivals. But capitalists cannot avoid increasing the amount of fixed capital per worker, since that is the only way they have to increase their gross profits. The result of such infinite accumulation is that the rate of profits falls to zero or thereabouts and the capitalist system implodes.

Piketty puts it in his own softer terms and does not present his trends as the inevitable laws they were in Das Kapital. If we take formula (2) $\beta = s / g$, Marx assumed g to be zero or near zero. In that case, β tended to infinity. If that was so, despite r tending to zero, α, the share of capital in national income in (1) was bound to grow until capitalists engrossed the whole of GDP (leaving only the bare minimum to allow workers to keep their number constant, one with another). Revolution would then follow.

Piketty is thoughtful enough to say that growth will be positive in the 21st century, but he adds that g unfortunately will grow more slowly than r the return on investment. So the death of capitalism would come from a thousand cuts rather than sudden revolution. Piketty does believe that technological advance will be weak. Or if it is not weak it will be embodied in robots that will make the economy infinitely capitalistic and totally displace flesh and bone proles. He mercifully tells us not to despair, since capitalism can be saved by reducing capital investment with the help of hefty taxes on inheritance and high marginal income tax rates.171

Absolute poverty and relative inequality

I started by noting that Piketty made a philosophical mistake when he justified private property on the basis of merit. A second fundamental mistake of his comes from not distinguishing between absolute and relative poverty and from thinking that it is enough to show that inequality increases within countries. His data on the relative increase of wealth of the top 1% or 5% of the population in advanced countries are no doubt interesting, though some have been disputed. But he simply

171 These are the kinds of proposals Marx and Engels made at the end of The Communist Manifesto (1848). See Piketty's section "Returning to Marx and the tendency of the rate of profit to fall" in chapter 6 and Part IV of the book, on "How to regulate capital in the 21st century".

does not deal with the fact that poverty and inequality in the world have been falling steeply since 1970. I know he trusts the figures he has laboriously teased out from income an inheritance tax statistics. But why does he say nothing about the work and conclusions of the many economists, in different universities and within the United Nations, who have reached conclusions on poverty and inequality diametrically opposed to those of his group?

At this point I would ask my readers to go back to my column on "Poverty and Inequality", written before I had even heard of Capitalism in the 21st Century. As regards poverty head-count, the fall has been such that the Millennium Development Goal, proclaimed by the United Nations in 1990, of "halving the proportion of people with an income level below $1/day between 1990 and 2015", had been achieved by 2012. This wondrous development must be mainly attributed to the typical capitalist phenomena of globalization and increased international trade to which Piketty gives only cursory attention.

Insufficient though such an achievement is, everyone must admit it is most welcome. Economists outside the UN have independently corroborated the Millennium results: Pinkovskiy and Sala-i-Martin172 calculate that, from 1970 to 2006 the number of people consuming less than $2 has been reduced by millions. Given that in those years world population increased by some 2.88 billion and that the number of poor should have increased because it is the poor who tend to have many children, that reduction in poverty must be proclaimed as hugely significant. It is welcome on its own terms, as signifying that fewer people suffer extreme poverty. And it is welcome in terms of equality, since such a reduction in the number of poor must have alleviated inequality at the bottom end of the scale—the most telling part from the point of view of the welfare of humanity.173 Should we really be worrying about a temporary increase in inequality in the wealthy United States when capitalism is showing itself capable or reducing poverty at such speed?

Pinkovskiy and Sala-i-Martin in their Appendix measure inequality with a number of indices, not only the Gini coefficient favored by them, but also different Atkinson Equality Indices and the Sen Welfare Index. All these show a clear reduction of inequality in the world as a whole and in its different regions. True, they also note some increase in inequality within richer parts of the world, especially in the 1990s, an increase to which they lend much less importance than Piketty.174

172 Maxim Pinkovskiy and Xavier Sala-i-Martin, "Parametric Estimations of the World Distribution of Incomes," NBER Working Paper No. 15433, October 2009. [Available online at: http://www.nber.org/papers/w15433.] 173 See Pinkovskiy and Sala-i-Martin (2009), page 38 for the empirical results of their paper. Piketty should have something to say on the effect of such steep falls in poverty on inequality in the world as a whole." Global income inequality has fallen between 1970 and 2006. This is true for the Gini coefficient, for a wide variety of Atkinson indexes and General Entropy

indexes as well as the 90th-to-10th and the 75th-to-25th percentile ratios." 174 This, they say, has given rise to the feeling that the degree of inequality has increased the wealthier countries. They attribute it to a diversification within the middle class in the richer part of the world, more than offset by the rise of the middle class in China and India. Pinkovskiy and Sala-i-Martin (2009), pg. 26.

Piketty's book woefully incomplete

The people who care for equality more than for competition, who worry about relative poverty more than about absolute destitution will no doubt go on looking askance at capitalism. But they should not overlook facts that run contrary to their expectations. We need to know who is right and to what degree. Piketty, faced with such empirical results as those of the Millennium Development Program and the many papers coming to contrary conclusions from his on poverty and equality, should show the "comitas eruditorum" he has in such abundance and help us make progress in the study of the relief of world poverty and the increase of freedom of opportunity for the whole of Humanity.

The Conundrum of Crowned Democracies

August 4, 2014

Spain is still dumb with surprise. Last June 2, King Juan Carlos I, after eighteen and a half years on the throne, unexpectedly announced he would step down. His abdication was made effective on June 18 with the requisite law voted by both Houses of the Cortes, the Spanish Congress. That very day and before the same Cortes, his son was solemnly sworn in as the new King, with the title Felipe VI.

Spain's new King

As a political and economic historian, these events have opened a floodgate of memories in me. The Spanish royal family has been a part of the life of my family ever since I can remember. As a university student and lecturer I got in trouble with the police and the courts for wanting to substitute a liberal monarchy for the Franco regime. I have a vivid memory of the moment when, with Franco just buried, Juan Carlos was crowned before the Cortes on November 22, 1975. Franco had overseen the education of the Prince and had chosen him as his heir to ensure continuation of his rule beyond his demise. Young Juan Carlos I, on succeeding his mentor, was vested with virtually the same powers as the old dictator, but just in case, Franco had left him with his own Prime Minister in charge. But the new King soon became his own man and dismissed the inherited government. By 1978, Spain had a democratic constitution. Another poignant memory of mine involves the way in which in 1981 Juan Carlos successfully and by sheer weight of authority put down the anti-democratic coup of some old style officers. By 1986, Spain had been accepted in what today is the European Union. There followed many years of progress and prosperity. Thus, in the first thirty years of his reign, Juan Carlos I successfully steered Spain towards becoming a full member of the civilized world. My youthful hopes of seeing freedom restored in my country were being realized.

But then the Crown started to lose its luster. In 2007 the real estate bubble burst and the Great Recession struck. Growth stalled and then receded. Firms began to fall in droves. Unemployment increased hugely. Savings banks went bankrupt and the other half of the financial sector had to be rescued. A conservative

government, elected to pull the country out of recession, imposed a severe tax increase instead of drastically reducing state expenditures. Widespread corrupt practices were uncovered. The size of the protest vote in the recent European elections shows just how far confidence in government has waned.

Then scandal hit the royal family. First, one of the King's sisters and her husband were arraigned for tax fraud and money laundering. It was even suggested in the press that King Juan Carlos could have been party to some of these deals. Then, in the midst of the crisis, the King had to be hauled from Malawi, where he had broken a hip on an elephant shoot. The public loves an elephant. There also was anger at such a pleasure trip when everybody was having to tighten their belts. Worse yet was the revelation of the company he had kept on this holiday: an Austrian belle whose role was to arrange business for Spanish corporations with clients in the

Gulf, where the King has many friends. Juan Carlos' love affairs had never before been discussed in public, mainly out of respect for Queen Sophia, who always behaved with admirable restraint. This time it was too much. The story and the photos hit the news. Juan Carlos felt he had to take the extraordinary step of apologizing to the Spanish people. His continued poor health must also have sapped his will to stay on the throne.

Nothing had been prepared for an abdication, except that there was a capable heir ready to take over. The last thing Spain needed in its present fraught situation was uncertainty about who presides over the State and even less a long battle about replacing the monarchy with a republic. The transition was unexpectedly smooth. Both Conservatives and Socialists backed it with their votes. The new King Felipe is young. His education includes a law degree, commissions with the Army, the Navy, and the Air Force and a Master's degree from Georgetown. His Queen Letizia is a divorced journalist and they have two lovely daughters. To avoid discussion over the place of the Church in Spain there was no crucifix by the crown and scepter when Parliament swore him in. Among the first people he received in audience was the Association of Gays, Lesbians, Transvestites and Transsexuals. King Felipe is even trying to build bridges between Catalan nationalists and the rest of Spain, to help avoid the country breaking up. Whatever the disquiet among Conservatives, the change of image is shrewd and is attuned to the new Spain of the 21st century.

The other monarchs

There are no less than ten democracies in Europe at whose head is a monarch. The full list will surprise many: the United Kingdom, Norway, Sweden, Denmark, the Netherlands, Belgium, Luxemburg, Liechtenstein, Monaco, and of course Spain. And there also are some crowned democracies in the rest of the world, such as Japan and some of the members of the British Commonwealth.

These years have seen a revival of the fortunes of the crowned democracies of Europe, with a general move to open the door to the younger generation. In April of 2013, the beloved Queen Beatrix of the Netherlands abdicated and Willem- Alexander was proclaimed King. His popularity has jumped, no doubt helped by his Queen Máxima, whom the Dutch say they find fascinating.

Less than three months later, King Albert II of Belgium abdicated in favor of his quiet and retiring son Philippe of Brabant. Albert had shown signs of exhaustion with his efforts to keep his country together despite the perpetual nationalist tensions between Flemish and Walloons. Philippe and his wife Mathilde have seen their popularity double, even among the Flemish who seek independence or want to join the

Dutch. His is an example Felipe VI of Spain must be trying to emulate in the matter of nationalist tensions between the Catalans and the rest of Spain.

Queen Margrethe II of Denmark, now seventy-four, famously declared on reaching seventy that she "did not intend to abdicate or quit smoking", so she must feel the monarchy is safe there. As to King Harald of Norway, he is not in good health but

no matter: both he and his heir Haakon enjoy popularity indices over 90 percent. And, if you watch the Nobel Prize ceremonies, you will have noticed how happy in his role King Carl XVI Gustaf of Sweden is—and how happy his people are that he is there to play it.

And I have no need to say anything of the place of Queen Elizabeth II of Great Britain and Northern Ireland in her subjects' hearts! A single detail will suffice: Alex Salmond, the Chief Minister of Scotland, who wants Scotland to be independent, has promised he would keep the Queen as the head of the new state. All this must look strange to American eyes? Be that as it may, crowned democracies seem to endure.

The knowledgeable are wont to present a constitutional monarch as a quaint figure with no political use. Questions keep being asked, especially in a country like Spain, gripped as it is by egalitarianism. Does it make sense to top a democracy with a monarch? Is it not a contradiction to combine the hereditary principle at the top with the electoral principle below?

The uses of monarchy

It was no doubt lucky for Spain in its present perilous circumstances that the changeover at the top happened without a hiccup, especially when there seem to be so few true monarchists around and society after the recession is in a fractious mood. People abhor a vacuum at the top. Historians remember the "Great Panic" that swept France after the beheading of Louis XVI. Paris seemed to have taken it in stride, but in the provinces communal life came to a halt. Even today, many would have felt alarm, if not panic, at the deposition of Felipe VI. The left would have welcomed it, no doubt, but conservatives would have seen it as the starting shot for revolutionary change—not the best development at this delicate moment of slow economic recovery.

A first explanation for the relief felt at the enthronement of Felipe VI could be the simple one of inertia. If this is meant to imply that people do not care a whit who is at the head of the state, the explanation is clearly wrong. One should rather speak of tradition, whatever that mysterious word may mean. In many crowned democracies the monarchy plays the same symbolic role as the Constitution in the United States: I mean a dignified role, not an efficient role, to follow Walter Bagehot's apt distinction. I will have more to say about the book Bagehot published in 1867 with the title The English Constitution.175 At this point I want to note that he was right in underlining the representative role of the Crown, embodied in his time in the person of Victoria Regina, the name she used in her official signatures. She was a symbol, a much needed element in attracting the allegiance of the people to the abstract machinery of government.

In the case of Spain, tradition is embodied in the very title of the King, the sixth of the name of Felipe. The romantic side of my historical avocation comes to the fore

175 Walter Bagehot, The English Constitution. (Boston: Little, Brown, and Company: 1872.) Online at Internet Archive.

when I think of some of his forebears of the same name: of Felipe II who built El Escorial and whose Armada the Dutch and the English (thankfully) routed; or of Felipe IV, the patron of Rubens, his

magnificent ambassador, and Velazquez, his masterly portraitist; or of Felipe V, the first of the Bourbon dynasty, who fought the War of Spanish Succession and opened the Age of Enlightenment. Still, many people do not have an 'historical ear' by which I mean they lack a 'musical ear' for the vibrations of history. So there must be other reasons.

If tradition does not move the masses, pageantry does. But it is pageantry of a special kind. It allows people personally to relate to the pomp and glory of the state. The public and the media show an interest in queens, kings and their families that verges on fascination. This interest cannot be attributed to mere snobbery, a feeling that perhaps moves the courting elite but not ordinary people. As Bagehot observed,

... a family on the throne is an interesting idea [...]. It brings down the pride of sovereignty to the level of petty life. [Thus,] a princely marriage is the brilliant edition of a universal fact, and as such, it rivets mankind.

We ordinary people love to see our pride, our happiness or our sorrow personified:

[A] Royal family sweetens politics by the seasonable addition of nice and pretty events. It introduces irrelevant facts into the business of government, but they are facts which speak to 'men's bosoms' and employ their thoughts. (Bagehot, page 104)

I am sure many of my readers have watched The Queen, the film by Stephen Frears. There you saw the English monarchy endangered because Elizabeth II did not seem to understand the outpouring of popular feeling at the death of Princess Diana. The Queen must have said to herself: 'One' does not show one's feelings with so little restraint; and 'One' need not publicly mourn the death of a young member of one's family, especially if deceased in such embarrassing circumstances. Tony Blair, of course, was right to convince his Queen to change her attitude and to take the lead of the mourning procession. That is how we the vulgar react, sometimes excessively, other times appropriately as with the wedding of Kate and William, the Duke and Duchess of Cambridge, and now the progress of their toddler son.

A King's political role

Despite his not exercising any political powers a constitutional king can have a political role that may prove crucial in difficult times. As Bagehot perceptively noted for the Britain of his era,

... the sovereign has, under a constitutional monarchy such as ours, three rights— the right to be consulted, the right to encourage, the right to warn. (Bagehot, page 139)

This is something Felipe VI seems to have taken immediately to heart. The Prime Minister, Señor Rajoy, is regularly received in audience to run over the affairs of government. Philip may be still too young and inexperienced to help much with his advice but the consultation with him will have a sharp edge, since he knows that, if the affairs of the nation do not start mending, his throne may be in danger. Unjustly perhaps, public opinion seems to expect that he will help to right the ship of State, buffeted as it is by contrary winds. This is true even of the radical left and the Catalan and Basque nationalists, who paradoxically want him to usher and ease the breakup of the ancient monarchy that has kept Spain together since 1469.

To understand his plight I will recall the book of another thinker who, you may be surprised, has much to say to a king of the present age: Niccolò Machiavelli. In The Prince,176 written five centuries ago almost to

the day but published only after his death in 1531, Machiavelli distinguishes three kinds of principalities: hereditary, new and mixed. Hereditary principalities are easier to keep than new. The prince who heads a state by descent has the simpler task; he need only avoid too much innovation and weather the storms that may come his way.

The prince of a new state on the contrary is always in danger of losing it for, as a newcomer, he will find it difficult to attract the love and obtain the obedience of his people, says Machiavelli. Now, do not mistake me. The methods of government sometimes proposed by the Secretary of the Florentine Republic for new princes are not fit for a Western democracy, be it crowned or not. The passages of The Prince which Felipe VI might find instructive are not those where Machiavelli praised the behavior of Cesare Borgia or of Pope Julius II, for their cruelty to their opponents or their lack of faith in their promises. On the contrary, he should read those pages explaining how a new prince can come to be regarded as an old sovereign, "with good laws, good arms, good allies, and good example". (Machiavelli, Chapter XXIV)

True, Felipe VI has inherited his throne; but many in Spain see him as something of an upstart with no right to lord over them. So, the model and duties of a mixed principality are the ones that best fit the estate to which he has acceded. He cannot imitate his father King Juan Carlos I, who came to the throne with much 'Machiavellian' ability, if I may say so in a positive sense. Juan Carlos first obtained the full confidence of General Franco but then managed to undo the Old Regime by bringing all parties, right, left and center, to agree to the establishment of a crowned democracy. Felipe VI, I am sure, is aware that heredity is not a right easily accepted by doctrinaire democrats. He has to bring politicians over to his side and conquer the loyalty of his people. He must start by helping rid Spain of some of the blemishes that spoiled the last years of his father's reign.

176 Machiavelli, Niccolò (1531): Il Principe. Giuliano Procacci and Sergio Bertelli, eds.: Il Principe e Discorsi sopra la prima decca di Tito Livio. Feltrinelli, 1984. Machiavelli's book is also available as a pdf file at Il Principe. L. Arthur Burd, ed., with an introduction by Lord Acton. Online Library of Liberty.

Felipe's personal behavior and that of his Queen must appear blameless in the eyes of his subjects. Bagehot wrote that the example of Queen Victoria led the British people

[...] to believe that it is natural to have a virtuous sovereign, and that the domestic virtues are as likely to be found on thrones as they are eminent elsewhere. But a little experience and less thought show that royalty cannot take little credit for domestic excellence. (Bagehot, page 118)

The Spanish people, tired of scandals, seem to want the same of their new sovereigns, Felipe VI and Queen Letizia. There is a great deal of anger in the country about the degree of corruption in political parties and trade unions and even the Royal Household uncovered during the crisis. It is clear that that there will be none of the indulgence that shielded the father in the first part of his reign.

One favorable trait of Felipe's character is the seriousness with which he takes his duties. Bagehot noted that "a king, to be the equal of his ministers in discussion, must work as they work; he must be a man of business as they are men of business." (page 91) However, the danger lurks "that a constitutional prince is the man who is most tempted to pleasure, and the least forced to business." In sum, it is clear that Felipe VI must be seen to behave well and work hard.

The antidote to republicanism

Whether Felipe VI endures and his eldest daughter succeeds him in good time on the Spanish throne future generations will tell. I have listed the many reasons for not breaking the tradition of crowning democracies where that tradition exists. However, before closing my reflections on this most peculiar of institutions, I want to throw light on an unnoticed contribution of kings and queens to the healthy functioning of democracies.

Monarchy has another positive contribution to make, especially to democracy in lands given to excessive political strife or administrative intrusion. Political activity is no doubt necessary in a democracy, but it must not encompass everything that people do, personally or collectively. In that sense politics could be likened to a nuclear power plant. These can be very useful installations but their reactor has to be placed in containment buildings with thick walls and their refrigerating system kept well insulated from the atmosphere.

There are many people, especially on the left, who believe that everything in a society is political and that all common decisions have to be taken 'democratically' by majority vote, from the conduct of corporations and the management of churches, to the working of schools and the organization of opera houses. Experience shows that if everything is politicized and becomes the object of ideological deliberation, the atmosphere of a society becomes suffocating and prone to explosive accidents.

Political democracy is based on the realization that there is no common system of values accepted by everyone. In matters that are not as divisible as they are in the economic sphere, political decisions imply imposing majority solutions on dissenting minorities. The more restricted the sphere of politics the larger the scope for differences in tastes, ways of life, moral beliefs, all uncurtailed by power. Neither religion, nor education, culture, sport, nor family life should be ruled by majority voting. Democracy is not a continuous plebiscite on all social or personal matters but only a useful procedure for a restricted number of communal decisions. Democracy must be limited or it soon becomes totalitarian.

The virtue of parliamentary monarchy is precisely that the King symbolizes everything that lies outside politics in a civilized society. If the succession to the highest office of state is automatic and if the Sovereign can take no political decisions, citizens in countries given to social tension or political busy-bodying can come to understand that the greatest part of their personal and social life should not be invaded by politics but devolved to the private sphere.

Europe in Disarray

September 1, 2014

The European Union is sailing through choppy waters. Actually, this can be said of Europe as a whole. One tends to forget that there are nations that have expressed a desire to be in the EU but are still in negotiations with the Union or, more alarmingly, have halted negotiations due to Russia proclaiming them a part of its Hinterland, as the Germans would have said in the 20th century. The shallows and miseries faced by the EU make up a long list. The economy is still not doing well two years after the end of the financial crisis. Germany and Italy have shown negative growth in the third quarter of the present year; France has not grown at all during the last six months. Where there is some growth, as in the United Kingdom, the fear is that it may be an effect of excessive money creation rather than increasing productivity.177 The new currency, the euro, is far from safe, principally from excessive debt, public and private. The late European Parliamentary elections have revealed the strength of euro-scepticism in all the member countries, especially France and the United Kingdom, and not all in reaction to the late financial crisis. Jean-Claude Juncker, the newly elected President of the Commission, has faced much opposition because he wants "More Europe!" rather than less, as the British and many voters in the whole of Europe have said they wish. The European Council has not agreed on who is to be its President, or the high representative of the Union before the rest of the world, of which more anon. A number of member states are facing separatist movements, principally the UK in Scotland and Spain in Catalonia. British Prime Minister David Cameron is demanding deep reforms in the EU as a condition for campaigning in favour of the continued membership of the UK in a referendum three years hence. On its borders, the EU not only faces anarchy in the Middle East but also Vladimir Putin's Anschluss in Crimea and other parts of Ukraine; and Putin is answering the EU sanctions against his henchmen by stopping food imports from Europe. Perhaps I should have said stormy rather than choppy waters.

EU affairs are always complicated and obscure for outsiders, no less than for ordinary Europeans. It would be an act of kindness to spare my readers the Byzantine details of the situation in the continent were it not for one thing: there is a lesson to be learnt by all democracies about the clash between politics and the economy; I should say, about the continuous and perhaps inevitable interference of politics in the economy. They are two worlds with their own logic, malfunctions and misunderstandings.

Complicated Institutions

Before proceeding I must remind my readers across the Atlantic of the institutional arrangements of the EU Though this breaks the rhythm of my exposé it is in fact

177 When unemployment is high there may appear an increasing productivity per worker still employed. The productivity to watch is total factor productivity, which follows not from money creation but from real factors, such as population growth, technical advances, and/or more competition.

essential to understand how the EU works and more importantly to follow the twisted course of European affairs, pushed this way and that by federalists wanting "an ever closer Union" and persistent nationalists resisting the increasing powers of the Brussels establishment.

Power in the EU is shared mainly by three institutions: the Commission, the European Council, and the Parliament. The Commission is really the government of the EU; it is the guardian of the treaties and

monitors the application of European law in all member countries. There is one Commissioner per state and each governs a department. The bulk of the EU civil service works there. The Commission also holds the exclusive right to initiate legislation. It has a fledgling Foreign Service headed by the High Representative for Foreign Affairs and Security Policy, a position that is also vacant due to disagreements in the Council. The new President of the Commission, Monsieur Juncker, is a federalist who will be trying to nominate people of his own bent as new Commissioners, twenty-eight no less, one per member state. As I said, David Cameron strongly resisted the nomination of Juncker but lost.

The European Council decides the political strategy of the Union. It is the voice of the member states; it comprises the heads of state of the different nations. It meets at least four times a year, the latest was to elect its own President—the place is full of presidents—and vet the proposed Commissioners. It failed to do either.

The Brussels Parliament has recently seen its powers increased.178 The general complaint is that it cannot represent the will of the European demos because there is no such demos. The participation of voters, reduced this time to 42.54%, has fallen in every one of the seven general elections since 1979. Voters in the different member countries take the European general elections as mid-term rehearsals for national elections.179 This is but one instance of what goes by the name of "the democratic deficit of the EU", in plainer words, the remoteness of the European institutions from ordinary people. Since most European citizens neither understand nor care what this Parliament does, the European elites are trying the remedy of giving it ever greater powers so that the people take more seriously a Chamber that so impinges on their daily lives. It shares legislative power with the Council and approves the budget in tandem with this body. It elects the President of the Commission, can withhold its approval of the Commissioners proposed by him, and has the power to dismiss the Commission with a no confidence vote; and (tremble ye free traders) must give its consent to trade agreements such as the North Atlantic Partnership now being negotiated with the United States.

The appearance of a more or less orderly division of labour among these three main bodies that share political power in the Union is deceptive. The Commission thinks

178 I should say the Parliament in Brussels (Belgium) and Strasbourg (France), for the Chamber periodically moves lock, stock and barrel from one to the other of these cities its every plenary session; and the Secretariat is in Luxembourg—all to accommodate national sensitivities. 179 The group which has suffered most is the European Liberals, who in this part of the world are the more pro-market. Euro-sceptics and decidedly anti-EU parties now make up no less than 16% of the Chamber or 29% if one adds the Greens and the non-aligned.

of little else but the expansion of its own powers of intervention, which can go from the number of hours a lorry driver can stay at the steering wheel over the week to the shape and size of the apples and bananas purchased by households—all in the name of an ever deeper union. The Council is the place where the voice of states resisting integration can be heard, though mutedly: in the end it is Angela Merkel, the German Chancellor, who imposes her will, as when recently during a leisurely walk on the beach with David Cameron she was overheard rejecting his objections to the nomination of Juncker for President of the Commission. Parliament untiringly demands wider powers to show how important it is. The number of languages heard in its hallowed halls is no less than twenty-four. You will have an inkling of this Babel of tongues and the work cut out for the numerous simultaneous translators by going to the website of the

European Central Bank: you will there see the name of this Bank written in a diversity of languages and alphabets.

The euro

Why do I mention the European Central Bank at this point? Because this is a crucial institution of the EU, though unelected and in principle apolitical. The Bank is the issuer of the euro, the currency that not all member states want to use; it acquired immense importance during the financial crisis of these last years and is looked up to as the possible saviour of the European economy. The euro was devised apparently for an economic reason, to help with the creation of a single market in the EU. In truth, the reason was political: to bind the Union more tightly around an everyday symbol, the currency constantly used by all and sundry. The first trouble was that the British, the Swedes, and the Danes did not want it and did not take it up. The next difficulty was finding a compromise between French fears that the euro might become a Deutschemark in disguise and German nightmares of runaway inflation as in 1921 and 1945.The new Bank, set in train with the century, was to be politically independent and have one single target, that of keeping the internal value of the currency steady. For these reasons the Bank would never receive instructions from the other European institutions and would have as its only target to maintain the rate of inflation at or just below two per cent a year. 180 It was set up as totally independent of the governments of Europe and its constituent nations, and hence was not permitted to lend funds to any European institution or national government. 181

The fractured character of the European Union has never been more evident than with the near catastrophe of the euro. Canadian economist Robert Mundell had set out the conditions of an Optimal Currency Zone in 1961:182 flexible prices and wages; free movement of goods and services; and to complement both, free

180 The ECB must keep the Harmonised Consumer Price Index of the Eurozone growing at two per cent a year or just under. It also must, as all central banks, keep the financial system functioning smoothly. 181 It could therefore not subscribe any government bonds at issue but could buy them on the secondary market for purposes of 'open market operations' whereby central banks control the amount of money in the economy. 182 Mundell, R. A. (1961): "A Theory of Optimum Currency Areas". American Economic Review 51 (4): 657-665.

movement of resources across the area, especially of labour. In other words, the single currency would function with ease if the member economies had converged or were on the way to converging.183 In the 1990s Mundell let it be believed that if Europe was not a monetary union it could quickly become one. And he was awarded the Nobel Prize for Economics. His avowed motive was that he wished to see another world currency come into existence and be a rival to the U.S. dollar.

Different member countries massaged their statistics to look as if they fulfilled the conditions for entry. These were the so-called Maastricht conditions: a stable exchange rate, low interest rates and, more importantly, a budget deficit not higher than the equivalent of three per cent of GDP and an amount of public debt also below the equivalent of three per cent of GDP. When the euro was launched, financial markets put their faith in the new contraption and proceeded to value the debt risk of the different countries as if they had converged, forgetting that the U.S. dollar zone had taken more than a century fully

to come into existence. When interest rates were brought to rock-bottom levels by the Federal Reserve, the Eurozone enjoyed a long Christmas office party. The rest of the story is well known.

There was one unnamed 'Maastricht condition' that should have forewarned frivolous entrants, to wit, "no bail-outs". This rule is in force in the U.S. monetary zone: bankrupt cities and states will not be saved by the federal government. When the crunch came, Greece was not expelled or suspended and its debt was restructured and reduced by half. On top of refusing to bail ailing regions, the American monetary zone has another mechanism to make the dollar function with less volatility and pain than under the gold standard: the automatic stabilizing effect of federal income tax. Of course you do not need these stabilizers if the economy is fully flexible and takes corrections on the chin, as happened under gold; but far west pioneers did not expect to be molly-coddled as we demand in the 20th century. In consequence it is proving impossible for the ECB to concentrate exclusively on its one target, keeping the value of the euro stable.

Such was the euro and its central bank at the moment of their foundation: twins of the Deutschemark and the Bundesbank. They were intended as a solid currency and an unforgiving bank. The pain of the financial crisis, however, is making them more and more similar to the dollar and the Fed. During the crisis, the ECB expanded its balance sheet to increase the liquidity of a congealed financial system; it is now reducing it by reselling the company bonds and commercial it acquired in an emergency. However, the cry is going up that it should imitate the quantitative easing of the Federal Reserve and the Bank of England to revive the faltering European economy. And there are unceasing complaints that the euro is too expensive and should try to depreciate like the dollar. However hard the Germans, the Finns, and the Dutch may try to resist, a majority in the Eurozone want to say good bye to the 'Germanic' euro and say hello to Keynesian policies.

183 Convergence on all these variables would mean that Euro-countries would be on parallel economic cycles.

Juncker's ten point programme[184]

The Union is slowly turning itself into a quasi-socialist welfare state. Continentals speak proudly of the 'European model' of human capitalism in contrast to the 'Anglo-Saxon model' of wild capitalism. The EU itself does not have much money to spend on favoured interest groups and mendicant nations, as its main sources of income are the tariff on imports and a small share of the VAT charged by member states. But, as George Stigler used to point out, regulation is another way of generating income for the chosen few—and the EU is the high kingdom of regulation. The Commission has even found a way of turning its Common Agricultural Policy into a policy to protect the environment: landowners (and I mean especially big landowners) are paid for leaving their land fallow so that wild plants (and their pocket books) prosper.

Let us look for a ray of hope in the ten points of the program of Jean-Claude Juncker put forward in Parliament when confirmed in his new post at the head of the Commission. It reflects the twin (and conflicting aims) of the EU. On the one hand he promised to work for the single market, that is, to make the EU a really integrated economy, with no obstacles to the internal free movement of goods, services, capital and people, which of course would increase European productivity and welfare. A single market Europe is far from being a reality. Juncker wants to push for integration on two difficult lines: within the first six months of his presidency, he wants to create "a connected single digital market", and over the five years of his Presidency "a resilient energy union". There are huge obstacles to both, namely governments' defence of their IT markets and their national energy companies, especially on the part of the French.

Thus, the state company Electricité de France has successfully stopped high tension cables across the Pyrenees because the towers might upset some flocks of wild goats who live in those mountains, thus unfortunately stopping Central European competitors from selling Spanish and Portuguese power. In his program Juncker added to his high hopes for a resilient energy policy the clause "with a forward-looking climate change policy". The catch is, as always, the environment. In any case those plans are well intentioned.

There are more hitches in Juncker's program. He says he wants to deepen the internal market but "with a strengthened industrial basis". Who will strengthen it he does not say. And he has a dig at London when he says that to re-industrialize Europe needs an integrated capital market. It is not every region in the world that has a financial market like the City of London.

The rest is all downhill. He wants to mobilise € 300 billion of public and private investment over the next three years. Tax evasion and tax fraud are disparaged in the same breath, though tax evasion is legal: the object is increasing the tax burden on ordinary citizens. Measures to make countries apply the conditions of the Monetary Union should be examined not only by financial standards but with "a social impact assessment" as well. The European legislation on genetically modified

184 10 Priorities. European Commission.

organisms (GMOs) should be changed so that member countries are not forced to accept them when public opinion objects. And the free trade agreement with the U.S. should be reasonable and balanced: "I will also be very clear that I will not sacrifice Europe's safety, health, social and data protection standards or our cultural diversity on the altar of free trade."185 The North Atlantic Partnership is not in the clear yet.

British demands

The British, with the exception perhaps of the Liberal Party, do not want any of that. Not even the Labour Party wants more Union in the form of a single currency or of externally imposed immigration and labour market rules as decreed by Brussels. This is the reason for Prime Minister Cameron promising to call an "in or out" referendum in 2017. He adds that if he does not get a change in the rules imposed on Britain he will campaign for the 'out'. Whatever happens, the British have thrown a gauntlet with consequences for all concerned. The questions are: Would the reforms demanded by Cameron be good for the Union as a whole? Would the EU lose much with the British secession? Could the UK prosper outside the EU?

In effect, a majority of the British resent the way Europe has developed. The common market seemed a good idea except for the agricultural policy included in the treaties to please the French. The free movement of goods and services would make the whole of Europe prosper. As to the free movement of Europeans within the EU, many British people now (wrongly) resent it at because it is means more competition in the labour market and (rightly) because immigrants often abuse the social safety net and the health service. In the UK there is great confidence in the court system and diffidence toward European judicial interference. The British are proud of their democracy and look askance at the goings-on in the European Parliament. The UK has always been a force for the liberalization of Europe: with the Brits out, the Junckers would have a field day. I know that all the member states are now solidly democratic or will soon be so when Soviet habits will have been expunged. But history counts, and nations which once were ruled by Salazar, Franco, Pétain, Mussolini, Hitler, Pildsuzki, and Horty and the colonels should treasure the presence of one of the oldest democracies of the world in their midst. As a Spaniard I would feel very

sad to see a nation with such a drive for economic and political freedom leave the Union of which I am a citizen.

The harmful effects of secession for the British would be weighty in the beginning: the EU is the largest market for British imports and exports, not less their exports in services. If the separation were acrimonious the negative developments could last for quite some time. In the long run however, the UK would be able to compete in a world free of the directives of Brussels—an interesting experiment and perhaps an alluring example for the rest of Europe.

Politics and economics

185 A Reasonable and Balanced Free Trade Agreement with the U.S. European Commission.

The EU is one of the most telling examples of the mutual interference of economic logic and political aims. The Founding Fathers of the EU, Konrad Adenauer, Alcide de Gasperi, Jean Monnet, Robert Schuman, and Paul-Henri Spaak, wanted to create the conditions for avoiding a repetition of the two terrible World Wars. Their idea was to use economic collaboration to pave the way for political brotherhood. They started with an agreement on coal and steel, which had been the material sinews of those two wars. To this they added the common exploitation of peaceful nuclear power. Then came the 1957 Rome Treaty setting up the common market, whereby it was hoped that growing prosperity would create the underpinnings of political harmony. Trade is not on its own an antidote for war, as the story of how Europe sleepwalked into the 1914 war clearly shows but politics and economics can work hand in hand.

The logic of politics, however, is the achievement and exercise of power and that of economics the fostering of voluntary exchange and unplanned collaboration. When economic activity and prosperity are seen as instruments of power they both suffer: the free market is turned into crony capitalism and political service turns into hostile power grabbing.

If Britain is forced from the European Union because the Union is bent on becoming a world power, the world as a whole would be the loser.

From the Edge of China

October 6, 2014

This month I do not write from Europe but from Hong Kong, where I attended the General Meeting of the Mont Pèlerin Society (MPS), founded by Friedrich Hayek in 1947. On our free day, I took the ferry from mainland Kowloon to the island of Hong Kong proper. The ticket machine returned me a one penny and a ten penny coin with on the obverse the head of Queen Elisabeth II, Defender of the Faith. The penny dropped, so to speak, and I was reminded of the fears rampant the previous time I came to Hong Kong. The year was 1978, the occasion, another general meeting of the MPS. Mao Zedong had only recently died. Hong Kong still was a Crown Colony, but in another twenty years the territory would probably have to be handed back to China. Would freedom subsist, we wondered? In 2014 the question was whether the new Chinese masters had changed the legal and economic regime bequeathed them by the British. Had the typhoon clouds then looming over this merchant city cleared? Would it still be free in the future? The serried ranks of sky-scrapers awaiting me on the other shore seemed to indicate that nothing much had changed. Was this impression a reality or a dream?

In 1978, when the first Mont Pèlerin meeting in Hong Kong took place, we were all awed by the prosperity and dynamism of the territory. After that conference, Milton Friedman stayed on to film one of the episodes of his revolutionary television series "Free to Choose". My wife and I joined the team. Friedman was able to show how much the ordinary Chinese of that tiny enclave had seen their lives bettered by capitalism, in contrast with the appalling poverty in which Mao had left the People's Republic of China. Of course we were not allowed to cross the border with our cameras, but the number of immigrants trying to enter the colony confirmed our expectation that, if they could, numberless Chinese of the Pearl River Delta would flee the darkness of mainland China for the multicolored lights of capitalist Hong Kong.

The miracle of a free economy

After World War I, the British governed their subject territories across four continents with an administrative paternalism that showed their low opinion of their subjects' economic capacities. It was the time of Imperial Preference in the commercial affairs of the Commonwealth. Measures had been taken to stop the cheap textiles of India from competing with those of Lancashire. The farmers of Africa could not sell their tea, cocoa, and sugar in the wide world but had to export their produce to privileged private companies or through state Purchasing Boards. After World War II, the treatment became even more poisonous. The Labour Party, in power in the United Kingdom after 1945, added a social dimension to this commercial paternalism. Bleeding hearts in London expected colonial administrators in far off lands to control prices, extend state schools, subsidize housing, introduce unions, and change labor laws. A creeping welfare state was the less admirable part of the legacy of the British in the world.

Despite all this, the city that welcomed the MPS in 1978 was free for a crucial reason: the Colonial Office in London had not been able to tame what would later be called the 'savage capitalism' of the colony. Unilateral free trade was the rule in the Colony, as it had been in Britain up until the First World War. The budget was small and strictly balanced. Prices moved freely, labor was unregulated, and taxes were low. Hong Kong could be thankful that Sir John Cowperthwaite (1915-2006) was its Financial Secretary from 1961 to 1971. It was he who consolidated the foundations of the free Hong Kong we saw in our 1978 visit.

His portraits show the face of a deceptively benign bureaucrat, but in truth this civil servant had steel in him. Interfering politicians feared him for the elegant and precise way he yielded the rapier of argument. It was he who coined the phrase "positive nonintervention" to mark the economic regime he wanted for Hong Kong. In his first budget speech he said:

In the long run, the aggregate of decisions of individual businessmen, exercising individual judgment in a free economy, even if often mistaken, is less likely to do harm than the centralised decisions of a government, and certainly the harm is likely to be counteracted faster.186

He was faithful to this principle even to the extent that he refused to collect statistics unless of the most innocuous kind, for, he said, statistics led governments to try and fix perceived ills that fix themselves if the economy is left alone.187

Low taxes and good laws The Colonial Office in Britain had made Singapore raise taxes, especially on the rich. When Labour Secretary of Defense Dennis Healey asked Cowperthwaite to levy more funds so that Hong Kong bore a larger share of the military expenditure of the Colony, Cowperthwaite flatly refused. This was his tax regime, still in force in Hong Kong today. When paying income tax, people could choose either a flat salary tax of 15% or a rate going from 2% to 17%. The tax on profits was 16.5%. Dividends and capital gains were exempt. The tax on property was limited to 15% on the income obtained.

He also sustained the independence of Hong Kong's judiciary and the excellence of its legal system, widely recognized among the best in the world. This system is now constitutionally guaranteed to stay separate from that of the People's Republic of China until 2047 at least. The Hong Kong Basic Law, drawn on the principle of "one country, two systems", states in article 8 that all laws of before the handover, including

186 Obituary of Sir John Cowperthwaite, The Daily Telegraph, 26 January 2006. 187 Remembering the Scottish referendum, I note that Cowperthwaite was one of those Scots who left behind Hibernia to prosper in London and the Colonies. Some were administrators who, like Cowperthwaite, governed according to the counsel of David Hume and Adam Smith; others went on to trade, as the Keswicks of the House of Jardine; or entered finance, such as the Sutherlands of the Hong Kong and Shanghai Bank, one of the three commercial banks issuing the currency of Hong Kong in the present day.

... the common law, rules of equity, ordinances, subordinate legislation and customary law shall be maintained, except for any that contravene this Law, and subject to any amendment by the legislature of the Hong Kong Special Administrative Region.

Human rights are protected by a Bill of Rights.188 Courts are known not to be at the behest of the authorities, in contrast with the mainland, where more than a quarter century since the death of Mao, civil law is only gingerly being built.189

There was a great deal of corruption in the police and among customs officials under British rule, so much so that Sir Murray (later Lord) MacLehose, Governor of Hong Kong from 1971 to 1982, set up an independent Commission against corruption, which still functions today. Slowly the habits of old China in matters of organized crime in gambling, prostitution and drugs were contained, and this has resulted in an absence of gross corruption, again in contrast with what happens on the mainland.

A sound currency

The keystone of Cowperthwaite's financial policy was a sound currency. He refused to move the Hong Kong dollar/pound sterling exchange rate even when in 1967 the devaluation of the British currency caused Hong Kong a great loss in the value of its monetary reserves. This system of a fixed exchange rate was maintained by later Financial Secretaries and continues to the present day, except for nine years of free floating in the late seventies. From 1983, Hong Kong opted for tying the local currency to the US dollar at a rate of HK$7.80 to US$1.00.190

When a country fixes the exchange rate with the help of a currency board, the Monetary Authority must limit itself to buying and selling its currency on demand unconditionally. This has meant that Hong Kong must totally dispense with monetary management and has no need for a central bank. The government cannot take any measures to counteract or soften external shocks. Ever since Cowperthwaite's time, Hong Kong has allowed external shocks to work themselves out in the economy without interference. How is this possible, a denizen of America or Europe will ask? The answer is that Hong Kong takes such external shocks in its stride because internal price and wage flexibility have allowed it to adapt rapidly to foreign losses and gains. Such a stoic attitude to economic ups and downs is what gives investors the confidence that the Hong Kong dollar is a solid currency.

188 Wikipedia: "Law of Hong Kong." 189 Thus the National People's Congress of 2007 passed a law accepting the right of private property generally, but excluded land property: individuals could enjoy and transmit rights of use but not own land outright. In fact we are seeing reports of zoning definitions being used to expropriate existing dwellers to permit forced gentrification in favor of Party officials, which has resulted in a number of sometimes violent clashes. 190 The HK$ is allowed to float between a strong rate of (HK$7.75/US$1) and a weak rate of (HK$7.85/US$1). See History of Hong Kong's Exchange Rate System, Hong Kong Monetary Authority.

So here we have an overarching policy principle: to fix the exchange value of the currency by keeping to the strict rules of a currency board. Maintaining a currency board in Hong Kong is subject to two conditions. One is that the Monetary Authority should be exclusively occupied with making sure that

... the Hong Kong dollar Monetary Base to be at least 100 per cent backed by, and changes in it to be 100 per cent matched by corresponding changes in US dollar reserves held in the Exchange Fund at the fixed exchange rate of HK$7.80 to US$1.191

Under a currency board regime, there is no one to manage interest rates or create fiduciary money. There will only be an Exchange Fund engaged in reactively buying and selling the local currency at the announced rate; and that Fund will have to keep a reserve that is equivalent to the base money of the economy and a little more.192

The other condition is that both the budget and the balance of payments should be in equilibrium, so as not to endanger the confidence of the public that the Fund's reserves will not be unduly used. Hence, the government cannot borrow to cover budget shortfalls, and wages and prices must be flexible enough for the country to maintain its competitiveness in world markets.

All this led Cowperthwaite to budget for surpluses year in year out, and also to leave large public works in the hands of private business. I was reminded of this during my second, more recent, stay in Hong Kong

when being driven back to the mainland through the tunnel under the bay. In the sixties, a group of businessmen approached Cowperthwaite to ask for the government to finance this tunnel. He replied that if it was useful private capital would do it. And private capital did it: this was the tunnel through which I was being driven back back from the Island to Kowloon.193

No central bank

At this point I must lodge a complaint about our monetary sessions at the Mont Pèlerin Meeting this September in Hong Kong. We were told that monetary policy was difficult, as indeed it is. We discussed the Fed's policies and lamented its mistakes. We heard contrary opinions about the dangers or virtues of deflation. The hall rang with demands for an active monetary policy to jump-start the economies of the world, mired in lackluster growth after the 'Long Recession'. All this was no doubt interesting. But nobody, just nobody, alluded to the fact that we were in a city with no central bank. The question should have been: is it possible to

191 Hong Kong Monetary Authority: "Monetary Stability". 192 The monetary base is the source of monetary liquidity of the economy: it is the sum of coins and notes, of HK Government Certificates of Indebtedness, of Exchange Fund bills and notes and the clearing accounts of commercial banks held at the central bank. Since shocks or even panics can happen that make the public try to go liquid and turn their HK$ holdings into US$, it is prudent that the Fund's reserve be larger than 100% of the monetary base. 193 Alex Singleton: Copperthwaite Obituary article, The Guardian, 8 February 2006.

dispense with a central bank, since Hong Kong seems to have done so well over the years with a passive Monetary Authority? Of course there have been wild swings in Hong Kong, some from monetary causes, some from real shocks: The Asian crisis of the 1990s hit the economy hard, as did the SARS epidemic. But according to the CEIC database194 the Hong Kong economy grew notwithstanding throughout this period: by 4% from 1966 to 1970, 6.2% in the 70s, 5.7% in the 80s, 2.1% in the 90s and 3.2% in the new century. The IMF classifies Hong Kong as third in the world by per capita income today, when in the 50s it was one of the poorest places in the world. If Hong Kong can do it, why not other countries?

The problem for interventionists is that such long term growth has been achieved by concentrating on the rule that there should be no budget deficits and that the economy should be kept highly flexible in terms of prices and wages. True, the U.S. dollar anchor to which the Hong Kong dollar is tied is not the best possible one: the Fed and the U.S. Treasury are wont to conduct a selfish monetary policy at the service of the electoral interests of the American government. Another anchor could be found for the Hong Kong currency or any moneys aiming at stability—gold, a basket of goods, a composite of world currencies. But the above discussion gives a clear and unwelcome answer to the question. By concentrating exclusively on keeping the value of its currency stable, a country can grow consistently, but it must allow all around flexibility in its economy and not mind macroeconomic volatility. This kind of monetary regime is not compatible with a welfare state.

The seeds of the welfare state

Cowperthwaite was a Gladstonian liberal who felt a sense of obligation towards the least fortunate.195 He organized an ambitious housing scheme for refugees from mainland China; he kept the system of free government schools that had been set up along the British model; he maintained strictly managed public hospitals that gave free quality medical services to the poorer part of the population. He thus planted the seeds of the welfare state in Hong Kong. These seeds started sprouting shoots under Governor MacLehose immediately after Cowperthwaite retired.196 He legislated nine years of compulsory free education for school-aged children. He re-hauled the healthcare system and also introduced Jobseekers, Elderly and Disability Allowances, paid holidays, redundancy payments, weekly rest days, and labor courts. Under him, the housing policy was extended to include a home ownership scheme. It is not surprising that MacLehose was the most popular Governor in recent memory.

Two remarks are in order here. The first is that the free economy was not inordinately affected by these welfare measures, so we can conclude that good

194 CEIC data for Hong Kong. 195 Copperthwaite Obituary, The Daily Telegraph 196 Not Sir Robert Black and Sir David Trench, who were supportive of the free market policies of Cowperthwaite. In the 1970s, however, MacLehose, a much more interventionist governor, partly rectified the Cowperthwaite stringent social policies. (Telegraph Obituary). It is typical of this Old Tory anti-market tradition that Chris Patten, the last British Governor, unsuccessfully proposed a 'pay as you go' pension system for Hong Kong 1997 just before standing down.

laws, independent courts, a stable currency, free trade, and the unhindered movement of capital will keep the market capable of delivering prosperity. The second is the caveat that any kind of welfare policy harbors dangers, however small and harmless it may look in the beginning.

On our second visit this year I found that the welfare programs of Hong Kong were growing apace—a development that could become more dangerous with attempts by the Chinese Chief Executive to seduce the democrats in the region. At present, half the housing of Hong Kong is public, either rented or subsidized ownership. Public spending on education amounts to 17.6% of government expenditures, allowing state schools and fully subsidized private schools to offer education at no cost. Since 2010, Hong Kong has had a minimum wage, which Professor Richard Wong has shown principally benefits members of middle class families.197 The expenditure on health care by the government is well controlled (equivalent to 3% of GDP) but is given for free at fifty public hospitals compared with twelve private ones. As for pensions, a Mandatory Provident Fund was created in 2000, whereby 5% of the pay of employees is docketed and matched by employers. There are various other public pension schemes.

All this seems small, but the pressure to increase the span of welfare will not diminish. The Hong Kong government is pulled two ways by the wish to be seen as small and the inclination to widen the reach of these programs. The inclination to introduce "new and enhanced services" while not abandoning "the principle of keeping expenditure within the limits of revenue" indicates a split mind. Also, lamentations in the press abound that labor laws are incomplete, even after the imposition of a minimum wage: they do not 'yet' regulate working hours and overtime pay; make rest breaks mandatory; protect part-time workers; impose family-friendly regulations; recognize trade unions as bargaining units; or make collective bargains legally enforceable. I feel great sympathy for the students demonstrating for greater democracy in Hong

Kong but I fear all these will come even if, or when Hong Kong becomes more democratic. Political freedom, if it comes, may play against the Hong Kong tradition of a free economy.

Demands for 'progressive' legislation take it as given that family help, private benevolence and individual foresight are always insufficient to deal with poverty, misfortune and illness. Experience shows that welfare policies tend to dry up those sources of social cooperation and often bring individual corruption through moral hazard.198 Further, if the welfare system grows excessively, it may come to affect the functioning of the market and thereby reduce growth.

197 Richard Y.C. Wong: "Why the Minimum Wage Harms the Economy",South China Morning Post, 12 June 2012. 198 A.C. Richard Wong has studied many examples of good intentioned interventions clogging up the wheels of the market, as when he analyzes subsidized housing in Hong Kong and proposes the privatization of 'social' home ownership. See his book On Privatizing Public Housing (City University of Hong Kong Press, 1998); and his many articles in the South China Morning Post, such as "Hong Kong Public Housing Policy, a Home Wrecker for Poor Couples", 1 July 2014.

In July 2010 The Economist magazine spoke of the "End of an Experiment" when noting that a minimum wage was in process of being approved by the Hong Kong Legislature. That article listed many of the distortions I have noted. I could also speak of the slow spread of anti-immigration and egalitarian feelings in the region. Introduced by British bleeding hearts and by favor-currying Chinese authorities, and now demanded by pro-democracy citizen groups and trade unions, those wellmeant interventions are slowly undermining the system that has made Hong Kong prosperous. I am afraid that after my second visit to Hong Kong I am less optimistic than after my first.

The Revival of Nationalism

November 3, 2024

This is the year when we commemorate the start of the First Word War, a ghastly conflict in great part attributable to the fanning of nationalistic feelings by politicians and soldiers playing power games. The human cost of that war should have forever put an end to the cultivation of tribal feelings in Europe. It was not to be. The break-up of old empires on the losing side resulted in the creation of a myriad of small fractious states. Russia, the first to leave the battlefield, conceded the independence of the Polish, Ukrainian, and Baltic nations and some in the Caucasus. The Turkish Sultanate had to cede its sovereignty over many of its subjects in the Middle-East and North Africa. On the ruins of the Austro-Hungarian Empire new nations were redrawn or born anew: independent Poland received territories from Germany, Austria, and Hungary; Hungary itself lost one third of its territory [see Addendum at the end of this article]; two short-lived Slav confederations were formed, Yugoslavia and Czechoslovakia; the Balkans were split into rival states. Many had been at war before 1914 and just as many voraciously claimed lands that had been theirs in more glorious historical times. Clearly the results did not fulfill the hopes of President Woodrow Wilson that there would be lasting peace among nations.

Wilson's Fourteen Points

President Wilson, at a joint meeting of the United States Senate and House of Representatives in January 1918, presented his plan to rebuild Europe and the territories round the Mediterranean on the bases of nationality and selfdetermination in his "Fourteen Points". War still raged in Europe, and Wilson hoped to end it by having his fourteen points accepted by all the belligerent countries. Let me quote a passage spoken by the President of a nation still at war with Germany.

We have no jealousy of German greatness, and there is nothing in this programme that impairs it. We grudge her no achievement or distinction of learning or of pacific enterprise such as have made her record very bright and very enviable. We do not wish to injure her or to block in any way her legitimate influence or power. We do not wish to fight her either with arms or with hostile arrangements of trade if she is willing to associate herself with us and the other peace- loving nations of the world in covenants of justice and law and fair dealing.199

President Wilson's proposals for establishing permanent peace were based on the belief that the satisfaction of the just claims of all peoples would make war an unnecessary instrument of politics, unless it be to repel aggression.

What we demand in this war [...] is that the world be made fit and safe to live in; and particularly that it be made safe for every peace-loving nation which, like our own,

199 Woodrow Wilson, "Speech on the Fourteen Points." January 8, 1918. Available online at: http://www.powerfulwords.info/speeches/Woodrow_Wilson/.

wishes to live its own life, determine its own institutions, be assured of justice and fair dealing by the other peoples of the world as against force and selfish aggression.

To this end, Wilson proposed two organizing principles: that the nation be the building block of a new and more just Europe; and that self-determination, a tacit application of the democratic idea, was to help in defining the limits of the different nations.

Enlightened opinion, both in America and in Europe, was attracted by the Fourteen Points. There were to be no reprisals on the vanquished. The post-war world would be organized on the principle of justice and attention to the wishes of the different peoples. Peace would be guaranteed by a League of Nations. It is a seductive but really utopian document that must be read to be believed. But French and British public opinion was intent on retribution, so the Fourteen Points were not taken as the basis for the Peace Treaties. A "Carthaginian Peace" was instead imposed on the losers. The disappointment of the defeated powers would fester in the succeeding years.

All this was to be expected. The nationality principle proved to be a source of conflict as it meant the dissolution of multinational states and empires, which was sure to be resisted by at least one of the contending sides. Also, it soon became clear that nationalities were inextricably mixed in Central Europe, so that borders could not easily be drawn on the ground of 'one nation, one state'. No remedy could be found in self-determination: even if the people of disputed territories were allowed to decide with their votes to which states they wished to belong, there would always be minorities feeling they belonged elsewhere; and it was adamantly resisted. The victors did not want to be deprived of their territorial spoils. Finally, the US and the USSR refused to enter the League of Nations, which proved unable to cope with the ambitions of Mussolini and Hitler.

The spread of the nationalist idea Certainly President Wilson was not the first to invoke the principle of nationality. Its roots are found in the French Revolution and the victorious efforts of the French to push back the concerted attack of the conservative states of Europe. The essential ingredients of nationalism are to be found in the Revolutionary Wars, before Napoléon arrived on the scene: one, a people ready as a body to take sovereignty from the hands of kings; the other, the productive capacity of the modern economy.

The contention that people, not least free people, are naturally organized in nations is a relatively modern concept. There are three special moments when the idea of a nation bloomed. The first moment was during the French Revolution, when a people in arms pushed back the armies of Europe and then victoriously invaded the Continent. The second was at the end of the World War I, when at the behest of President Wilson, the right of each nation to become a state was

proclaimed. The third was on the occasion of the Bandung Conference of 1955200, when the idea was launched that the countries of the third world had a right to become independent states on a par with the older nations of Europe that had lorded over them. At each of these three moments, the idea of the nation and the right of a people to become a nation-state was presented as self-evident, but soon showed deep contradictions. The French revolutionaries worshiped at the altar of Universal Reason but then tried to impose French civilization on the peoples they allegedly freed. The European nations born of the splitting of the Austrian, Russian, Ottoman and German Empires discovered that they were multinational themselves and were soon at war within their own borders and with their multifarious neighbors. The new third world states had no compunction to stamp out all freedoms within their new and somewhat artificial borders in the name of national liberty.

The origin of the two kinds of nationalism

Let me start with the ideological element. There are two kinds of nationalism. The first was born in the 17th century with the English revolution and the beheading of King Charles I. This was the concept of the nation as a framework for freedom. The poet John Milton (1608-1674) did not battle to free England from a foreign yoke but to deliver "man from the yoke of slavery and superstition". He wanted to go back to the ancient laws of England, so as to protect the Englishman's personal, civic and religious liberty. In his famed pamphlet Areopagitica201 (1644) he argued for "the liberty of unlicensed printing". In other political writings he defended the execution of Charles I for being a tyrant, and demanded that Parliament recognize that "the whole freedom of man consists either in spiritual or civil libertie". 202 John Milton's ideas were put in practice in a prudent and progressive way in England over the centuries, starting with the Glorious Revolution, when James II fled the country after throwing the Seals of State into the Thames and William and Mary ascended the Throne.203

The Americans with their Declaration of Independence in 1776 wanted to defend English traditional liberties: the Common Law, personal and religious freedom, civic representation, federal devolution.204 Here, too, the nation was conceived not as a personalized political and spiritual entity, but as a home and framework for the enjoyment of liberty by the people.

200 More information available online at https://history.state.gov/milestones/1953- 1960/bandung-conf. 201 Available online at http://www.econlib.org/library/Essays/miltA1.html. 202 "The Readie and Easie Way to Establish a Free Commonwealth" (1650, 1999), pages 439-441, See also "The Defence of the People

of England" (1651 and 1654). Areopagitica and other Political Writings of John Milton.Liberty Fund, 1999. 203 Hans Kohn (1955): Introduction (2.), Nationalism, its Meaning and History. Van Nostrand, Princeton. 204 John Milton also defended individual merit and local devolution of power. "The other part of our freedom consists in the civil rights and advancement of each person according to his merit [...]. Both of which in my opinion may be best and soonest obtained, if every countie in the land were made a kind of subordinate Commonaltie or Commonwealth." ("The Readie Way", pg. 441.)

The second conception was based on the romantic ideas of Rousseau. Always the Genevan puritan, he had nothing but disgust for the luxurious way of life of the French Court. Mankind, when unspoilt by civilization, showed its original goodness. "Man is born free, and everywhere is charged with chains" was the starting phrase of his earth-shaking book, Le contrat social (1762). Power in the city was based on the agreement of the sovereign citizens when not moved by their particular interests or joined in association or party.

There often is a great deal of difference between the will of all and the general will; the latter only looks at the common interest, the other looks at private interest and is only a sum of particular wills. (Rousseau, Le contrat social, Chapter III)

Thus society itself acquires a personality and lives for the good of the people when differences disappear and only the common good is sought. Each member of the city, after having agreed by covenant to alienate himself totally with all his rights to the whole of the community finds that:

Each one of us puts in common his person and all his power under the supreme direction of the general will; and as a body we receive each member as an indivisible part of the whole. (Rousseau, Chapter VI)

This was the political philosophy of the Jacobins during the French Revolution, whereby the individual alienated himself to the salut public, or public health and safety.205

Lord Acton in 1862 put the two views of nationality most clearly, as corresponding to the French and English systems. For him they were at the opposite poles of political thought.

In one case, nationality is founded on the perpetual supremacy of the collective will, of which the unity of the nation is the necessary condition [...]. Connected to this theory in nothing except in the common enmity of the absolute state, is the theory which [...] is distinguished from the other, because it tends to diversity and not to uniformity, to harmony and not to unity. [...] While the theory of unity makes the nation a source of despotism and revolution, the theory of liberty regards it as the bulwark of self-government.206

Modern industry and democracy

Reducing the spread of nationalist ideas purely to intellectual evolution does not paint the whole picture. Here I will contrast the views of two critics of nationalism

205 Rousseau's economic ideas tally with his political philosophy of enmity to civilization. A fragment in Volume III of his Collected Works (edited under the direction of Bernard Gagnevin and Raymond Avec, page 52), demands that all work-saving devices be proscribed, "all machinery or invention that give the same results as human labor with less effort". 206 Lord Acton (1862): Essays on Freedom and Power. Extract

included as Reading 8 in Hans Kohn (1955): Nationalism: Its Meaning and History. Van Nostrand, Princeton.

whose lectures I attended at the London School of Economics in the 1960s, Elie Kedourie and Ernest Gellner.

An outright rejection or a melancholy understanding of nationalism has characterized the writings of many an enlightened thinker, especially after the shambles brought by the Wilson doctrine between the two World Wars. Those who have most deeply lamented the havoc brought by nationalism in Europe and later in the world at large usually come from countries that used to be a part of 19th century multinational empires. Joseph Schumpeter, for example, was an old style Austrian gentleman who never really felt at home in America. The nostalgia for non-nationalistic days was especially keen in assimilated Jews, such as the Viennese Karl Popper and the Estonian Isaiah Berlin, as also the two writers whose views I want to consider now.

Elie Kedourie was an Iraqi Jew who found it impossible to live in the post-Ottoman Middle East. Ernst Gellner was the son of German speaking Jews who had fled Bohemia. Both writers found a home in Britain, then a land free of nationalistic fever though undoubtedly patriotic. I often conversed with them when writing my thesis on Mill. They both wanted to find an explanation for the phenomenon of unbridled nationalism, which had so impacted their lives.

Kedourie considered nationalism a venomous ideology born of the philosophy of the Enlightenment.

Nationalism is a doctrine invented in Europe at the beginning of the nineteenth century. It pretends to supply a criterion for the determination of the unit of population proper to enjoy a government exclusively of its own, for the legitimate exercise of power in the state, and for the right organization of a society of states. (Kedourie, Nationalism, page 9)

The doctrine he thus criticized had its roots in Kant's idea that the individual was free only when moved by her own conception of the good, impervious to rewards and with no regard to consequences. Self-determination justified all actions in search of the moral life, both of the individual and the nation. This doctrine, he added, became a part of the political rhetoric of the West and then of the whole world.207

Gellner thought that nationalism was more than an ideology. He thought that the kind of society created by industrialization was fertile ground for the spread of nationalism, so that nationalism was not a contingent intellectual development but a necessary consequence of the new mode of production: the population became mobile, literacy spread, individuals lost their local ties, expectations became egalitarian, government turned centralized, the state was able to mold their peoples and regiment them. The role of ideology was only to help stateless intellectuals and politicians exploit those conditions.

207 Elie Kedourie (1961): Nationalism. Hutchinson University Library.

Gellner did not want to deny that "humanity has always lived in groups" and that "a certain amount of patriotism is a perpetual part of human life". But for him nationalism was a very concrete kind of patriotism transformed by the social conditions of the industrial world. Nationalism changed a constant trait of humanity, to live in groups, into a powerful political force taken over by the state.

Gellner should have added that industrialization came before nationalism. From the time of Adam Smith to that of Bismarck, liberal capitalism seemed to have opened the way to unrestricted globalization. The effect on wealth had been spectacular and trade seemed to have guaranteed lasting peace among civilized nations. There even was strong resistance to the acquisition of colonies, especially in England, voiced by Jeremy Bentham and the philosophical radicals, and by Richard Cobden and John Bright. This period of progress through commerce culminated with the 1865 free trade treaty between Victorian England the France of Napoleon III, signed by the Trade Secretaries Cobden and Michel Chevalier. But around 1870 trade and the economy were 'nationalized' and put at the service of state-building. Protectionism was launched by Bismarck, the German Chancellor, and that policy slowly spread among other nations in Europe. Brink Lindsey in his book The Dead Hand (2002) has proposed two theses: that globalization was not inevitable and could be reversed, as had happened in other historical instances; and that from 1870 to 1950 there seemed to be no limit to the political use of the capacities of capitalist production. Lindsey calls this backward-stepping period the "industrial counterrevolution". The egregious politicization of industry and trade in the period before World War I and during the war itself showed the terrible consequences of putting the new industrial capacities of national expansion at the service of the national state.208

Concepts of liberty

Isaiah Berlin in his deservedly famous essay "Two Concepts of Liberty209" (1958), drew the difference between 'liberty from' and 'liberty to'. If one studies the essay carefully, it becomes clear though that Berlin added a third kind of liberty to the first two. For him there was first 'liberty from', which unfortunately goes by the name 'negative liberty' but should be called 'formal liberty'. Second came 'liberty to' or 'positive liberty'; and thirdly 'status liberty' or 'national identity'. The three kinds of liberty are best summed up under the motto of the French Revolution: Liberté, Égalité, Fraternité. Let me attend to Fraternité.

This third kind of freedom Berlin defined as group dignity and self-rule.

208 Brink Lindsey (2002): Against the Dead Hand: the uncertain struggle against global capitalism. See also the book by Margaret MacMillan (2013): The War That Ended Peace: How Europe abandoned peace for the First World War, on the Paris Universal Exposition of 1900, pages 1-7; the change in society due to industrialization, pages 9-24 and chapter 9; and on Socialism, pages 285-293. In general, this distinguished book gives an excellent picture of the social and economic scene in the years before 1914. 209 Available online at https://www.wiso.unihamburg.de/fileadmin/wiso_vwl/johannes/Ankuendigungen/Berlin_two conceptsofliberty.pdf.

I may be seeking not for [...] security from coercion, arbitrary arrest, tyranny, deprivation of certain opportunities. [...] What I may seek is to avoid simply being ignored, or patronized or despised [...]—in short, not being treated as an individual, having my uniqueness insufficiently recognized. [...] This is hankering after status and recognition. (Berlin, "Two Concepts of Liberty," pages 157-158)

In the 19th and 20th centuries the demand for status at the expense of individual liberty took at least two forms: privileges for trade unions and the right of national self-government. As Isaiah Berlin noted:

It is this desire for reciprocal recognition that leads the most authoritarian democracies to be, at times, consciously preferred by its members to the most enlightened oligarchies. (Berlin, page 157)

As to trade unions, in Britain they slowly gained privileges that made them special kinds of association. Unions were legalized in 1851 and gained exemption from liability for strike action with the Trade Disputes Act of 1906. This Act also legalized closed-shop clauses, whereby workers could be forced to join the shop union under pain of dismissal. The 1992 Trade Union and Labor Relations Act passed at the behest of Margaret Thatcher reversed the trend and forbade closed shop arrangements, demanded a ballot before a union called a strike, and made 'sympathy strikes' illegal. In the US, under the inspiration of Franklin D. Roosevelt in 1935, the Wagner Act legalized collective bargaining and closed shops, and set up the National Labor Relations Board. The worst anti-competitive features of this Act were corrected by the Taft-Hartley Act of 1947, allowing states to pass rightto-work laws, whereby nearly half of American states are union free. Similar developments were seen in other European nations. Though they did not impinge directly on national policy, they did indirectly on the demands for wider representation.

Self-determination in the 21st century

Nationalist aspirations have certainly not disappeared in the present century. I will apply the notions examined above to three instances of aspiration to separate from encompassing states and the creation of new ones: oslovakia, Scotland, and Catalonia.

Czechoslovakia

The separation of the Czech Republic and Slovakia was decided in 1992 between Václav Klaus, the then Prime Minister of Czechoslovakia, and Vladim¡r Meciar, the political leader of Slovakia. Klaus's first idea was to discuss a tighter federation between the two nationalities but he soon saw that the path towards a peaceful separation into two independent states was best. Public opinion in both countries was against separation, but Klaus and Mečiar went ahead.

The two countries had lived separate lives under the Austro-Hungarian Empire, as Bohemia and Moravia, on the one hand, and Slovakia, on the other. On the

dissolution of the Empire they were merged into a single country independent from 1918 to 1945. The Communists formally kept a united Czechoslovakia until 1969, when the Prague Spring was forcibly put down: the country was turned into two 'Socialist Republics' with separate puppet governments. With the dissolution of the Soviet empire in 1989 they returned to being a single state. Four years later, they split again. From the point of view of identity it was clear they were different nations.

The romantic hankering after a separate nation-state has not turned out to be as dangerous for personal liberties as could have been the case, because both countries wanted to enter the European Union with its provision for human rights. Only Klaus has denounced the dangers of the bureaucratic interference of Brussels, where the establishment hankers after a centralized European federation.

The grounds for complaint in both nationalities before the split was the weight of fund transfers from Prague to Bratislava. The Czechs bore the taxes needed to pay for subsidies to the Slovaks. The recipients of the transfers fretted under the interference of the grantors. After the "velvet divorce" the Slovaks govern themselves and have had to learn from their own mistakes: they are a model member of the Union and the euro. And political relations between the two governments and personal intercourse of ordinary people of the two nationalities are more cordial.

The peaceful divorce between the Czech Republic and Slovakia leads me to three conclusions: (1) The two countries had many precedents of separate existence, so that the separation did not even need a referendum; (2) the umbrella of the European Union abated worries about personal freedoms after a victory for what I have called "romantic nationalism" but substituted Brussels' interventionism for that of Prague's; (3) multinational states have great difficulty in staying together with a background of financial transfers from one region to another and with bloated welfare states.

Scotland

The Scots and the English have had a long history of conflict and rivalry but they started coming together as far back as 1603 when they shared the same king in the person of James VI of Scotland and I of England. In 1707 the Parliaments of both countries voted to join them in a United Kingdom.

After the Union, the peace and quiet of Scotland was disturbed by at least four Jacobite expeditions attempting to restore the Stuarts to the throne of Britain. The first was led by the son of the deposed King who styled himself James VII, in 1689: he found his main backing in the Highland clans. The second was in 1715, led by James VIII, the Old Pretender who soon was forced to return to France. The third was aborted in 1719, despite the landing of a Spanish force. The fourth in 1745 was the most forceful, led by the Young Pretender, Bonnie Prince Charlie, who invaded England down to near London vainly hoping for an enthusiastic reception of a

Catholic king in the south of the United Kingdom. The uprising was finally routed at the battle of Culloden.

In the end, it was a clash was between the Highlanders and their Tory supporters in England, and the more forward looking Lowlanders and the Whig Party. When the conflicts ended, Scotland was fully on the path of the ideals of the Enlightenment. Thus, the circle around Hume and Adam Smith was clearly in favor of the new regime, despite attempts of the Scottish Nationalists of today to enlist these luminaries of the past: Hume spent time in Paris as a member of the British Embassy and Adam Smith, in the last part of his life, was a UK Commissioner for Scottish Customs.

Nationalism in all parts of the world unscrupulously enlists history in its cause with scant interest in the past wie es eigentlich gewesen war, as it actually happened, in the words of Leopold von Ranke. The deformation of Scottish history has gone from ignoring that the Jacobite uprisings were a civil war between clans to forgetting the many Scots and English who preferred the William and Mary as their new King and Queen. From Sir Walter Scott novels to the film Braveheart, history is used to paint a romantic and false picture of Scotland's past.

The recent referendum campaign, which I followed very closely, was in reality a dispute about how much England sent Scotland (and Wales and Northern Ireland) as a subsidy to try and reduce the inequality among the nations of the UK. Now that they have lost, the Nationalists are sure to try and get as much devolution as they can. In principle that is not bad, since one should reduce centralization as much as possible. From what I heard, the Nationalists wanted to have more say in their own affairs mainly to ensure the continuity of their profligate welfare state: National Health free at the point of service; more generous public pensions; better unemployment benefits; greater assistance to single parent families and poor children; free University education for Scots; and subsidized re-industrialization to counter Margaret Thatcher's "trail of destruction". To finance it all they also demanded full control of Scotland's share of

North Sea Oil. They also hoped to renew European regional subsidies as soon as they could. For me, the main lesson from that campaign is that calls for independence would not be so keen if the democratic state did not suffer from elephantiasis: people use nationalism to increase their share of the pie. Well, as long as the Scots pay the full bill, let them try.

Another proposal was to send away the Trident submarine base at the Clyde Loch back to England, as nuclear arms were "immoral weapons of mass destruction". The phrase had an echo in the predominantly leftist opinion of the Scots. During the debates, someone asked Alex Salmond whether, after independence would he visit Vladimir Putin in Russia and Kim Jong Un in North Korea to ask them to follow suit. Though he spoke of creating a Scottish Armed Force, the truth is that those peaceloving nationalists always rely on someone else to defend them—be it England or the United States.

Of course there is an element of the subordinate Principal Minister wanting to become an independent Prime Minister and partake in the councils of the EU on a par with the 28 nations at present in that organization. Mr. Salmon said he wanted to keep the Queen and the pound sterling forever, and get the help of England to return to the EU. The irony is that in due course we could see Scotland in the EU, selling whisky and festivals to its European partners, and using the euro, so as to have a respectable currency under the protection of the ECB—while England was out of both.

Why do I see Scottish independence less kindly than the "velvet divorce" between the Czechs and Slovakia? I am unhappy with the idea of 'self-determination'. Whose self-determination? We have seen the vote for independence lost 45% to 55%. Public opinion in a country whose inhabitants and culture are so intertwined by centuries of common history has been split in two by the referendum. The Scots living in England and the rest of the world were denied the vote, and the unionists within Scotland were accused of voting with their pocket books and not with their brave hearts. The Referendum could have been won by a simple majority a question on whose wording David Cameron, the Prime Minister, did not even consult the UK Parliament. To split the country thus would have been a flagrant instance of the abuse of power of a slim majority over a large minority.

Catalonia

The history of Catalonia in Spain is even longer than that of Scotland in the UK. It started with the marriage of Queen Isabella of Castile to King Ferdinand of Aragon in 1469. Catalonia was a county of the Kingdom of Aragon on a par with Valencia, the Balearics, and Naples. Charles V of Castile and I of the Holy Roman Empire consolidated the union by putting down a rebellion in Castile. In 1640 Catalonia and Portugal rose up in arms against the Crown on a question of taxes and military service. Only Portugal split away. During the war of Spanish Succession at the turn of the 18th century, the Kingdom of Aragon sided with the Austrian pretender but the Bourbon King Philip V won the war and abolished their liberties. As often happens with aspiring nations, the Catalans commemorate the defeat of 1713 as their national day. Catalonia prospered under centrally organized 'enlightened despotism'. In the 19th century commercial protectionism fostered the industrialization of Catalonia and the Basque Country at the expense of the rest of Spain. This special protection continued in the 20th century, especially under Franco until the dictator was forced to open the economy in 1959. Much of this favoritism is forgotten in the rewritten Catalonian history now being taught in schools. The Catalans have a right to speak their language as they wish, but I find it a little silly to teach children Spanish as a foreign language. This by the way is an indictment of all democracies that use state education and impose programs on private schools to foster to "build a country". As Mill used to say, it is "not to be endured, that a government should, either de jure or de facto have complete control of the education of the whole people. To possess such a control, and actually exert it, is to be a despot."

My point is again one of 'self-determination' as an abuse of democracy. Both the imposition and the rejection of independence in a country split down the middle would be discrimination against a large minority. At present the Catalan Nationalists are visiting shops to ask them to put up a sign of sympathize with their aims: To say no is to signify oneself. Large and small businesses are mostly keeping quiet for fear of losing clients in Catalonia—or in the rest of Spain. People who would prefer not to be separated from Spain are being tarred with the brush of treason.

Catalonia has a degree of devolved power that Scotland can only dream of. Surely devolution could be taken further. It should also be possible to review the excessive amount of regional transfers borne by the Catalans and also the Madrid Autonomy. The roots of nationalism are to be found, not only in the wish of local leaders to see their importance increase by playing on romantic feelings, but also in the temptation to keep their funds for the local welfare state. They would have great difficulty in financing the pensions and health care promised the population let alone bearing their part of the Spanish public debt—now at an equivalent to 100% of GDP.

Nationalism and patriotism

My rejection of the excesses of nationalism from the point of view of individual freedom does not mean that I overlook the existence and force of patriotic feelings. It is one thing to aid and abet aggressive uses of power to form nations or increase their territory, and quite another to feel a deep attachment to one's country. Spain is not better than other countries in the world in its past history or its present state. Would I be ready to take up arms to defend her from an unwarranted attack? My answer would be yes. And I am sure that many people in Catalonia would say the same, as they heroically showed in the resistance they put up against the French invasion during the Napoleonic Wars.

It is the artificial creation of nation states that lays the ground for the invasion of personal liberties. Moving borders often leads to the shedding of blood, as Europe discovered to its cost during the 20th century. Attempts to build new nations by carving up or forcefully joining old and settled societies, gives rise to the kind of tensions we are today witnessing in the European Union.

The paradox of nationalism

The presumption that nations have a natural right to form their own state deserves criticism. Nationalism is a case of abuse of the principle of majoritarian democracy. Nationalists usually claim to be democratic or at least claim to be answering the wish of the sovereign people. Nationalism is not freedom-loving by nature. At birth, nations are created out of disparate elements. In the course of their lives, they must be maintained against centrifugal forces, since the principle of nationhood can be claimed by other regions in the nation. However, political self-government, which ideally is the corollary of individual self-government, can normally only be organized within a nation-state. Liberal democracy and nationalism are

antithetical but citizenship needs a nation-state to function politically. Here is a contradiction that modern democracies do not seem to be solving neatly.

Don□t Cry for me Argentina

June 5, 2015

In November last I was in Argentina, the country of Evita Peron, for a Liberty Fund colloquium on whether commercial banks should back deposits with 100 percent ready money to avoid runs when confidence falters. What I have come to think about fractional reserve banking I will leave for a later column. Today, my topic is almost as distressing as that of banking crises, for it deals with the future of Argentina and other Latin American countries that follow the same populist path as that perpetually ailing country.

On my way to the city of Rosario where the colloquium was going to take place, I was told that the official rate of exchange was nothing short of extortionate. Foreign trade is the soul of Rosario. It is at the center of one of Argentina's most productive agricultural regions: soya, corn and other cereals, and formerly large amounts of beef are exported to the world through some twenty private ports on the river Paraná. (I say 'formerly' because the Argentine government has been trying to fight inflation by stopping meat exports to lower the local price of beefsteaks: the result, Uruguay has now more cattle than Argentina.) It could not be so difficult to find some establishment in Rosario where I would be quoted a price for my dollars that would take into account the galloping inflation.

The hotel concierge offered me the stingy amount of 8.50 pesos per U.S. dollar, which would make what I bought or spent in Argentina prohibitively expensive. I objected, "But that is the official rate; could you not give me the black market one?" Very correctly, the concierge answered that the only rate they were allowed to offer was the official or 'white' rate. I could get a better price ("Don't say 'black market rate,' but 'blue rate,' please.") at a small restaurant some blocks away. I walked to that establishment where the owner offered me 11 pesos per U.S. dollar—nearly thirty per cent more than the official rate. I suppose I could

have bargained for more, but I was content with having both sides profit. In any case, the white and blue colors by which Argentinians call the official and the parallel rate piqued my curiosity and I decided to learn more about this multicolored currency.

The first step was to distinguish the official currency rates from those quoted on other more or less shady markets. The legal rate for 'white' dollars was indeed the overvalued one the hotelier had quoted me. However, to say that one can buy dollars even at this distorted rate is disingenuous, because the authorities will only grant permission to do so if they consider the buyer a person of sufficient means. Two months ago, a grandfather took the federal government to court because he had been denied permission to buy US$10, which he wanted to give his grandson. The President of Argentina, Cristina Fernández Kirchner, had the cheek to mock him in a television fireside chat for being such a miserly grandfather.

This is not the end of it. Since all real estate transactions in Argentina are conducted in U.S. dollars, one is permitted to purchase dollars from one's bank at the semi-official 'azure rate' of 10.71 pesos per U.S. dollar, on condition the notary

avers that they are being invested in property. When tourists pay with a foreign credit card, the shop-keeper or the hotelier applies the 'gold' rate of 11.56. And when a soya exporter brings back the sums obtained with his exports he will only be paid 5.53 pesos per U.S. dollar, and that after the deduction of a profit tax of forty per cent. So the state exploits people who do not trust the local currency and want to sell their goods for dollars.

This public policy has given rise to a lively black market (excuse me). Just before Christmas the illegal price for 'blue' dollars at exchange shops was 12.87 pesos. If one lived in Buenos Aires, one could buy so-called 'green' dollars at the better rate 13.07 pesos. Why 'green'? The dealers who pay this rate stand planted, so to speak, in Calle Florida in the country's capital city, and the ever humorous porteños call them 'arbolitos', or 'little trees'—hence green. Finally, if you badly need dollars to import parts for your car factory or tires for your tractors, the inexhaustibly inventive Argentinians have found another, though more risky way, of supplying them, by purchasing state bonds for pesos and selling them for dollars on Wall Street—at the 'grey' rate of 11.47 per cent.

Argentina□s plight

This welter of prices for the national currency may seem anecdotal, but in truth it is a symptom of the dire situation of Argentina's economy and polity. Economists call all this toing-and-froing the 'shoe-leather cost' borne by ordinary citizens who try to minimize the burden of inflation. The government prints too much money and tries to force individuals to accept the devalued pesos willy-nilly; the long suffering individuals then look for ways to get rid of this funny money for the highest value that can be got; the hope is to invest one's savings in a currency that does not melt like snow on the high peaks of the Andes in summer.

Since exchange rates are in the end related to the purchasing power of the respective currencies, the first thing to be asked is the rate of inflation in Argentina. The concept of a cost of living index, by which inflation is usually measured, is itself an abstraction, since every person buys a different basket of goods and therefore sees the value of money change differently. Despite this, many countries calculate inflation with the help of a weighted average rate of consumer price increases. Unfortunately, there was no such a thing as a well calculated inflation rate for Argentina. Some provincial governments do calculate the rate in their

territory; others did in the past but have given up. The government, after demoting the Statistical Office to the rank of a mere bureau within the Ministry of Economics, finally started compiling a national price index in February 2014. The Minister of Economy, the young Keynesian Axel Kicillof, has set the inflation rate for the present year at 24 per cent, while the opposition parties in the Argentine Congress claim it is above 41 per cent. Public opinion tends to believe the pessimists, if one can call Kicillof's rate optimistic. Whichever figure is right, inflation will in the end have the effect of stopping economic growth.

The question to be asked at this point is, why are prices climbing so fast? As Milton Friedman used to say, "Inflation is always and everywhere a monetary

phenomenon". The National Bank of Argentina must be creating an excessive money supply. This usually happens when the government cannot cover its expenses with its tax intake. And in fact, Argentina shows a large and increasing budget deficit. Public debt becomes more and more expensive to issue and the public starts to suspect that in the end the government will have recourse to 'print' the money it needs to spend.

From 2001 up to 2007 Argentina's public accounts showed a surplus. But public expenditures have been going up relentlessly since 2002, especially to pay for an increasing number of public employees and to defray the costs of ever more generous social services. There has been an attempt to finance these growing expenditures by applying fiscal pressure: the take has gone up from around one fifth of GDP in 2002 to one third in 2014, an increase of 11 percentage points in twelve years. When the product of taxes and Social Security contributions started to falter in 2007, the budget deficit came back. It is now at more than 6 per cent of GDP and growing. So the government issued debt. The figure stands at over 38 per cent of GDP, which sounds small in comparison with the debt of developed countries. But such is the plight of poor nations—and the curse of rich nations which seem to be able to bear debts greater than their GDP. The late clashes of the Argentinian State with its foreign creditors show that the present budget deficit is simply not sustainable.

The irony of this situation is that the deterioration has coincided with ten very favorable years with regard to agricultural, mineral and oil prices: from 2007 to 2013 the terms of trade for Argentina improved by 75 per cent. Despite this, the basic balance of payments is now in growing deficit and the official exchange rate keeps falling despite the Central Bank having spent $25 billion from its reserves in propping up the peso. The terms of trade advantage has thus been squandered. During the presidency of Nestor Kirchner and the first term of the Presidency of his wife, Cristina Fernández Kirchner, growth and populist redistribution seemed to go hand in hand. Joseph Stiglitz even spoke of an "Argentinian model" to be imitated in other progressive developing nations and especially by Europe. Now the rate of growth expected for Argentina in 2015 is minus 4.5 per cent.210 Good old Stiglitz, always backing the wrong horse!

The legacy of General Peron

But who is this Cristina Kirchner? What is the origin of her world-view, now shared by other populists in Latin America and in the European Union? Why does she hail back to 'Peronism'? The only thing the advanced world seems to know about this congeries of ideas and endeavors is the musical Evita. The heroine of this show is Eva Duarte de Peron, Evita for her fans. A second rate actress who suffered the poverty of an illegitimate child, she seduced her political hero, Juan Domingo Peron, who married her in 1945 when he was running for President. In 1946 he won the election with her decisive help. She never held a government post but took as her own the social policy of the Government during Peron's first stint as head of

210 Source for the data is a presentation at Rosario by José Luis Espert, on November 10, 2014. See http://www.espert.com.ar.

the country. Her very personal mixture of glamour and sentimentalism caught the imagination of the masses. With the proceeds of the National Lottery she funded hundreds of hospitals, schools, and homes for the aged around the country and personally doled out help to the needy. Attributed to her is the saying, "every need is a right". She was mainly responsible for giving Argentinian women the vote. The "shirtless", or "descamisados" as she called them in Spanish, revered her. I quite remember the delighted surprise felt by the people of the dour Spain of General Franco when she visited us: a bejeweled beauty spectacularly clad in her furs, able to show heartwarming sympathy to the toiling women and men in factories and fields. She died at the early age of thirty-two. Her adoring followers tried to have her canonized by the Church. Her embalmed body suffered a fate worthy of the magical realism of a Latin-American novel: when Peron was overthrown in a coup her body was whisked to Italy, then to Madrid to the home of her exiled husband, then to a crypt in the presidential palace, finally to be buried in the tomb of her family in Buenos Aires.211

Cristina Kirchner is ever trying to become Evita; her ideology is still that of Peron. The general, an admirer of Mussolini in his years as a military attaché in Rome, raised the political banner of resistance to the U.S. hegemon in Latin America and tried to define a middle way between capitalism and socialism for his country. His aim was to create a just society, hence the name "Justicialismo" he gave his ideology. That implied nationalism, industrial protection, trade-unionism, and an all-encompassing welfare state.

The figures of Peron and his Evita are the incubus of Argentinian politics, ever present never exorcized. In one form or another Peronism has been in government in the Argentine provinces and in the federal government since 1945, except during the periods of military dictatorship. After Fidel Castro took over Cuba, Peronism found a growing echo in large parts of Latin America, where a number of countries now seek independence (from the US) and socialism (of the 21st century) by joining an organization called ALBA,212 founded by the late Hugo Chavez of Venezuela.

When Argentine was rich

Between 1860 and 1930 Argentina became the star of Latin America, not only economically but also culturally and in terms of political stability. The economic historian Mauricio Rojas213 relates how the city and port of Buenos Aires grew to be the metropolis we can still admire today, despite the decadence of the last

211 The entry in the Encyclopedia Britannica draws a fetching portrait of this political star. Tomás Eloy Martinez has written a masterly novel on the travels and adventures of her embalmed body, called Santa

Evita (1997), where fiction becomes reality and long suffering Argentina is shown to have found her defining myth. 212 ALBA is the acronym of the "Bolivarian Alliance for the Peoples of Our America", encompassing countries going from Cuba in the Caribbean to Ecuador and Bolivia in the Andes. It was founded to counteract ALCA, the U.S.-inspired "Free Trade Area of the Americas". The countries in ALBA are in close contact with MERCOSUR, the attempted customs union of the South of the Continent, whose principal members are Brazil and Argentina. 213 Mauricio Rojas: Historia de la crisis argentina. (Cadal and Timbro, 2001).

eighty years. The extermination of the Indians of the Pampas in 1879-80 left the land free to be engrossed by a very small number of powerful landowners, who in effect ruled the republic until the crisis of 1930. They were the class that the Peronists would contend with in the second half of the 20th century. The development of steam transport, both by rail and by ship, opened a huge market for the wool, wheat, and beef Europeans craved. Argentina also opened its shores to poor immigrants of Italy and Spain, who mostly went to the cities and started shops and small industries. Exports were the mainstay of landowner prosperity, consumer industry the supplier of the urban middle class. The value of real exports multiplied 13 times from 1865 to 1914. Industrial production and the railways also expanded—so that the average yearly growth of the Argentine economy from 1869 to 1914 was more than six per cent.

However, far from being an ultra-liberal economy and a paradise of free trade, protectionism gathered strength all through the last quarter of the 19th century, as Dr. Rojas shows. Strangely for an economy whose engine was foreign trade, there were continuous tariff hikes, despite the complaints of exporters who faced retaliation. Local wheat and maize producers obtained a tariff to protect them from foreign competition. This was also the case with refined cane sugar. Especially after 1900 local consumption industries were able to hide behind a tariff wall, which reinforced the tendency in Argentina towards shallow industrialization concentrated on finished goods. Argentina was lucky to be at the receiving end of long term foreign capital investment in railways, port facilities, urban equipment, and trade services but growing anti-foreign capital rhetoric lay the ground for expanded protectionism. Oil was the special point of contention and Standard Oil became the whipping boy of nationalism. As ever, foreign capitalists were portrayed as leeches sucking excessive profits from a subject country.

In the Roaring Twenties the weakness of the Argentinian economy began to show. Agriculture needed foreign capital and better management. Industry was not ready to compete in the world either, turned as it was mainly towards the domestic market. Also, social tensions increased after World War I, in sympathy with a new spirit of confrontation fostered by the example of the Russian Revolution. The day of reckoning came on Black Friday 1929. Suddenly, the market for primary goods dried up. Industrial sectors could survive only by selling on the domestic market. The situation worsened with the sudden surge of protectionism among Argentina's customary clients. The Smoot-Hawley Tariff of 1930 caused immense harm in Argentina and around the world. The United States and other advanced countries have much to answer for the harm done to Argentina and more generally to economic freedom in the years after the Great Depression.

Populism in the World

I need not spend much time in describing Peron's policies when he was elected President in 1946. They are those of Cristina Kirchner and of the other nationalpopulist governments of Latin America today—only the present economic climate has changed radically and those dreams have turned into nightmares. Colonel Peron was pro-Nazi during World War II and maintained his anti-Americanism all

through the fifties. As President, he set in motion a massive redistribution of income and property with forcible wage increases and a wide array of social benefits and entitlements. Docile trade unions became an instrument of statepower. Agricultural exports, except cotton, were centralized and monopolized under a State Trade Board. The profits from the primary goods trade monopoly were channeled towards an aggressive policy of industrialization, with statecontrolled companies at the forefront. The domestic market expanded behind ever higher tariff walls. As a consequence of all these developments the weight of the state in society increased immensely.

As I went from pillar to post in search of a good price for my dollars I thought I saw Colonel Peron and dear Evita round every corner. Only those policies which looked so promising and patriotic half a century ago were in tatters in the fair land of Argentina. That is why I watch the development of populist movements in the world today with some despair for our lack of conviction in the practice of capitalism. All this is our fault—Peron, Evita, Kirchner, Chavez, Evo Morales, the mild revolutionaries of southern Europe, the protectionists in the United States and the United Kingdom. Liberal democrats who pose as the standard-bearers of capitalism have promised the impossible: to keep our economies growing while resisting competition and guaranteeing an ever more generous welfare state. The recent crisis should have been an object lesson in the failure of our middle of the way policies. We in the advanced nations do not want to recognize that a huge state sector doling out generous supplies of money to keep private industry happy is simply unsustainable. Populism is our Dr. Frankenstein, who now has turned angry because he believes that the recent crisis was due to too little rather than too much Peronism.

Greece and the Euro, All Over Again

February 2, 2015

The inventors of the euro thought that by artificially constructing a single currency and imposing it on the nations of Europe they would strengthen the Union they were intent on building. The effect has been to deepen its divisions. The aim, for the Germans especially, was to build a solid currency of stable value issued by an independent central bank, along the lines of the Deutsche Mark and the Bundesbank. They meant well, but the Great Recession of 2007 uncovered some defects in the design that led to a general revolt. Defective or not, the euro as originally intended is today rejected by the greater part of the Eurozone. The governments of the southern reaches of the Union are trying to create something quite different. Even Signor Mario Draghi with his Quantitative Easing seems intent on changing the euro fully into a fiat currency with no institutional limits to discretion. The ultimate reason is that voters in many member countries, not just in Greece, feel that the solid euro is too harsh a discipline given their profligate habits.

The original euro

After many tries the euro was adopted in 1997 in Maastricht, a charming walled town in the Low Countries, famed for its antiques fair. A number of conditions were set for members wanting to enter the Eurozone, the principal ones being: a low rate of inflation; sustainably moderate interest rates; a balanced budget with at most a deficit of less than three per cent of GDP, and public debt equivalent to 60 per cent of GDP or less. These conditions were demanded so that the members of the future currency zone would not be too far separate as regards their financial structure and would react in harmony when an unexpected shock struck the zone. This would allow the central bank to apply the same interest rate policy to all members without unwanted effects.

Germany however drew attention to the need for the same rules to apply to members of the monetary union once it was formed, to control possible free riding by countries using the low interest rates to finance large public deficits. A "Stability and Growth Pact" was agreed to along those lines just before the euro was introduced in the year 2000. Unfortunately, in 2003 Germany was still spending large sums to aid the ex-communist part of the country, and France was suffering the hangover from the Keynesian policies of President Mitterrand; both countries indicated that they would overstep the Maastricht limits and the Union decided to soften the rules. In 2011 the harsh lessons of the crisis forced a return to the more severe rules.

In its original form the euro was meant to function as a quasi-gold standard. For a time during the first seven years of the new century, with the European Central Bank charging the same low interest rate to all parts of the region, it looked as if the skies over continental Europe were perpetually blue. This could not last, first

because the ECB's generous monetary policy fuelled real estate prices and profits; and second because ever larger public expenditures could not permanently be funded by loans. In some countries the crisis went from financial to fiscal: the 2007 crisis uncovered the financial weakness of unwisely marketed mortgages, so governments had to step in to save banks, as happened in Spain when the real estate bubble burst. In other countries, the crisis went from fiscal to financial, when over-indebted Treasuries were forced to borrow abroad at extortionate rates, if they could find a lender.214 Markets had been asleep during the halcyon days but finally they cracked their whips. What had become clear is that the ECB could not apply a prudent monetary policy unless it took asset prices into account and not only consumer prices; and that countries could not hope to stay in the euro if year after year they overspent on the welfare state, as was the case in Greece.

In the end, an inflexible euro was doing its job, as did gold drains in the 19th century or speculation against currency pegs in the 20th. If one wanted to abide by the gold standard or keep the peg or stay within the Eurozone, sacrifices had to be made. A fixed exchange rate demands that prices, and especially wages, be flexible. Large budget deficits must be avoided since mountains of debt tempt governments to inflate. When markets realize this means that a monetary or an exchange crisis is developing the heavens fall in. To avoid catastrophe, harsh austerity measures become necessary. Thus the single European currency turned out to be a brake on easy monetary policy and on excessive government expenditure.

Financing Foreign Deficits

The trouble is that it took too long for the brakes to work. The ease with which balance of payments deficits were financed within the Eurozone led to belated reaction to wrong policies. Also, a dangerous feature of the euro was overlooked. It goes under the obscure name of TARGET2. In the present world there is a whole industry engaged in finding attractive acronyms to shorten the forbidding names of bureaucratic institutions. For example, the body of doctors who, under the British National Health Service, decide whether persons of advanced age will receive expensive treatment is known as NICE, for "National Institute for Health and Care Excellence"—a job that I would not want. As regards the euro, TARGET2 clearly wins the rhetoric stakes for bowdlerization of inglorious administrative appellations.215 TARGET2 stands for "Trans-European Automated Real-time Gross settlement Express Transfer system", a second generation of the automated system for clearing payments within and across euro-countries. Let me explain the workings and disastrous effects of the TARGET2 payments system. Imagine a Spanish driver who orders a gleaming motorcycle in Germany. He owes his bank the euro price of this machine. His bank now is a debtor to the Banco de España,

214 An outstanding analysis of the two forms the 2007 crisis took—financial to fiscal, and fiscal to financial—is masterfully explained by Leszek Balcerowicz in "Euro Imbalances and Adjustment: a Comparative Analysis", Cato Journal, vol. 34, no. 3 (Fall 2014). PDF file. 215 By the way, rhetoric is much more important and pervasive than people think, and if you do not agree let me recommend a book by Sam Leith, You Talkin' to Me? Rhetoric from Aristotle to Obama (Profile Books, 2012). We defenders of liberty have great need for good rhetoric or the art of persuasion as it is called today. The least we could do is follow the example of Mark Antony's speech rather than Brutus's in Shakespeare' Julius Caesar.

which in turn becomes a debtor to the ECB, which credits the Bundesbank the money transferred to commercial bank of the motorbike seller. The essence of this transaction is that the payment for the motorbike is channeled through the ECB and paid in ECB euros, so that in the end the balance of payments deficit caused by the purchase of the machine is financed by the Bundesbank. If Germany is a net exporter to the rest of the Union its TARGET2 credit grows and grows. And vice versa for debtor countries.

The reason the ECB wants to be the exclusive channel through which all these debits and credits flow in real time, for a very small commission and no collateral, is that it wants to give the euro a good reputation for being a reliable currency in which everybody in the Eurozone automatically accepts for goods and services, whatever the credit standing of the member country making the payment. The result of this, however, is that countries can run huge balance of payments deficits without being called to question. It is thus that Spain was able to run such large payments deficits during the crisis: for example its current account balance showed a shortfall of ten per cent of GDP in 2007-2008. As can be seen in Figure 1, the main creditor for these and other countries buying more than they sell with the help of TARGET2 was Germany. If one of these debtor countries (for instance Greece) left the euro, the Bundesbank would suffer a large loss. Also, as there are no limits to running up debt though this facility and the same flat commission is charged to all users, whether or not they have large deficits, the incentive to excessive spending will be irresistible.

Figure 1. TARGET2 balances in the Eurosystem from January 2007 to April 2014 (monthly data in millions of euros)

It is neither inevitable nor necessary that these transfers be channeled through the "European System of Central Banks". The member countries of the euro could have been left to make their own arrangements for international settlements through private banks, as is now the case for clearance with residents outside the Eurozone. The effective nationalization of foreign transfers within the Zone on the pretext of making the euro popular was a clear mistake and resulted in putting the euro out of kilter.

Greece's Protest vote

A single currency, such as the gold standard was or the euro aspired to be, works more smoothly the more flexible the economy is. This is the implication of Robert Mundell's seminal 1961 article on Optimum Currency Areas (OCAs),216 where the exchange rate cannot be used as a policy instrument. The rate of exchange of a Eurozone country, let us say Greece, is by definition fixed. Hence, the Greek National Bank has no power over monetary policy. The ECB sets the basic interest rate, which may or may not suit Greece if its real economy has not converged with the rest. The interest rate adapted to the average circumstances of the Zone will cause unemployment in Greece if it is too high (or an artificial boom if it is too low). The remedy for such disharmonies is for factors of production quickly to move out of the country (or move in). The trouble with the Eurozone is that, due to the diversity of language and culture, labor is virtually tied to its original location. The other remedy to lack of economic convergence is productive flexibility, in the form of welfare cuts and changes in wages and prices. Absent such flexibility, there will be need for more foreign aid or additional issues public debt and there will an increase in unemployment. This is exactly what has been happening in Greece: the funds supplied to Greece by the rest of the Eurozone in the form of loans or bonds amounts to no less than €253 billion ($282 billion), a sum equivalent to 275% of its GDP in 2013, even after half the debt owed to foreign banks was forgiven; and the unemployment rate averages 27 per cent.

The harshness of the euro as originally conceived has led to disaffection precisely for the reasons that make it a better currency than pure fiat moneys. Austerity in the form of cuts in public services, reduction of pensions, pressure on those who never paid a tax, labor law reform and the resulting unemployment have been felt in Greece as a bitter and unjust medicine. Syriza, the leftwing populist party, after winning the general election on the 25th of January, is just one seat short of absolute majority in Parliament and has been able to form a coalition Government with the near-fascists of Golden Dawn. The new Prime Minister, Mr. Tsipras, has pledged to restructure the national debt and put an end to austerity.

"Restructuring" is one of those weasel words that mean something different from what they sound. Restructuring the debt means not paying your debts in full, and the new government should say it clearly. Greece already restructured its debts when EU governments forced foreign banks to cut their claims by 50 per cent. Though Mr. Tsipras has suggested his government may be content with extending

216 Mundell, Robert A. (1961): "A Theory of Optimum Currency Areas", American Economic Review, vol. 51, no. 4 (September), pages 657-665. PDF file.

the life of the bonds while recognizing their nominal value, but is adamant he will reject any more austerity measures. Putting an end to austerity may in fact go against repayment. Austerity means trying to live within one's means, but in the minds of the Greeks is associated with unending despair. Tsipras did say during the campaign that he would keep his promise to Frau Angela Merkel to balance the primary budget but that he rejected any more cuts in public expenditures. This clearly means higher taxes. Since the government will be left-wing, we can expect all the usual baloney about taxing the rich. This will not satisfy

the so called "troika" (made up of a representative of the IMF, the European Commission, and the ECB) who can refuse to free the funds needed by Greece to pay next quarter's pensions and civil service salaries. The classic game of chicken.

Delayed Backlash

Greek voters have set a pattern which may be repeated in Ireland and is even more likely in Spain. It is striking that the protest vote comes when austerity finally producing positive results. The Greek economy is growing again, if only at a rate of 0.6%. The IMF expects it to grow by 2.9% in 2015. The primary budget (i.e., not counting the service on the debt) is in surplus. But people have suffered too much, especially as regards the loss of jobs, and they have voted against the whole program of cutting the size of the state. This backlash is fuelling the progress of the populists of Sinn Fein in Ireland and Podemos in Spain, two other countries where austerity is getting results—but too late in the view of ordinary voters.

Everybody in Europe needs more growth quickly, not least orthodox governments. The reaction of Signor Draghi of the ECB has been precisely the wrong one. Instead of encouraging European authorities to insist on structural reforms, on flexibility, on productivity, it has launched what in my view is an illegal QE program to buy €1.3 trillion ($1.56 trillion) worth of bonds from the present month of February to September 2016. It will be like pouring oil on the choppy waters of the Eurozone. For a time this will make for plainer sailing. But it is the euro ship itself that badly needs mending.

Housing Bubbles and the Laboratory

April 6, 2015

The anecdote is well known. Queen Elizabeth II was visiting the London School of Economics in November 2008 for the first time in her long reign. Professor Luis Garicano (a Spaniard who has just entered the political fray in Spain under a quasi- Friedmanite banner of 'there is no such thing as a free lunch') was charged with the task of explaining to Her Majesty the sudden severity of the credit crunch. The Queen then asked him, "Why did nobody see it coming?" and proceeded to remark that the effect had been "awful". It is not often that a British monarch voices an opinion on a substantive problem of the country but she was only echoing the feelings of most of her subjects: this time it was the economists, not the sovereign, who were parading with no clothes on.

The 2007-2010 crisis has thrown the economics profession into confusion. During the twenty years of the "Great Moderation" that preceded the crisis, high rates of growth coincided with consistently low inflation, so that central bankers, led by Alan Greenspan, were confident that they could keep recessions at bay by managing the interest rate and hence, the quantity of money. They sometimes had doubts: in 1996 Greenspan himself had sounded a warning about the "irrational exuberance in stock markets"—an unexpected remark from the lips of an Ayn Rand disciple; but he soon repented and went on to become an enthusiastic champion of the "Goldilocks Economy". Well-respected Nobel laureates held the same view. For example, Robert Lucas said in 2003 that macroeconomists "had solved the problem of depression prevention". Indeed Lucas, even as late as 2008, a few days after the collapse of Lehman Brothers, expressed scepticism about the likelihood of the American economy falling into recession.217

Greenspan, Lucas, and the other orthodox economists of the Chicago School based their confidence on the "efficient markets hypothesis" proposed by Eugene Fama, another Nobel Laureate. Fama's research of the late sixties and early seventies did not lead him to conclude that free markets were always efficient, but rather that they were informationally efficient, in that the current prices of stocks and property gathered all the information there was to be had, and that it was a mistake for anyone to believe they knew better.218

This confidence in the information communicated by markets had four implications for central bankers: (1) that it is very hard to tell in advance what the price of assets should be or when such prices are running above their fundamental value; (2) that bubbles, if they exist, cannot be predicted; (3) that central bankers should not worry about bubbles nor try to prick them but should reduce themselves to controlling inflation and keeping the payments system in working order; and (4)

217 Richard A. Posner, "Economists on the Defensive: Robert Lucas," Atlantic, August 8, 2009. 218 This also meant that money managers and ordinary stock pickers could never know more than the market and could never beat it: unless they had inside information; or acted as long term investors like Warren Buffet does, based on an intimate knowledge of the companies concerned and becoming members of their boards.

that the only thing a central banker could do after the bubble burst was, in Greenspan's words, "mopping up", i.e., maintaining liquidity by acting as lenders of last resort, if necessary on the scale of Bernanke's and Paulson's money creation in the last months of the Bush presidency.219

That central banks should behave asymmetrically when confronted with large increases in the prices of classes of assets—do nothing before and mop up afterwards—has been hotly debated. On the one hand, there are those who insist that nobody can tell whether there is a bubble in the making since asset price increases might only reflect expectations of greater productivity. On the other hand, there are those who insist that the low interest rates favoured by central bankers to avoid recessions cause asset prices to rise artificially, since bonds and property vary inversely with the cost of money. Let us stop by both.

The New Yorker interview with Eugene Fama

I well remember meeting Eugene Fama at one of Karl Brunner's "Economic Analysis and Political Ideology Seminars" at Interlaken in Switzerland in the late 1970s. He was then and still is a supreme student of finance. He was also a vigorous man who climbed mountains at unbeatable speed, and he was renowned for his wicked humour that kept us on the ball during discussions. He still is just as sporting and says with a twinkle in his eye that he has chosen to live in California because he can go surfing all year round. In 2010, he gave an interview to John Cassidy of The New Yorker in which he showed himself to be the same independent-minded economist as in Switzerland all those years back.220 When asked the question that everyone was asking, whether the rational expectations theory had worked well in 2007-8, he answered:

I think it did quite well in this episode. Stock prices typically decline prior to, and in a state of recession. This was a particularly severe recession. Prices started to decline in advance of when people recognized that it was a recession and then continued to decline. There was nothing unusual about that. That was exactly what you would expect if markets were efficient.

This surprised John Cassidy, since most people lay the blame for the Great Recession on the malfunction of the financial system. On the contrary, the essence of Fama's thought on the late financial crisis and recession is that banks and

219 Ben Bernanke was the outstanding specialist of the Great Depression in the tradition of Milton Friedman. He remembered that Friedman and Schwartz had underlined the mistake of the Fed in the early

thirties in starving the banking system of funds. At a celebration in 2002 to mark Friedman's 90th birthday, Bernanke apologised on behalf of America's central bankers for deepening the Depression by not doing enough to save sound commercial banks, saying, "You're right, we did it. We're very sorry, but thanks to you, we won't do it again." Later, Anna Schwartz wrote that Bernanke was wrong in likening the 2008 Great Recession to the 1931-32 Great Depression; the 21st century crisis was a balance-sheet crisis, not a liquidity crisis. It now looks like Anna Schwartz was right. 220 John Cassidy, "Interview with Eugene Fama". New Yorker, January 13, 2010. This was the second in a series of interviews with Chicago School economists after the financial crisis, titled "After the Blowup".

shadow banks were not the cause but the victims of what happened in the economy. Asset prices started to fall because a recession had begun in the real economy. As to what caused the recession, he said that economists simply do not know what brings recessions:

We don't know what causes recessions. Now, I'm not a macroeconomist so I don't feel bad about that. (Laughs.) We've never known. Debates go on to this day about what caused the Great Depression. Economics is not very good at explaining swings in economic activity.

Cassidy insisted. How could one say that the market functioned well when there was such a great amount of ill-judged investment? Fama replied: ill-judged...

... [a]fter the fact... There was enormous investment across the board: it wasn't just housing. Corporate investment was very high. All forms of investment were very high. What you are really saying is that somewhere in the world people were saving a lot—the Chinese, for example. They were providing capital to the rest of the world. The U.S. was consuming capital like it was going out of sight.

However, the sceptical interviewer went on, banks meted out subprime mortgages imprudently to unworthy clients. Fama replied:

You can blame subprime mortgages, but if you want to explain the decline in real estate prices you have to explain why they declined in places that didn't have subprime mortgages. It was a global phenomenon. Now, it took subprime down with it, but it took a lot of stuff down with it.

Cassidy was trying to make a larger point. The general opinion was that the newfangled financial instruments invented in the last thirty or forty years (subprime mortgages, collateralized debt obligations, structured investment vehicles, credit default swaps and others), must have played a role in the disaster. Fama would have none of this. He went on to defend the financial innovations that public opinion has blamed for the Great Recession!

I wonder how many economists would argue that the world wasn't made a much better place by the financial development that occurred from 1980 onwards. The expansion of worldwide wealth—in developed countries, in emerging countries— all of that was facilitated, in my view, to a large extent, by the development of international markets and the way they allow saving to flow to investments, in its most productive uses. Even if you blame this episode on financial innovation, or whatever you want to blame, would that wipe out the previous thirty years of development?

Fama was saying that even after the crash, one had to recognize that the innovative financial industry of the West had made huge contributions to the greater wealth and higher standard of living of the world; and he

added that the financial failure brought about by the crisis originated in, or was magnified by, widespread and misguided government intervention. He certainly had a point there. Other authors,

such as John A. Allison, have convincingly argued the same point.221 There seemed to be no rhyme or reason to the interventions by the U.S. government. Some banks were rescued at huge cost, others were allowed to fail. He mentioned the harm done by the "too big to fail" mantra and added that, "if it becomes the accepted norm that the government steps in every time things go bad, we've got a terrible adverse selection problem".

In sum, Fama concluded that he could imagine a bubble affecting a stock or even a local real estate market, but not the world as a whole. If the bubble could have been predicted "somebody should have made a lot of money betting on that, if you could identify it".

Economists who think there are bubbles

I have paid so much attention to Fama because his position on the power of the free market is so unyielding that it presents a useful contrast with what I shall say on a new approach to economic rationality: that associated with the experimental economics of yet another Nobel laureate, Vernon L. Smith.

However, I must briefly mention two schools who admit the possibility of mistaken optimism in free markets. They both have a long pedigree and many followers. First is the Austrian school. All the luminaries of that school, Ludwig von Mises, F.A. Hayek, and their disciples, extending even to Lionel Robbins in his 1934 book on The Great Depression, analyzed booms and busts within the framework of Knut Wicksell's distinction between the nominal and the real interest rate. Artificial booms happened when the central bank created money at will to lower nominal interest rates and foster growth. The lower interest rates led to imprudent investments, which failed when the expected returns did not materialize. My point here is that for the Austrians, bubbles and artificial booms very much exist on the strength of a (much debated) theory to explain the economic cycle. For the Austrians it is central banks which are to blame for the ups and downs of the economic cycle. They fundamentally disagree with the view of Fama and the defenders of the efficient market hypothesis that economics does not have an explanation of the cycle. Curiously, their policy proposals as to what to do when a recession or even a depression finally strikes are the same as Fama's: to stand aside and let the economy be purged of the loss-making investments made in the cheap money period. As Fama told his interviewer:

The experiment we never ran is, suppose the government stepped aside and let these institutions fail. [...] So you would have just let them...Let them all fail. (Laughs)

The other school is the Keynesians. Their point of view is that the market is much too important to be left in the hands of economists—just like war in the hands of generals. Their latest recruit is Judge Richard Posner (pace Gary Becker, his late co-blogger). In September, 2009 he wrote a shattering essay in The New Republic

221 John A. Allison, The Financial Market and the Free Market Cure. How Destructive Banking Reform Is Killing the Economy. McGraw Hill, New York, 2013.

titled "How I Became a Keynesian"222. Reading that piece gave me a feeling of deja vu. Posner was marshalling all the arguments of the Keynesian school that always left me dissatisfied when recounting them in class over the years. This piece and Posner's later book A Failure of Capitalism: The Crisis of '08 and the Descent into Depression223 both deserve a future column when the economies of the world will

have returned to normal. I will only make a few remarks now. The first thing to be realized is that John Maynard Keynes' book The General Theory of Employment, Interest, and Money was not at all about the economic cycle as today's Keynesians seem to think, but about an economy falling into a situation of perpetual unemployment. Keynes was not addressing the question of booms and slumps but the strange fact that the British economy persistently and lamentably suffered a ten per cent rate of unemployment throughout the 1920s, even while the American economy was booming. He would not accept the explanation given him by Jacques Rueff that unemployment especially was due to real wages being kept too high by trade union action and high unemployment benefits, which to me is much more convincing.224 He preferred the explanation that it was the capricious "animal spirits" of private investors that caused the short booms and slumps along the equilibrium line of gloom and despondency. The solution for Keynes lay in large public investment, because at bottom he thought capitalists were irrational, politicians dumb, and only enlightened civil servants (like himself) were far-seeing enough to be trusted with saved funds.

While Keynes was writing the General Theory the Great Depression struck. When the book came out in 1936 he added a "Short note on the trade cycle" at the end and as an afterthought. When one reads that note, it becomes clear that Keynes was only groping for an explanation with the help of the analytical tools in the body of his tome and not quite getting it, even in his own terms. Again he blamed the instability of the expectations of private investors as to the future yield of capital goods. His prescription for slumps was even patchier than his diagnosis: they should be corrected by a mixture of work-sharing, increased public investment and raising the price level. Well, well! He concluded that,

... the right remedy for the trade cycle is not to be found for abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom.

With his discerning legal mind, Judge Posner should know better than to fall for this kind of mishmash.

222 Richard A. Posner, "How I Became a Keynesian."The New Republic, September 23, 2009. 223 Richard A. Posner, A Failure of Capitalism: The Crisis of '08 and the Descent into Depression. Harvard University Press, 2011. 224 Jacques Rueff (1896-1978) published two articles on the causes of unemployment in 1925 and 1921, of which Keynes was well aware. Rueff there showed that unemployment was not due to insufficient aggregate demand but to high unemployment benefits and powerful trade unions not allowing the labor market to clear. "Les variations du chômage en Angleterre", Revue Politique et Parlementaire, 1925, volume 32, pages 425-437. "L'Assurance-chômage: cause du chômage permanent", Revue d'Économie Politique, 1931, volume 45, pages 211-251.

Bubbles in experimental economics and the real world

How do we decide who is right? Can there be bubbles in finance and housing, as so many economists and commentators have said, contra Fama? Must markets be shepherded by the state if disasters such as the one we have just gone through are to be avoided? The answers must be precise and well-researched.

The methods to evaluate the models we economists use are various and none foolproof. First, we may use internal consistency, as I have just done when speaking of Posner and Keynes. Secondly, we may use historical evidence, as when we say that the 2008 crisis has refuted the belief that macroeconomists have solved the problem of depression prevention. Thirdly, we can use econometric models to test time correlations and possible causality, as when Fama says that the fact that stock and house prices typically

decline prior to and during a state of recession is well corroborated. However, there is a fourth method that mainstream economists have tended to overlook, me included: the use of economics laboratories to design virtual markets where human reactions can be examined in defined environments.

It is shocking that the profession should have given so little attention to the experimental method of study and testing markets, when this branch of economics has been cultivated at least since the 1960s. It is for this form of enquiry that the Nobel Committee awarded Vernon Smith the 2002 Nobel Prize in economics "for having established laboratory experiments as a tool in empirical economic analysis, especially in the study of alternative market mechanisms".

To answer questions about the possibility of bubbles appearing and in what markets I claim that it would be inexcusable to pass over the new book by Steven D. Gjerstad and Vernon L. Smith, Rethinking Housing Bubbles: The Role of Household and Bank Balance Sheets in Modeling Economic Cycles225. They use the results of experiments in laboratories to check the rationality of the economic behaviour of individuals posited by economists. Let us see what laboratory experiments tell us.

The essence of the book is summed up in the second chapter, "Goods and Services Markets versus Assets Markets". At its head we find a quotation from a Bernanke interview on July 1st, 2005 (with real estate prices diving), on being asked whether a market-wide cave-in of house prices was possible.

It's a pretty unlikely possibility. We've never had a decline in house prices on a nationwide basis. So, what I think is more likely is that house prices will slow, maybe stabilize, might slow consumption spending a bit. I don't think it's gonna drive the economy too far from its full employment path, though...

In the New Yorker interview Fama denied that such price gyrations constituted an (irrational) bubble. Can it be the case that some markets do not function efficiently from an informational point of view as Fama believes?

225 Steven D. Gjerstad and Vernon L. Smith, Rethinking Housing Bubbles: The Role of Household and Bank Balance Sheets in Modeling Economic Cycles. Cambridge University Press, 2014.

Gjerstad and Smith propose that we make an exception for asset markets when positing the full rationality of dealers in all exchange activities. On the one hand, laboratory experiments show that, when dealing with nondurable consumption goods, markets clear even more easily than microeconomics textbooks say. On the other hand, however, it appears that asset markets do not function so efficiently as markets for non-durables, especially when the assets are long lived and their market value "may be influenced by the future price expectations of the participants". Under laboratory conditions one can observe bubbles forming when long lived assets are traded. This may explain why bubbles appear in stock exchanges and property markets in the real world. Experiments have modified our understanding of both kinds of markets—consumer nondurables and long lived assets.

Experimental markets for non-durable goods

As far back as in 1962, before computers were in use for these studies, paper, pencil and white-board games were set up to explore "open-outcry continuous double auctions" for consumer non-durables.226 The book describes the result of an experiment run by Smith in that year, with twelve traders using the dollars they had been given to play or keep. Players cried out their bid and ask prices and trades were closed. A number of conclusions emerged for non-durable goods markets: (1) it was not necessary to have many buyers and sellers to reach a competitive equilibrium outcome; (2) traders might not be able to name, or be conscious of their reserve price but they revealed it by dropping out of the auction; (3) traders did not need to have full and perfect information of market conditions for a stable equilibrium to be reached. Microeconomics textbooks turned out to be unnecessarily strict when they posed the condition of large (or infinite) numbers of traders and of perfect information for market-clearing equilibrium to be reached in non-durable goods. This lab experiment, and many others performed along the years, fundamentally changed our understanding of the competitive conditions necessary for stable equilibrium prices to appear. In fact, there was no need any longer to distinguish perfectly competitive from merely contestable markets.

Experimental markets for durable assets Markets for long-lived assets turned out to perform quite differently from consumer goods markets. In these markets, items exchanged are not consumed by their first buyer and can be re-traded. They have long lives and their market values are influenced by future price expectations. Markets for long-lived assets turned out to perform quite differently from consumer goods markets. They have long lives and their market values are influenced by future price expectations. This is

226 These 'laboratory' experiments are games where participants are allotted real dollars to spend or virtual assets to sell at auction. The experimenter defines the 'values' of the good for the different buyers and the 'costs' of the good for the sellers. Buyers are paid the difference between their values and the trade prices obtained in the open outcry auction; sellers are paid the difference between the price they receive for a good and their cost for the good. This process can now be automatized with the help of computers.

what makes them behave differently from markets for goods that are consumed once acquired.

As Gjerstad and Smith say, mainstream financial economists assume that markets function efficiently according to the rational expectations assumption, i.e., that current prices fully incorporate past and present information. To verify this assumption, simple experiments were carried out in the 1980s, which instead turned out to falsify it. In these experiments subjects were given the same total amount of cash and assets in varying proportions. The assets were not consumed on purchase but could be sold and resold during it lifetime. 'Fundamental values' were supplied by the experimenter on the basis of pre-defined dividends. It was observed in hundreds of replications by many scholars that public information about fundamental values227 did not make prices converge on those values for quite long periods.

These experiments were used to see what institutional changes could be introduced to prevent bubbles. The introduction of short selling did not help, and margin selling made things worse. On the other hand, the introduction of futures markets, and of 'circuit breakers' in the form of maximum falls or rises per day, did help to bring prices back to fundamentals.

Gjerstad and Smith summarise shared characteristics of asset markets in the laboratory and the economy: (1) bubbles commonly turn up in experiments; (2) liquidity exacerbates price bubbles; and (3) trading volumes decline before asset bubbles burst.228 The authors conclude that:

Twenty-five years of experimental research on asset market bubbles show that under a wide variety of treatments, asset prices deviate substantially from those predicted by the rational expectations market model.

To call these bubbles and their collapse "black swan" or "fat tail" accidents is to present them as low probability events, which is a mistake. The fact that they cannot be dated precisely does not make the probability of their occurring over a given period equal to zero. They are "positive feedback loops" which can be predicted to occur with a positive probability under definable institutional arrangements.

Gjerstad and Smith make many more contributions in their book than their analysis of bubbles in markets for long-lived assets. Their interpretation of the Great Depression, their reasons for holding that "housing market crashes bring recession but stock market crashes do not", the lessons they draw from economic crises outside the United States, their critique of the behavior of authorities during the Great Recession, their observation that deficit spending is a bad way out of a

227 Thus, the fundamental value of a declining asset with a life of, say, fifteen periods amounted to the discounted value of future dividends expected from that asset at each period. 228 A characteristic of real housing markets appeared in these laboratory experiments: when the market was nearing its peak offer prices were not lowered but assets stayed unsold for longer experiments.

solvency crisis, and much more make fascinating reading. Modifying the institutional arrangements of asset markets after careful experimental study to make them function better is a challenge economists should face without fail.

Now, laboratory experiments do not necessarily translate into societal phenomena without fail. I am sure much work is needed to unravel real world instances with the help of the conclusions of laboratory experiments. But we must realize that

[a]lthough economists have now largely come to recognize these results, their implications for the aggregate economy have not been examined.

A careful study of this book and the more than fifty years of experiments recounted in it should be a required assignment for all macro and monetary economists.

Sound Money through Monetary Competition

May 4, 2015

Money is the wild card of the capitalist game. In the past century, financial and monetary upsets recurred, with the Great Depression as the nadir. In the present century, just when the End of History was around the corner and political and economic democracy seemed victorious over all other social systems, the Great Recession hit. We do not yet have a complete picture of why this happened, but there is little doubt that our monetary arrangements proved defective. This was especially so when central bankers went beyond their duty to supply sound money and tried to manipulate the real economy: some even thought they had the means to get rid of the business cycle once and for all. The enemies of the free economy now sing three mantras: climate change, growing inequality, and the malfunction of financial markets. The first two I will leave to the care of statisticians, who can better analyze the defective extrapolations of data on which they are based. Today I will concentrate on money, an institution that is of the essence of the market economy and that gainsayers proclaim can, under no circumstances, be left to the market.

My Peruvian proposal for Greece

My thesis is as follows: A sound currency is a necessary condition for people safely making the free choices that lead to sustained growth. Sadly, however, sound money seems to be beyond the ingenuity of most countries. In some instances, monetary competition results in sound money, especially in Latin America, where the outstanding case of parallel currencies is Peru. In contrast is the failure of the 'eurolization' of Greece (if I am allowed the neologism), by which an outside currency, the euro, is imposed on a country incapable of fulfilling the necessary conditions for is success. My suggestion will be that Greece move to a scheme of parallel currencies of the kind I observed in Peru during my last visit there. With both the euro and a new drachma running in Greece, the country could stay in the Eurozone but do so under less offensive political restrictions and at a much lower social cost.

The case of Peru is not the same as that of the 'dollarized' economies of Panama, Ecuador, or Hong Kong (or those of the Eurozone). Peru is not dollarized but runs a system of parallel currencies. For a decade and a half Peruvians have been allowed to use and to hold two currencies in competition with each other: the Peruvian sol and the US dollar. Peruvians are free to buy and sell, to deposit and lend, to save and invest, at home and abroad, in either currency. The exchange rate between the two is in effect fully flexible. This means that if individuals and businesses in Peru were to lose confidence in the sol there could be a run on the national currency—a harsh discipline on the Central Reserve Bank of Peru which reinforces its resolve to keep prices in check. In my view, a crucial element of Peru's well managed monetary arrangements is that the national currency is in the last resort subject to the discipline of monetary competition through a free and flexible exchange rate. The result for Peru over the last ten years has been outstanding: the

yearly rate of inflation in sols has averaged 2.5% and the real rate of growth 6.5%— despite the recent fall in the prices and production of the primary goods they export. Since for Greece eurolization has been a failure, should we not learn from the example of a two-currency economy such as that of Peru?

The aim of monetary arrangements

Sound money is one where changes in the general price level do not distort the relative price of goods, services and assets.229 When the productivity of the economy rises, the general price level tends to fall, which is the same as saying that the value of money should go up. However, most central bankers continuously try to avoid any fall in the price level as 'dangerous deflation', unwilling to admit that there are 'good deflations' brought about by all round lower costs of production. This is what leads me to criticize the idea that a central bank must stabilize money by keeping the consumer price index (CPI) at a 2% increase per year, which the economics profession says is equivalent to zero if improvements in the quality of goods are taken into account. In an improving economy the general price level should fall with total factor productivity. What should be aimed at is not price stability but sound money, whose effects on the real economy are 'neutral' because the price level is allowed to fall with increases in general productivity.

If stable money is the best central banks can offer us, we should be thankful for small mercies. By aiming to keep the value of their money stable, central banks will at least refrain from using their power to issue money to meddle in the national economy; they will also be strengthened in their resistance to improper government demands, and they will have more reasons to call for the lifting of all price and wage controls.

A central banker's lot is not a happy one, as Gilbert and Sullivan would have us sing. We should perhaps let the optimal quantity of money be determined bottom up by competition in the market, rather than top down by central bankers and governments. We shall see how a regime of parallel currencies approximates this ideal.

Monetary strategies

Four main kinds of monetary policies are being applied in the world today to supply neutral money (as far as is possible).These strategies are: (1) giving up the national currency altogether for one of the world currencies; (2) pegging the rate of exchange to the dollar, the euro, or to gold, via a currency board; (3) permitting the

229 As Jerry Jordan writes: "A belief in sound money is not the same as a belief in 'price stability.' Sound money (like under the classical gold standard) is when people make decisions in the firm belief that all observed changes in prices—of assets as well as goods and services—are changes in relative prices, and that all observed changes in interest rates are changes in real interest rates. That does not, and cannot, happen when money is 'managed' in a fiat money world. Central bankers (and their political overseers) are so fearful of the dreaded 'deflation' that there is an institutional bias in favour of at least a mild positive rate of inflation." http://soundmoneyproject.org/2015/03/managed-money-%E2%89%A0-sound-money/, March 2015.

use of parallel currencies with fully flexible exchange rates, leading to the discipline of possible runs on the domestic currency if badly operated; and (4) trying to manage the national currency independently and responsibly by 'inflation targeting'.

1. In Latin America stability is often approximated by 'dollarizing' the

economy. A strong foreign convertible currency becomes the legal tender of the country. It is easier to do so in small countries because in any case they would not be able freely to manage their exchange rate. Populist policies will drain the liquidity of the country. Dollarization or 'eurolization' is what disciplines the

profligate governments of Ecuador or Greece. 2. A country with a currency board pegs its money to a convertible currency

accepted worldwide. Such is the case of Hong Kong, whose rate of exchange has been kept in a narrow band centered on HK$7.75 per US dollar. If the budget did not show a small surplus and prices and wages were not fully flexible, the fixed exchange rate would lead people to hoard or export the good currency while reserves last and bad money would displace good: 'Gresham's Law' would lash in.230 3. Under parallel currencies the central bank must treat a world currency as if

it were legal tender side by side with the local one. Peru is the shining example. The domestic currency must not be over-issued for fear of seeing the 'Reverse Gresham's Law' operate. With a flexible exchange rate and free capital movements, people do not fear the Government will suddenly expropriate their holdings in good foreign money: so they tend to use only the foreign currency and treat the domestic currency as small change if too much is printed. To avoid the drift, budget surpluses; low foreign debt, both private and public; no bailing out of banks and businesses; and prices and wages flexible downwards are in order. The advantage of parallel currencies is that the ups and downs of the business cycle or sudden reverses of the terms of trade can be temporarily accommodated. 4. Inflation targeting is more often employed by large countries that do not

have the possibility or the will to hook onto sounder money. Their governments do not want to lose their sovereign right to lay an inflation tax on their currency—that is to say, to engross the benefits of inflation finance—or to give the economy stimulating pre-election shots in the arm. They promulgate self-denying monetary rules, such as making their central banks independent or promising to keep inflation within a band around a path of 2% yearly price rises. But inflation targeting is not enough unless the central bank is really independent. Hence, the commitment to low inflation is well complemented by the discipline of a parallel currency. As in Peru, belt and braces is best.

230 Originally Sir Thomas Gresham (1519-1579) explained the disappearance of silver coins in England by pointing at the increase in the price of silver, which made shillings worth more than their face value. He should have added that within a shilling coin the rate of exchange between the face value of the coin and the silver content is fixed by law and cannot change to follow the movements in the price of the metal. When the market revalued the silver content of the shilling people could do one of two things: hoard and export the coin; or clip it and file it, which is a way of reducing the amount of silver per monetary unit.

Parallel currencies in Peru

When I visited the two capable persons in charge of monetary policy at the Reserve Bank of Peru I was struck by two things: how very much on top of the management of the sol they were, and how they balked at the idea that the US dollar served as a kind of macroeconomic discipline. They were rightly proud of the Bank's record of low inflation and how this had contributed to Peru's continued growth but gave the impression that they would prefer to have the dollar play a much smaller role than it does.

There are good reasons for this downplaying of the dollar. Obviously Peruvians cannot control the monetary policy of the Fed, which is exclusively centered on the United States. This exposes a small country partially tied to the dollar to large unexpected shocks. The recent announcement by Janet Yellen that the Federal Open Market Committee might consider raising the federal funds rate in June has sent shivers down the spine of many a central banker, in addition to shaking bond markets round the world.

Imagine the effect of a return of the United States to positive real interest rates on dollar denominated mortgages! So it is understandable that the Peruvian Central Bank should be happy with a reduction of the dollar portion of the payments and assets of its residents.

The year 2014 was a relatively hard one for Peru, almost as bad as 2001. Oil and natural gas prices had been falling for some time. Other primary goods, such as gold, copper and zinc, were also in retreat, as were foodstuffs exported by the country. El Niño led to a necessary suspension of fish catches. This had repercussions on internal activity and demand. GDP grew by 'only' 2.4%.

The fact that Peru had two currencies allowed the government and the Reserve Bank to take some compensating measures. Public expenditure increased and monetary policy was eased, always with an eye to inflation and the rate of exchange. Now the country is back on its growth path.

The primary obligation of the Reserve Bank according to the Peruvian Constitution is to preserve monetary stability. This it does by using sophisticated instruments with which they have successfully adhered to a yearly inflation target of 2% (+/-1): a hardy model of the economy; a watchful eye on inflation expectations to see if they are 'anchored'; management of the interest rate and for assurance sake an 'old fashioned' instrument, to wit, required reserves.

The fact that Peru has two currencies complicates the Bank's management of the interest rate. It can only set the interest rate for the sol, since that for the dollar is determined by the Fed. For this reason, the Reserve Bank of Peru manages dollar denominated assets and loans with what I have called an unfashionable instrument: the required reserves of the commercial banks. Banks must deposit 50% of new dollar denominated deposits at the Reserve Bank but only 9% of those denominated in sols. Lenders who have not reduced consumption loans in dollars

by a set amount by the end of the year will face an increase in their required reserves. The main effect of these discriminatory measures is to reduce external financial risk while still allowing full convertibility and transferability of Peruvian funds.

The management of the exchange rate is of special interest in this analysis of a country with two currencies and free movement of capital. Since August of last year, the US dollar has been appreciating markedly. The Reserve Bank of Peru, instead of letting the sol depreciate further, which is what so many countries have been doing, especially in the developing world, has started buying local currency, while keeping a prudent reserve in foreign currency. Forex interventions to reduce volatility in the short term are transparent, since they appear on an electronic board visible to dealers; and long swings of the exchange rate are fully allowed to take place.231

It is understandable that the Reserve Bank should mainly focus on a successful domestic monetary policy rather than on the fact that Peruvians deal in two currencies. The Bank could in principle move to a well governed domestic fiat money, with foreign currencies playing no special monetary role. This could only be achieved on the basis of consistently well behaved and reliable governments. In the four large countries whose monies compose the Special Drawing Rights of the IMF (dollar, euro, pound, and yen) monetary competition is only effective in the long run. Peru however is a small country in Latin America, where not only governments but Constitutions are unstable, so that mistakes of monetary policy quickly show up on the exchanges.

Conventional wisdom has it that an orthodox monetary policy is incompatible with real growth. Peru is a counterexample. Ever since 1991 Peru has lived under the tight discipline of a system of parallel currencies with free prices and virtually no business subsidies. The average rate of growth over the last ten years has been 6.5%, despite the fall of primary good prices and the effect of "el Niño". The average rate of inflation over the same period has been 2.1%, generally seen as nearly zero.

All this does not mean that the Peruvian economy is free of problems. The need for better productivity is noted by the Reserve Bank itself, demanding a correction of institutional defects such as ill-defined property rights, confusing and incoherent taxation, the low efficiency of the goods markets, and an over-regulated labor market with as much as half the labor force forced underground. An orthodox monetary policy, however, clearly contributes to the progress of the country.

Two currencies for Greece?

The monetary dispensation under which Greece is laboring is the first one of the four I listed above: 'eurolization'. For small countries dollarization or eurolization are similar to being on the gold standard. To stay on the dollar, the euro, or gold and avoid suffering unduly, a number of conditions must be respected: ready liquidity

231 In January 2013 the price for dollars was as low as 2.55 per sol; in March 2015 it was 3.09.

must be at hand to maintain the money supply, the budget should be in surplus year in year out, and prices and wages ought to be fully flexible. For a country like Greece that relies on runaway credit, groans under an overblown welfare state, is tied down by a surfeit of regulation and politically set prices, enforces rigid labor laws, keeps a large bureaucracy, and fosters labor unions, an outside monetary standard demands reforms that public opinion will not suffer. It is clear that Greece will never be able to repay its debts: it owes the European Central Bank €104 billion ($112 billion) and that is only 30% of its total debt, when its GDP amounts only to some €224Bn. As Wolfgang SchĘuble, the Finance Minister of Germany said at the recent IMF Annual Meeting in Washington, "Our goal is not about the debt, it's about making Greece an effective, competitive economy, and for its people to prosper." The Greeks, because of the cost and for ideological reasons, seem to find it impossible to understand that if they want to stay in the euro they will have to carry out reforms demanded by its creditors. A referendum with the choice starkly put may break the deadlock. But is there not a danger that to ease the way for Greece and other euro-members in difficulty the very concept of the euro as a stable currency will be put in jeopardy? It is now clear that the euro was an economic mistake. The single currency should be redrawn by letting Europeans choose it for their transactions, their savings and their investments. Currency choice could be instituted by the reissue of their original denominations with the permission for the euro to circulate alongside with it at a fully flexible rate of exchange. If the domestic central bank starts to over-issue, the reverse Gresham's Law would kick in. Then the domestic currency would tend to be used only as small change and the state would be deprived of most of its 'seignorage'. The ECB could then manage the euro with the only aim of making it a really solid currency. Such a move would have to be carefully designed but is not unfeasible. In the case of the Greek drachma, the new currency would be issued at a 1/1 rate with the euro. It would then float down to the level where the foreign balance would right itself. Pricing wages, taxes, social benefits and domestic assets in drachmas would help make the Greek economy competitive in foreign markets and attract outside capital. The once-and-for-all cost could be hefty but the unceasing bleeding would stop. The ECB would have to proffer a guarantee that euro deposits in Greek banks would be safe and fully mobile. Foreign debts expressed in euros would be a burden which could be alleviated along the well tried lines of the Club de

Paris for sovereign debt and the "London Club" for private. Mortgages denominated in euros would be a problem for local residents, just as they would if Greece crashed out of the euro. As regards new bank deposits in drachmas, they would again be fully mobile but at the current rate of exchange. The crucial idea is that people should be able to choose in what currency, the euro or the drachma, they would denominate their future contracts: if in drachmas, they would be more competitive. The drachma need not disappear if the Greek Central Bank applies a conservative monetary policy—indeed the incentive to behave would be there if they wished to maintain their seignorage income. Thus, the optimal amount of local currency would be decided bottom-up by individuals and firms, depending on the rate of exchange.

The mismanagement of the Greek crisis could turn out to be a blessing. The original design of a single currency has turned out to be unfeasible. It implied transforming nominal convergence of deeply diverse economies into real convergence, which is proving socially and politically too costly for some members. The time has come to examine the possibility of turning the euro into a choice currency in competition with the national currencies. Making the euro a common rather than a single currency could have rescued Greece from its plight and can help other member countries in difficulties to heal their economies while not forsaking the European currency project.

Jeremy Bentham´s Mistaken Universalism

June 1, 2015

Many years have gone by since I first gave my time to studying Jeremy Bentham's utilitarianism. My main contact with Bentham was in the late sixties, when I partook in his Correspondence at University College, London. Now that I have reembarked on the translation into Spanish of Bentham's letters with politicians and philosophers in Spain, Portugal and Latin America, I have felt the need to take up again the critical analysis of the political philosophy of happiness. My interest is twofold: I am fascinated by the changes ideologies undergo when moving from one culture to another; and I want to understand why utilitarianism is still very much in vogue today.

Jeremy Bentham was always ready to ply his trade with absolute sovereigns and liberal governments from Russia to Mexico, from England to Greece, hoping to be offered the possibility to rewrite their laws or carry out administrative reforms on the basis of his philosophy. The case of the Iberian world is especially interesting, as indicated by the more than 260 documents of his Correspondencia ibérica and many other works from his pen that I am in course of having translated.

It was in the 1820s that Bentham took special interest in the affairs of the Spanish and Portuguese speaking world. Liberal revolutions swept through the Iberian Peninsula and the Indies. The effect of Bentham's efforts on Iberian reality was in the end rather scarce. Political philosophies suffer diffraction when transported to a different culture.232 This was the case for the political and administrative philosophy of Jeremy Bentham: much was 'lost in translation' when his ideas were received in Spain, Portugal and Iberian America. This is ironic, given Bentham's belief that his philosophy was universally valid.

The reason he wrote so confidently to sovereigns, politicians, writers and educationists of all lands was that his proposals for the wholesale reconstruction of society were 'rational' and based on a simple model of human nature. In this he was the typical 'constructivist', to use F. A. Hayek's expression. Anything

smacking of historical tradition or unplanned evolution was anathema to him. Bentham was so interesting because he was so unreasonably rational.

Bentham's travels and travails

Jeremy Bentham was born in London in 1748 and died there in 1832. This does not mean that he was averse to travelling both in fact and in imagination: he wrote his famous In Defense of Usury (1787) while staying with his brother Samuel in Russia; and in his sixties he seriously contemplated going to live in Mexico, Argentina, Venezuela, or Chile. This indifference to what country he resided in while doing his work I take as an indication of his conception of the law. He gave his whole life to jurisprudence and the application of his kind of political and administrative reform

232 Some prime examples are Marxism in Russia and China, and democracy in parts of Africa and Latin America.

to every human society on the lines of what he considered rational and proper. For him, jurisprudence was a universal science, based on two immutable principles of human nature: the search for pleasure and the avoidance of pain.

If society were the result of the natural harmony of individual utilities, there would be no need for law. As James Madison said, "If men were angels, no government would be necessary". Bentham was fully aware that when individual utilities clash there must be laws to impose artificial harmony, but he was less than aware that much in society is in fact the result of spontaneous evolution and not the result of legislation.

In the beginning, Bentham tried to convince enlightened despots, such as Frederic the Great or Catherine of Russia, that he possessed the formula to make their subjects happy. The logic of his utilitarian philosophy led him to write a "Project for a Constitutional Code for France" around the change of year 1788 to 1789, in which he advocated a great widening of the suffrage and the secret ballot. The French Assembly made him an honorary citizen, but the Terror turned him against the Revolution to the point that he forgot his erstwhile position. Around 1802, however, disappointed with the sovereigns in whom he had put his faith, he became increasingly radical. The failure of his attempt to convince the government to reform the procedure of the Scottish Courts and the failure of his project for a "Panopticon" prison, which had been approved by the House of Commons but was never built233 opened his mind to radical reform. By 1809 James Mill, John Stuart Mill's father, was able to turn him into a democrat, if by that we mean the extension of the suffrage to the middle classes. From then on Bentham embarked on the study of the ways to align the interests of governments with those of the governed, so as to maximize the happiness of the greatest number.

This new line of research took shape with the questions posed by the independence movements in America and by the restoration of the liberal Constitution of Cadiz in Spain in 1821, which led him to start work on a Constitutional Code addressed to "all nations and all governments professing liberal opinions".

Let me remind my readers of some of the works of this indefatigable 'projector'. In 1776 he published his first work, A Fragment on Government (anonymously and with some success), in which he for the first time applied "the fundamental axiom that the measure of right and wrong is the greatest happiness of the greatest number". His second book of political philosophy was An Introduction to the Principles of Morals and Legislation (1789) whose opening words I will comment on immediately. Bentham's legal philosophy spread in Europe (and later in the Americas) thanks to the three volume arrangement and

translation of some of his manuscripts into French by the Genevan Étienne Dumont (1759 -1829), titled Traités de Législation civile et pénale (1802, 1820). It appeared in Spanish in 1821,

233 "Sinister interests", as he would later call them, successfully resisted the construction of that scientific prison in London. Panoptic prisons were built in other parts of the world, but never in England. The buildings were circular, with individual cells like orange slices. The inmates never knew whether a guard was invigilating them from the center—hence the name of Panopticon. The expenses were to be defrayed with the produce of the prisoners' work.

just as the Cadiz Constitution of 1812 was reinstated.234 This excellent summary of Bentham's legal writings is what many Spanish, Portuguese and American liberals read. This was the first example of the way Bentham's doctrines spread in the Spanish world: through the untiring efforts of his devoted disciples.

One of his constant endeavors was the reduction of civil, penal, and procedural laws to clear and complete legal codes, so that judges would not act as legislators and people would know their rights and obligations. Political developments in the Iberian Peninsula and in America fanned his interest in constitutional questions: what he wrote on the 1812 Constitution of Cadiz and the American colonies and the interest he took in Greek independence led to his writing his Constitutional Code, of which only the first volume was published in his lifetime (1828). He also wrote amply on questions of political economy, where he showed himself less convinced by laissez-faire than is usually believed. He wanted to transform and spread education by means of a new kind of "Chestomatic" schools. Naturally he was a feminist. His manuscripts on Sexual Irregularities and Sexual Morality, in which he criticized the criminalization of homosexuality and other conducts, are in the course of publication now. As it was forbidden to use bodies other than those of criminals for anatomy lessons, he entrusted his own body to his friend Dr. Southwood Smith: his bones were then boiled, covered with his clothes and topped with a wax head by Madame Tussaud. This can be seen in a glass case at University College London, an institution he patronized. His manuscripts are being published by the Bentham Project of that self-same College—31 volumes up to now, going to 50.

Bentham□s legal and political philosophy

His first publication came in 1789, under the title An Introduction to the Principles of Morals and Legislation.235 It contained the essential elements of his legal philosophy, maintained throughout his life. Chapter I on "The Principle of Utility" started with the following words:

Nature has placed mankind under the governance of two sovereign masters, pain and pleasure. It is for them alone to point out what we ought to do, as well as determine what we shall do. On the one hand the standard of right and wrong, on the other the chain of causes and effects, are fastened to their throne.

He immediately proceeded from this assertion of linked value and fact to his philosophy of law and the state:

234 Tratados de legislación civil y penal: obra extractada de los manuscritos del señor Jeremías Bentham, jurisconsulto inglés por Esteban Dumont, miembro del Consejo Representativo de Ginebra, y traducida al castellano con comentarios por Ramón Salas. Madrid, 1821, in five volumes. 235 Edited by J. H. Burns and H. L. A. Hart. The Collected Works of Jeremy Bentham. Oxford University Press, 2000. Gated access at: http://library.nlx.com/xtf/view?docId=bentham/bentham.00.xml;chunk.id=div.bentham.pmpreface.1;toc.depth=2;toc.id=div.bentham.pmpreface.1;hit.rank=0;brand=default.

The principle of utility recognizes this subjection, and assumes it for the foundation of that system, the object of which is to rear the fabric of felicity by the hands of reason and law.

One can understand the enthusiasm of his future disciples when they discovered in Bentham's works such a simple and seemingly all powerful principle, which jurists and politicians could take as a guide through the maze of social norms in any country of the world.236

Utilitarianism in personal morality

The problems posed by this ethical principle are twofold: one regarding personal morality and the other regarding the organization of society. First, as a guide for personal morality it was (and is) widely felt to be too narrow a representation of what moves individual people for good and for bad. The explanation of all human behavior cannot be reduced to 'the avoidance of pain and the seeking of pleasure'. This is shown by the slow emptying of the concept of 'utility' in economic theory in the 20th century: today, utility is not understood as happiness but defined as anything individuals choose to value. In any society, especially a free society, there will be a great variety of choices and preferences. In extreme situations, some people are ready to set aside their personal interest for a selfless aim. These cases are insoluble from the utilitarian point of view.237 If Antigone had been nothing but a superstitious young girl and Creon a selfish tyrant, the play would have been nothing but a banal drama. When Creon asks Antigone to understand that it is his duty to apply the law that forbids her to bury her brother on pain of death and tells her to marry Haemon and be happy, she insists that she will perform the customary rites: "I am not here to understand. I am here to say No and die". Socrates, rather than flee the city, drank hemlock, not because he looked forward to eternal happiness in the Elysian Fields but because the gods told him to seek justice and virtue. Galileo should have been more prudent than ask skeptical Princes of the Church to observe the moons of Jupiter through his new looking glass; he was not trying to make them happy but to show them what he thought was the truth.

Then, should we conclude that individuals do not systematically try to maximize their utility? Remember Adam Smith's famous dictum: "It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but

236 Bentham was conscious that he was treading on slippery ground when linking pleasure, pain and ethics in a single passage. He was clearly committing a logical fallacy, later called 'the naturalistic fallacy'. He was familiar with David Hume's writings and the warning that 'ought' propositions could not be derived from 'is' propositions. As Dr. Dinwiddy has underlined, Bentham did end his paragraph with the following words: "But enough of metaphor and declamation: it is not by such means that social science is to be improved." A dangerous metaphor, as I shall argue. However, it is my contention that the utilitarian philosophy is a clear example of the 'naturalistic fallacy'. Despite Dinwiddy's explanation (Bentham, Alianza Editorial, 1995) it still is my contention that Bentham wanted to base both his individual psychology and his moral philosophy on a single principle, the principle of utility. 237 Amartya Sen for this purpose distinguishes "basic" and "non-basic" values, the basic being those that are defended whatever the consequences. (Collective Choice and Social Welfare, 5.3. 1971, Oliver & Boyd, Edinburgh.)

from their regard of their own interest."238 Individual self-interest has great explanatory power when analyzing human behavior, not only in markets but also in non-market contexts. This was the position of Nobel laureate Gary Becker. He was the economist who extended economic calculus to non-market goods that do not have a money price, such as racial discrimination, crime, marriage, number and quality of children, and labor supply. Was he applying utilitarian analysis to new fields previously ignored by economists? Not quite.239

Though Becker did take "an economic approach to human behavior" he was no narrow utilitarian. First, the principal aim of Becker's work was not to tell us what we ought to do, as Bentham would, but to analyze what in fact we do. Further, in his analysis he did not assume that we individuals are exclusively moved by pleasure and pain. The basic goods we humans value and try to maximize include the material, the immaterial, the religious, the social—such as life, health, protection, a happy conscience, love, the meaning of life, proper use of language, social consideration... not exclusively pleasure and pain. These fundamental goods are produced in the household, which functions as a kind of small factory, demanding the necessary inputs on the market or in society at large and combining them to the best of its knowledge. Homo Benthamicus only comes in when households demand these inputs, which are the arguments or elements of a conventional utility function.240

Becker was agnostic as to the happiness value of goods judged from outside. But this did not stop him from studying the formation of tastes.241 He did not rest content with assuming that individuals will value this or that good because the happiness it elicits is more intense or nearer in time.242 Individuals do not have an instant happiness meter. Neither is it enough to say that individuals modify their utilitarianism by rationally taking into account the long term consequences of their actions. For Becker, preferences are not formed rationally or consciously in that way. Preferences are in great part formed during childhood under the influence of the rules and behavior of their parents. In this, the traditions of society will be transmitted to children. As regards adults, their past habits in great part will guide behavior. Good habits are beneficial in as far as they increase future utility; they

238 An Inquiry Into the Nature and Causes of the Wealth of Nations, par. I.2.2, by Adam Smith (1776). The £20 note at present legal tender in England and Wales on the reverse bears a portrait of Adam Smith and a quotation of his pin factory example of the division of labor. It should have been the butcher, the brewer and the baker. It is typical of today's instinctive rejection of free markets that bureaucrats should have chosen the division of labor rather than the operation of self-interest as the most important idea of The Wealth on Nations. 239 See the "Introduction" to R. Febrero and P. Schwartz, eds., The Essence of Becker. Hoover Institution Press, 1995. 240 Becker even showed that a normal demand curve (i.e. that the quantity demanded increases when price falls) could be derived even if the individual was assumed not to behave rationally. See "Irrational Behavior and Economic Theory"(1962), Febrero and Schwartz eds. Op. cit., article 2. 241 Gary Becker: Accounting for Tastes. Harvard University Press, 1998. 242 This is what Bentham tried to do with his "felicific calculus". See Chapter IV of his Introduction to the Principles of Morals and Legislation (1780), titled "Value of a Lot of Pleasure or Pain, How to be measured".

increase 'positive enjoyment capital' and make people inclined to consuming classical music or jogging, for example. Bad habits will reduce future utility and destroy 'enjoyment capital', so that larger and larger doses of liquor or drugs will be needed by addicts or alcoholics, for example, to maintain the same intensity of enjoyment.

Thus Becker shifted the attention of economists away from individual utility to opportunity cost, which influences actual choice and allows one to explain and predict behavior. The observed (equilibrium) mix of resources demanded by the household will depend on the opportunity cost of the elements in that choice, the main costs being price but also time, which is limited, and information, which is imperfect. As an example, let me mention Becker's study of racial discrimination. He started by admitting that there are employers who dislike people of other socalled races and prefer not to employ them; that is a given. But the more competitive the market in which they operate, the higher the cost they will have to bear in terms of

lost talent if they follow their preferences. The predicted result is that minorities will be employed at a vanishing difference in wage. Preferences do not automatically translate into observed fact.243

Utilitarianism in public ethics

The greater problem with Bentham's utilitarianism is the transition from personal pain and pleasure to "the greatest happiness of the greatest number". Why should any authority care for the greatest happiness of its subjects? Must we suppose the law-giver or ruler is free of selfishness? No, we cannot. Bentham was the first to see that: hence his Securities against Misrule (1822-23), which he wrote for Tripoli and Greece; and the first volume of his unfinished Constitutional Code (1828).244

Then there is the problem of minorities. Why should legal and political decisions be in the hands of the majority? This could result in democratic oppression, especially since for Bentham, constitutions could be changed at the behest of each Parliament and no special majorities would be demanded to change or repeal fundamental laws. For him, total transparency, two year Parliaments and the "Public Opinion Tribunal" were enough guarantee. The experience of democracies in the 20th century, especially as regards taxation, may lead one to doubt such optimism.

Finally, there is Bentham's conception of the law. Three characteristics of Benthamite law fill one with apprehension: (1) that all law is an act of will of the sovereign upheld by penal sanctions; (2) that existing law should be razed to the ground, reconstructed and codified; and (3), that the resulting legal codes should exclusively be based on reason, i.e., on the principle of utility.

From the very beginning of his study of jurisprudence, Bentham saw punishment as the essence of social obligation. Penal codes were the base on which all other

243 Gary Becker, The Economics of Discrimination. University of Chicago Press, 1971. 244 Securities against Misrule and Other Constitutional Writings for Tripoli and Greece, Phillip Schofield ed., in The Collected Works of Jeremy Bentham, Oxford University Press, 1990; and Constitutional Code, volume I, F. Rosen and J. F. Burns eds., Oxford University Press (1830, 1983).

codes, civil or constitutional, were built. To be obeyed by their subjects, sovereigns had to announce and enforce penalties for disobedience.

It is not that Bentham ignored the existence of a body of law based on judicial precedent. On the contrary, Bentham fought the Common Law system all his life, because of its obscurity, casuistry, contradictions and lack of clear connection with utility.245 He wanted the whole body of law in England to be replaced by a coherent, all embracing system of codes (penal, civil, constitutional, and procedural), preferably drafted by Bentham himself and rationally deduced from utilitarian principles.

True, codification was all the rage in Europe at that time. The major model was Napoleon's 1804 French Civil Code. But the intent of these codifiers was not happiness but unification of the law in the name of unity around a national state. Also, given the continuous expansion of statutory law, codes in the end proved always to be provisional. Finally, codes are by necessity incomplete because most of the rules in any society have emerged and not been decreed by any sovereign; people abide by them not for fear of punishment but because the expectation of their being obeyed suits all parties.246

The greater part of social rules, not rational

One could not imagine a more constructivist system than Bentham's. On the basis of the natural impulse of mankind to seek happiness, a rational legislator could draw the blueprint of a perfect society to be willed into existence by an enlightened sovereign.

There is a still more fundamental argument against political utilitarianism. In a most perceptive essay on the origin of social values, Friedrich Hayek underlined the large part played by the spontaneous evolution of rules. Even more important for our theme today, he showed in 1979 that happiness is not a very good guide for the advance of civilization and the prosperity of the Open Society.247

It is typical of constructivists and social engineers such as Bentham to think that the rules of conduct in our societies are either derived from our feelings of pleasure and pain, or consciously built by rational engineers. Hayek added a third source of values as bases of our organization beside the natural or the rational: blind cultural evolution.

245 Bentham's first publication was an anonymous pamphlet titled A Fragment on Government (1776), consisting of an attack on the Commentaries on the Laws of England by the great defender of the English Common Law system, Sir William Blackstone (1723-1780). 246 See Pedro Schwartz, "Happiness Is Not within the Government's Remit: The philosophical flaw in happiness economics," in Philip Booth, ed. ... And the Pursuit of Happiness. Institute of Economic Affairs, 2010. PDF file. 247 "The Three Sources of Human Values", the Epilogue to the three volumes of Law, Legislation and Liberty (University of Chicago Press, 1979).

The basic tools of civilization—language, morals, law and money—are all the result of spontaneous growth and not of design, and of the last two organized power has got hold of and thoroughly corrupted them. (Hayek, page 163)

This does not mean that rational criticism and amendment of traditional law is to be totally avoided, only that the legislator should be aware of the extent of his ignorance and prepared for unexpected consequences in any reform. Social engineering has such a good press among intellectuals and mainstream economists because people want to resist the spontaneous evolution of open societies. Many are the features of an open society that go against the grain of our nature as it was formed during the many centuries of tribal life. The customs and rules of the market economy clash with much of our inherited make-up and make us unhappy. Hayek gives a number of examples of 'unnatural' practices prevalent in market economies:

... the toleration of bartering with the outsider, the recognition of delimited private property, especially in land, the enforcement of contractual obligations, the competition with fellow craftsmen in the same trade, the variability of initially customary prices, the lending of money, particularly at interest... (page 161)

These practices grate with the customs of small face-to-face societies where our instinctive moral reactions were formed.

The harsh discipline of freedom All this leads Hayek to underline that "[t]he morals which maintain the open society do not serve to gratify human emotions". Since the open society was never an aim of evolution (if evolution can have an aim), the emotions imprinted in the human breast only told man "what he ought to do in the kind of society in which he had lived in the dim past". The open rules learnt by cultural selection

... became necessary chiefly in order to repress some of the innate rules which were adapted to the hunting and gathering life of the small bands of fifteen to forty persons, led by a headman and defending a territory against all outsiders. (pages 161-162)

This disharmony in civilised life makes it impossible to use happiness as a guide for all the decisions that we must make in today's societies. Utilitarianism is basically flawed because it tries to base the ethics of the open society on the natural impulses of pain and pleasure, and "man has been civilized very much against his wishes". (Hayek's emphasis, page 168)

The Great Society has not come about as a result of consciously trying to promote the maximisation of happiness and it cannot be assumed that it will survive if we consciously pursue that aim.

Bentham's failure in the Iberian world

My translation of the Iberian correspondence will include nearly one thousand documents. Bentham's feverish activity regarding the Iberian world is an indication of his efforts to spread his ideas and have them applied in the different nations of the civilized world—and beyond.

Let me give a taste of who his correspondents were in Iberia and Latin America during the twenty five years from 1807 to 1831.

Bentham touched on Spanish affairs in nine of the many letters he exchanged with Etienne Dumont, his Genevan translator. He also corresponded with Joseph Blanco White, a writer well known as the editor of magazines in Spanish that he published from the safe haven of London; he had fled Spain and had established himself in England as early as 1810, in search of political and religious freedom. He was lucky to have the protection Lord Holland, a great friend of the Spanish liberals during the Peninsular War against the French. Bentham also exchanged letters with Holland on an extraordinary commission: to ask him to intercede with the then Minister of Justice in the Spanish Government, the great writer and economist Gaspar Jovellanos, to grant him permission to go and live in Mexico; for he could not stand the London weather, he said. At that time he was sixty!

While the Peninsular War raged, Bentham shifted his attention to Spanish America, where the first stirrings of independence were being felt. Buenos Aires was the first territory to cut ties with Spain. He had received a visit from Bernardino Rivadavia, later the first President of Argentina. Bentham gave him a copy of his Tactique des assembleés législatives (1816) and wrote to him when he was back in South America. Rivadavia had a most agitated political life. He tried to turn Argentina into a centralized state along utilitarian lines but was thwarted militarily in his plans and died in exile, in Cadiz of all places. His only lasting Benthamite contribution was the book of procedure of the Argentine Assembly, which still bears the mark of Bentham's Tactique.

When in 1821 a liberal regime was reestablished in Spain by force of arms and the 1812 Constitution reinstated, Bentham saw this as a precious opportunity to influence the Cortes' legislative program. He had a number of helpers and correspondents in this endeavor: mainly two Englishmen, Edward Blaquiere and John Bowring, and a number of Spaniards, mainly Jose Joaquin de Mora and Toribio Nunez. Many letters passed between them. I have counted twenty-nine letters exchanged with Mora, who translated some of Bentham's works into Spanish; and four with Nunez, who wrote a book on The Spirit of Bentham (1820) and attempted to effect a synthesis between utilitarianism and the philosophy of Kant. Another large body

of letters was that of his correspondence with Count Toreno on a proposed penal code. The full extent of Bentham's attempts to intervene in Spanish affairs can be gauged by the writings translated by Mora: two letters against the creation of a House of Lords, four on freedom of the press, three Tracts Relative to Spanish and Portugueze Affairs and seven Letters to Count Toreno on the

Proposed Penal Code. 248 Among his manuscripts one can also find three full works of comment on the 1812 Spanish Constitution with an exhortation to give up their Empire. Unhappily, he only finished them after 1823, when King Ferdinand VII had re-imposed absolutism and done away with all traces of liberal thought among his subjects—except for the rebels in America.249

The letters to Portuguese correspondents were also abundant: seventeen to the Portuguese Cortes directly and another thirty five to different officials. The Cortes of Portugal officially had invited Bentham to write some of their legal texts, but the liberal regime in Portugal only lasted from 1821 to 1822 and the whole project fell by the wayside.

By the year 1825, Spanish liberals had been imprisoned, put to death, or forced into exile. The Spanish Indies had attained full independence. Bentham turned his attention to America, with nine letters exchanged with the great Venezuelan leader Simon Bolivar, one sent to the Argentinian Jose de San Martin and four with Jose Cecilio del Valle from Guatemala.

Few in Spain paid any attention to Bentham's diatribe against an Upper Chamber. The Penal Code of 1822 shows no trace of Bentham's objections set out in his letters to Toreno. In South America, Bolivar tried to create a centralized Federation along the lines of the US and in keeping with the spirit of Bentham; he failed dismally. Later, after an attempt on his life by a group of radical students, he forbade the use of the Traité at the Faculty of Law. From his base in Argentina, San Martin freed Chile and Peru from Spanish domination but refused to have any part in post-colonial political squabbles. And Valle, who tried to unite Central America into a single state, failed and duly fell from power. Only in today's Colombia were Bentham's ideas central in the attempt of the state authorities to take education from the hands of the Church. Bentham's blueprints for the Iberian world went the way of many other rational reconstructions of society in Western history.

In sum, utilitarianism is a choice example of what Hayek denounced as political 'constructivism'. It is fundamentally oblivious to local tradition, so it did not fit in well with the circumstance in those faraway lands. And its mechanical rationalism strongly appeals to political philosophers inclined to rebuild societies after their own preferences, one of the distinguishing characteristics traits of today's welfarist democracy.

248 Not all the essays for Count Toreno were published at the time. See On the Liberty of the Press and Public Discussion and Other Legal and Political on Spain and Portugal, the Collected Works, Catherin Pease-Watkin and Philip Schofield, eds., Oxford University Press, 2012. 249 Peter Schofield ed., Colonies, Commerce, and Constitutional Law. Rid Yourselves of Ultramaria and Other Writings on Spain and Spanish America. Oxford University Press, 1995.

Lady Chatterley´s Lover or the Poverty of Social Choice

July 6, 2015

Although Lady Chatterley, her husband, and her gamekeeper were all English characters in D.H. Lawrence's novel, it would be difficult to reduce what Professor Amartya Sen had to say about this book into a merely European question. Sen made his point relevant to political philosophy in every part of the democratic world. Lady Chatterley's Lover, privately printed in France in 1928, published without cuts in the United States in 1946, was the object of an obscenity trial in London in 1960. The English jury cleared it for publication, a verdict that, by dealing a blow to obscenity laws, resounded round the world. Actually, the reason why Sen, an Indian economist by birth, used it in his welfare analysis had little to do with its literary contents. Sen may not have even read it, for all I know. So let us leave Europe for a while to enter the Theory of Social Choice.

Amartya Sen in his monograph on Collective Choice and Social Welfare1 used the disagreement about the proper way to deal with the dilemma who should (and should not) read Lawrence's sensational book as a telling case of contradiction between personal liberty and social welfare.250 If, as Sen proves it, a free society is deeply paradoxical, then the belief in freedom of classical liberals (rather than 'liberals' in the modern American sense of Franklin Delano Roosevelt) is not logically consistent and therefore inherently weak. If we cannot hold individual freedom as the supreme value, then we in effect have lost the battle of ideas. Freedom becomes one of the many values of the good society, on a par with equality, good health, opportunity. It is telling that Sen ended his book on Collective Choice with the following phrase, which can be immediately applied to freedom: "while purity is an uncomplicated virtue for olive oil, sea air, and heroines of folk tales, it is not so for systems of collective choice." (Sen, page 200) If it turns out that Sen and the other practitioners of the collective choice philosophy are right, and liberal democracy is paradoxical and liberty to be valued sub conditione, then what are we classical liberals to do? Are we to become American liberals? You will agree the question is weighty.

The impossibility of classical liberalism

Sen's Collective Choice was a valiant attempt to rescue welfare economics from the doldrums where the utilitarians had left it. Welfare economics is the branch of economics that aims at making the theory of economic policy scientific. The utilitarians could not find a way to extricate themselves from what G.E. Moore called "the naturalistic fallacy;" they were unable to find a way across the logical frontier traced by David Hume between 'is' and 'ought' propositions. Then, in 1932, came what seemed to be the final blow: Lionel Robbins powerfully argued that the happiness or welfare of one individual could not be compared with that of another. This made the summing of individual welfares demanded by Jeremy Bentham

250 Sen later expressed some regret at the sensation caused by his having used Lady Chatterley to illustrate the paradox of liberalism. See "The Impossibility of a Paretian Liberal," Journal of Political Economy, volume 78, 1970.

illogical, the notion of collective happiness inconceivable, and thus welfare economics impossible. So: the end of 'the greatest happiness of the greatest number'.251

The King is dead, long live the King! Welfare economists are perpetually engaged in a fight with Hume, whose interdict has reverberated through the ages. They pursue social welfare, but their starting point is

individualistic, for which we should be grateful. They are well aware of the naturalistic fallacy but will not give up interpersonal comparison, about which we should be skeptical. The object of Sen's exercise, as that of a distinguished cohort of thinkers led by Abram Bergson, Paul Samuelson, and Kenneth Arrow, is to sail welfare economics out of the Humean doldrums.

Enter Lady Chatterley and her gamekeeper

This is not the place to discuss Sen's encompassing proposal to solve the problem of welfare economics by finding some factual bearings to make collective choice a practical craft for ethical voyages. I wish to concentrate on a partial point of Sen's imposing system of economic philosophy: his criticism of liberalism.252 With the example of whether individuals should be free to read D.H. Lawrence's Lady Chatterley's Lover, he wants to uncover a fundamental contradiction or paradox in liberal ideology and thus lay a depth charge under classical liberalism.

From a liberal point of view we must conclude that individuals should be free to read it or not depending on their personal preference, though the book was seen by many as obscene.253 Their preference in Sen's example however, not only regards themselves but the possible negative effects of the book on others (what an economist would call 'external effects'). A true liberal should not be nosey and still hold that the people concerned must be free to follow their preference even if it impinges on those of others. "Nosiness", as Sen calls it, is far from exceptional in a free society, but it makes the choice of individuals very much a social choice. Liberalism thus implicitly becomes the typical object for a collective choice rule, and here Sen proposes is where it becomes paradoxical.

Sen proposes that a minimum condition for a liberal society, which he denominates L, is that at least two254 of its members should be able freely to choose among three alternatives according to their preferences, and that what they choose should be accepted by the rest of society as its collective choice. In the Lady Chatterley example, two individuals, Mr. Prude and Mr. Lewd, must choose among the following three alternatives: (a), that Mr. Prude read the book; (b), that Mr. Lewd read the book; and (c), that no one reads it.

251 See "Jeremy Bentham's Mistaken Universalism" by Pedro Schwartz. June 1, 2015. Library of Economics and Liberty. 252 I will use the denomination of 'liberalism' in its classical sense of 'the system of individual freedom' and not as used in the United States after Franklin Roosevelt kidnapped it in the 1930s. 253 So much so that so that the publishers were taken to court in 1960, when a jury finally acquitted them. 254 If it is only one person to thus dictate the collective rule, then he would became a 'dictator', which is not very liberal.

When transposed into a collective choice rule, the order of their preferences gives rise to a circle or contradiction. Thus, Mr. Prude prefers (c), that no one should read it but if it cannot be helped he would prefer (a), that he himself read it rather than let Mr. Lewd be further corrupted by the novel. On the other hand, Mr. Lewd is titillated by the thought of (a), Mr. Prude having to read it; if not that, then he prefers (b), that he himself should read it, since option (c), that no one should read it, would be a waste of a good tale.

In the following table P means □preferred to□:

Table 1. Preferences, Prude v. Lewd.

In the table we see that Mr. Prude prefers that no one should read it, but in a pinch he is ready to read the book himself. As for Mr. Lewd, he would prefer that Mr. Prude should read the book and if not, he would be ready to see if he can glean some new ideas for his love life. The crux of the matter is that, on the basis of Principle L, the individuals' choice becomes the choice of the whole of society. In this case a cycle appears making the social preference is intransitive: society prefers c to a, a to b, and b to c and back again. This paradox ties the liberal society in knots.255

What does 'Paretian' mean?

The first time Sen used Lady Chatterley for philosophical purposes was in a soberly titled essay "The impossibility of a Paretian liberal".256 What does the failure to be 'Paretian' imply in this context, and what does 'Paretian' mean?

The mysterious lore of welfare economics is a closed book for non-specialists when they try to debate actual policies 'rationally' or 'scientifically'. One of the more recondite concepts of that lore is the Pareto principle. This was proposed by the Italian economist and sociologist Vilfredo Pareto who thus ingeniously grappled with a fundamental difficulty of political economy: the impossibility, also alleged by Robbins, of fully measuring and comparing the utility, satisfaction, or happiness of different individuals. How can one say that a situation or policy is better than another when the utilities of the people it affects are incommensurable? Pareto proposed a criterion to aggregate individual utilities so that something could be

255 Sen dissects the difficulties encountered in generating a collective choice rule out of the preferences of two individuals (in this case Messrs. Prude and Lewd) in "Conflicts and Dilemmas", chapter 6 of Collective Choice and Social Welfare (1970). The common sense conditions that cannot be fulfilled in the Lady Chatterley case are: that the social decision should be rational by not falling into a circle, and that the solution be applicable whatever the content of the dispute. 256 Journal of Political Economy, volume 78, 1970. He then expounded his arguments in his 1970 book.

said about society as a whole: a criterion that, although incomplete, can sometimes give us an indication of the way to follow.257

Simply put, a Pareto optimum is one where no one can be bettered without somebody else being worsened; and a Pareto improvement takes place when one individual is bettered without anybody else being worse off.258 A Pareto improvement should be uncontroversial, unless we find envy permissible. The Pareto principle, however, is incomplete, since it gives no guidance for situations where some gain and some lose.

The appeal of the Pareto principle is that it turns out to be unanimity under another garb. Logically speaking there are two ways of conceiving unanimity. One is the strict interpretation of everyone saying yes or no. The other, weaker, one is when a person (or in the Chatterley case, two) agrees, all the rest abstaining. This latter kind of unanimity is labelled nemine discrepante unanimitas—unanimity with nobody disagreeing. In our Chatterley case, Messrs. Prude and Lewd freely express their preferences, the combination of which should become a collective choice rule if the rest of society abstains. What could be more acceptable for a liberal democracy than a collective choice rule be induced from the preferences of two individuals, the rest of society abstaining?

Sen was putting across the idea that the principle of individual freedom could clash with the Pareto principle as a guide for defining a best decision for society; that is to say, he wanted to show that a liberal solution in the Lady Chatterley case would have to override democratic unanimity. The thesis of this essay of mine is that, although we must agree with Sen that cycles will happen, societies in fact avoid these contradictions with the help of institutional fire-doors.

Dr. Sen as a teacher

Let me recall that I was a student of Amartya Sen when reading for my Master's degree at the London School of Economics in 1972-3. Quite some time has passed but I still remember why I chose his course despite its unappealing title of "Project Evaluation". I was impatient with the kind of theoretical political economy I had been taught and wanted to be trained in immediately applicable techniques. I found him one of the most inspiring teachers I ever been privileged to follow. His lectures lasted for one and a half hours without a break and not one of his students blinked. He covered the blackboard with mathematical logic derivations and explained them so clearly that we could all excitedly follow them. I especially profited from studying his rather advanced 1970 book. His kind of project evaluation was not a collection of recipes but a corollary to the collective choice theory he had helped

257 Pareto also solved the difficulty of basing the negatively inclined demand curves in markets on the law of decreasing marginal utilities. Instead of demand curves he used 'indifference curves', whose points indicated bundles of goods regarding which individuals are indifferent. This avoided the need to measure or rank utility, as in ordinary demand curves. 258 In Sen's formulation it boils down to two rules: "(a) if everyone in the society is indifferent between two alternative social situations x and y, the society should be indifferent too; (b) if at least one individual strictly prefers x to y, and every individual regards x to be at least as good as y, then society should prefer x to y." See Chapter 2, "Unanimity" of Sen (1970).

to create. He explored countless new avenues in welfare economics before coming to discuss whether a bridge should be built across the river though it displaced the bargee. I had thought welfare economics had been killed by Lionel Robbins when he denied the possibility of interpersonal comparisons of utility. Sen tried to show otherwise. Rarely have I been treated more courteously in class than by Dr. Sen. I took a keen interest in his approach to collective choice and social welfare. In the end, however, I was not convinced and am still not convinced today.

Escaping the contradiction of democratic liberalism

Tough Sen does not say so, the kind of infernal circle he traced in the Chatterley case can lead to confrontation, with Prude demanding that the police impound the book and Lewd distributing free copies at school doors. In view of this. Sen suggested that

... the eventual guarantee for individual freedom cannot be found in mechanisms of collective choice, but in developing values and preferences that respect each other's privacy and personal choices. (page 85)

Indeed, habits and traditions can play a moderating role when the mechanism of collective choice fails. This was the guarantee suggested by Alexis de Tocqueville in the second volume of Democracy in America259 when he said that the mores of a free society could be a bulwark against the incursions of democracy into personal liberty.

I think I can go further than this. It is my belief that societies, especially democratic societies, evolve institutions that overcome the contradictions between personal and political freedom, on the one hand, and the democratic principle, on the other. Laying all one's hopes for personal liberty on the growth of civilized habits in democratic societies cannot be the whole story. We must see if human societies have self-healing capacities for 'Lady Chatterley' kinds of conflicts, in the form of the emergence and growth of institutions.

Isolating Lady Chatterley paradoxes

The sum of what Sen has to say about societies trying to be liberal and democratic at the same time is that they are prone to logical contradictions which will give occasion to conflict, unless an outside arbiter invents and applies the necessary rules.

My thesis is that societies evolve institutions that cut the cycle and stop conflict from spreading. The market is one of those institutions that emerge over time in societies to act as a 'fire-wall' to cut the spreading of cycles and thus avoid the occasions of conflict due to indecisive social situations of the kind we have just described. The market is the prime example of systems that harmonize individual preferences and at the same time fulfill the Pareto criterion of limited unanimity.

259 Alexis de Tocqueville. Democracy in America, Historical-Critical Edition. Indianapolis: Liberty Fund, 2010. Available online at the Online Library of Liberty.

Given sufficient competition, the market is the vehicle for separate individual agreements, where external effects, negative and positive, are channeled through prices. These prices are impersonal bits of information, which individuals take as data. Of course competition must be understood dynamically, in the sense that monopolies and oligopolies tend to be eroded over time, unless protected by government. From the point of view of social welfare, however, the market usually gets short shrift, and is seen as a very imperfect mechanism that needs to be constantly overseen by regulators.

Another of these fire-wall institutions is private property. This is not the place to discuss the theories presented through the ages in defense of private property. My particular argument in this essay is that the institution of private property must be seen as another evolutionary response to self-destructive social conflict. I therefore find it little short of irresponsible that the institution of property does not get full attention in the collective choice literature. In fact, 'private property' is not even mentioned in Sen's book.

More generally, the kind of society that these collective welfare theorists outline is a kind of never-never land, devoid of institutions apart from voting rules, where disembodied individuals are organized by some all-knowing academic from Harvard or Princeton, totally oblivious of the operation of the forces of spontaneous order.

Let me show how the fangs of conflicts such as who is allowed to read Lady Chatterley's Lover can be drawn by the emergence of property rights. If Mr. Lewd possessed the only copy of Lady Chatterley in the market, all others having been burnt by a re-born Inquisition, then he could sell the copy he had just purchased on the black market to Mr. Prude for a (considerable) price, before he had had time to read it. Mr. Prude would then keep it uncut and under lock and key. That sale would be a Pareto improvement, as resulting from a voluntary contract, whereby Mr. Lewd had received a price high enough to pass on the property to Mr. Prude, who would reach his preferred state of no one reading the book. And vice versa if

Prude was the original owner of the novel and needed funds for his charities. Simply by attributing the ownership of the book to one or the other of the two, the spell would be broken.260

I think most of my readers will agree that no kind of discussion of social can proceed without taking the preservation of human society into account. As David Hume put it, society cannot subsist without two kinds of moral duties being generally observed: "justice or a regard to the property of others, fidelity or the observance of promises".261 The need and convenience for the respect of property and contract have not been invented by some social welfare theorist but are the result of successful evolution. These observations of Hume's are wrongly interpreted as

260 Notice that by defining property rights is how Ronald Coase showed that society spontaneously overcomes negative external effects. Remember "The problem of Social Cost", Journal of Law and Economics, Vol. 3 (October, 1960), pages 1-44. 261 David Hume, "Of the Original Contract," in Essays Moral, Political, and Literary. Indianapolis: Liberty Fund, 1987. Hume's italics. Online at the Library of Economics and Liberty.

some kind of utilitarianism. I rather see them as an expression of the general doctrine of the Scottish moralists about the establishments nations stumble upon, "which are indeed the result of human action, but not the execution of any human design".262 I am here laying my own kind of depth charge under collective choice theory: Bergson, Samuelson, Arrow, Sen, all think they know and should re-read Friedrich Hayek's 1945 article on "The Use of Knowledge in Society".263

262 Adam Ferguson: An Essay on the History of Civil Society, 1767. Online Library of Liberty. 263 "The Use of Knowledge in Society" by Friedrich A. Hayek. American Economic Review. XXXV, No. 4. pp. 519-30. Online at the Library of Economics and Liberty.

Keynes as Lucifer

September 7, 2015

Few economists in history have attracted such a large following as John Maynard Keynes. Not only did he fascinate two generations in the 20th century, he still is an inspiration for today's large and distinguished 'New-Keynesian' school—or should I say, 'schools'. The conundrum is why so many swear by his name though so little has been kept of the original model of his General Theory of Employment, Interest, and Money (1936), except his insistence that aggregate demand is the main mover of the economy and that the price system does not function well.

A number of circumstances and coincidences explain this everlasting fascination with Keynes. First and foremost is the failure to foresee, account for, and remedy the Great Depression of the 1930s—and the same with the Great Recession of 2007-11. Secondly, his own seductive personality fits in supremely with the new morality of the progressive elites. Thirdly, people of progressive intent feel a crying need to find some excuse for continued government intervention in society, after Marxism, socialism, economic planning, imposed egalitarianism, public schooling, and state welfare have signally failed to fulfil their promises or are threatened with impending failure.

Keynes's rejection of the classical model opened a door to the many who were unhappy with the orthodox belief that supply created its own demand; that unemployment was self-righting; that the gold standard was the best monetary system; that investment could be left in private hands; that the stock market, despite temporary episodes, reflected the fundamental values and trends of the productive system; and in general, that laissez-faire was the best possible social arrangement.

Even after so many years it is difficult to resist Keynes's power of seduction. He was blessed with the gifts of greatness. His distinguished parents formed a home that suited that supremely intelligent and restless boy. He shone as a scholar at Eton. At King's College Cambridge he studied mathematics and probability theory but then was attracted to economics under the influence of his father and Alfred Marshall. He soon acquired the knowledge and abilities of a percipient monetary economist and applied them with good fortune to financial investment and public advice. He was a master of English prose, in explanation, metaphor and invective. In debate he was convincing and could be deadly. In friendship he was intense and attractive. His patronage of the arts, the theatre, and the ballet count among his greatest glories. And though during World War I he was a conscientious objector, he should be remembered as a patriot, of whom his friend and disciple Lionel Robbins said that, in his effort to obtain the American loan in the last year of his life, he died for his country as surely as if it had been in the trenches.

Keynes□s early beliefs

Despite all his gifts and achievements, his influence on economics, in his time and now, was destructive of the fundamentals of a free society.

I am averse to using psychology (Freudian or not) to explain the path followed by great men and women in life. However, I think that the fundamental beliefs of the protagonists of history do shape their behavior throughout their lives. My ideological thesis is that Keynes's fall from the realm of light to the depths of deception would not have been so steep had he not looked at competitive capitalism and the free market in the decadent spirit of the 'Apostles' and the 'Bloomsbury' group of his younger years—as a necessary but rather vulgar social system, unworthy of the refined and the civilized.

The essay titled "My Early Beliefs" which Keynes wrote later in life makes unworldly reading for those who think that the Victorian virtues were not as laughable as Lytton Strachey portrayed the in Eminent Victorians (1918). The period of his life he portrays there is that of his membership in the secret Society of the Apostles at Cambridge University. It was an old Society, Christian in tone at its foundation in 1820, philosophical when Keynes joined it in 1903, Marxist in the 1930s when it became a breeding ground for future KGB spies, and at the turn of the 21st century full of welfare economists. As can be seen, the Society changed in character through the different generations. When the young Keynes belonged to it the inspiration was the philosophy of G.E. Moore.

Nothing mattered except states of mind, our own and other people's of course, but chiefly our own. These states of mind were not associated with action or achievement or with consequences. They consisted in timeless, passionate states of contemplation and communion, largely unattached to 'before' and 'after'. (Keynes, "My Early Beliefs," page 436)

It was Moore who had written:

By far the most valuable things, which we know or can imagine, are certain states of consciousness, which may be roughly described as the pleasures of human intercourse and the enjoyment of beautiful objects.

Soon this kind of quasi-religious mysticism extended to physical love. But the main doctrine was a rejection of Utilitarianism and of "the final reductio ad absurdum of Benthamism known as Marxism." (page 446). These Apostles saw human nature as fully rational.

[Bertrand Russell] in particular sustained a pair of opinions ludicrously incompatible. He held that in fact human affairs were carried on after a most irrational fashion, but that the remedy was quite simple and easy, since all we had to do was carry them on rationally. (page 449)

Keynes sums up the character the group with a most arresting metaphor:

I can see us as waters-spiders, gracefully skimming, as light and reasonable as air, the surface of the stream, without any contact at all with the eddies and currents underneath. (page 450)

Ten years later, the horrors of total war would destroy this dream like world.

True, Keynes's student days as an Apostle were a passing phase in his life. Soon he was hard at work for the welfare of his country and for the progress of economics. Led by a burning passion for rationality, he soon engaged himself to the hilt in questions and activities of great practical import that he thought were badly managed. But those early beliefs marked him for the rest of his life in two ways: he was the philosopher-king to his last day and he did not abandon his dim view of capitalism. My thesis is that Keynes, despite his public spirit and his good work, was fundamentally unengaged with the philosophy of economic endeavor, social competition, productive innovation, personal ambition, and fair dealing that is the hallmark of the freedom-lover of today.

Change of direction

This Apostolic philosophy soon resurfaced in Keynes's thought. Despite the underlying continuity in his economic thought, I see a fundamental change of direction around 1925. Before that time he was a monetary economist in the wake of Marshall. In his first work on economics, Indian Currency and Finance (1912), and in his 1923 Tract on Monetary Reform (to which I will return) he explained with great clarity how a nominal currency could be properly managed, both for the silver rupee in India before World War I and for a paper currency world in turmoil after the war. But around 1925, he started to move down a new theoretical path and left the strict monetarist fold of his earlier years, much to the shock of the other disciples of Marshall. He started to concern himself with what we today at his behest call 'macroeconomics', leaving behind the simple world of money and finance to enter a murkier one, where hidden psychological forces resulted in faltering aggregate demand and involuntary unemployment. This change was induced both by external events and by internal developments. As for events, he was reacting to decisions he deplored, such as Britain's return to the gold standard; also, there were unexplained situations from which he hoped to find an escape, such as the continuously high unemployment in Britain in the 1920s, and the unexpected depth of the Wall Street crash and the ensuing slump. As for internal developments, his radical change away from what I consider sound economics was impelled by his lifelong questioning of the morality of capitalism. His practical inclination led him to move away from the study of money to the real economy. In his Treatise on Money (1930-32) he started to question two of the central tenets of economic orthodoxy: the certainty that supply would always find a market; and the proposition that savings and investment would be in equilibrium. The experience of the Great Depression reinforced his growing doubts about the efficacy of cheap money and more generally of monetary policy, and it would

confirm him in his search for systemic failures in the capitalist economy. So, after much soul-searching and technical discussion, he built and launched the General Theory of Employment, Interest and Money in 1936. 264

The Keynes we remember today was thus born again in the mid-1930s. I prefer the Keynes of 1923 to the Keynes of 1936. The change away from the 'classical' doctrine of the Tract was deep and momentous. From simply explaining how to manage fiat money he moved to explaining how to manage society. Keynes's admirers say that he was on the side of the angels; that he was trying to save capitalism from itself; and that we poor misguided liberals should be thankful for small mercies. I find this disingenuous. Perhaps capitalism can save itself without us following the angel of light in his fall.

A Tract on Monetary Reform

Monetary questions have a permanency that lends an intemporal quality to the best monographs on the subject. If I were asked what authors a budding monetary economist should read today, my list would begin at Henry Thornton and David Ricardo, proceed to the young John Stuart Mill, go on to Walter Bagehot, and then (you may be surprised to hear) turn to Keynes's A Tract on Monetary Reform of 1923. It is in my view one of the best exposés of the functioning of that strange institution we call "money", especially when it is money created by state fiat.

The aim of the Tract was to propose a new monetary policy for times of inconvertible paper currencies. As a start, Keynes somewhat irresponsibly mocked the belief of the investing classes in the stability of the value of money, in the same tone that Lytton Strachey had adopted in Eminent Victorians (1918).

To save and to invest became at once the duty and the delight of a large class. The savings were seldom drawn on, and, accumulating at compound interest, made possible the material triumphs which we now all take for granted. [...] God and Mammon were reconciled. Peace on earth to men of good means.

Still, he had to admit that the admirable story of economic growth in the 19th century in great part depended on the stability of money, and that for a hundred years the gold standard system worked, throughout Europe, with extraordinary success and facilitated the growth of wealth on an unprecedented scale. (Vol. IV, page 6)265 The unstable currencies of the 20th century would prove to be a loss for the class of savers cum investors. Other classes in society would also suffer from the instability of the measure of value embedded in the currency. "Rising prices and falling prices each have their characteristic disadvantage." In sum, "inflation is unjust and deflation inexpedient". (A Tract on Monetary Reform, page 36)

264 Robert Skidelsky discusses these points perceptively page 439 ff. of volume 2 of his biography of Keynes: The Economist as Saviour. MacMillan, 1992. 265 I will be using the different volumes of The Collected Writings of John Maynard Keynes published by Macmillan St. Martin's Press for the Royal Economic Society. The dates in the text are those of the original publication of the works mentioned.

The quantity theory of money To explain the effect on domestic prices and foreign exchanges of the gyrations of paper currencies he used the quantity theory of money, after adapting it "to the existing regime of mutually inconvertible paper standards". The quantity theory! One could not be more classical than that! Of course, he later repudiated this quantity theory in his anti-classical General Theory.

The formulation of the quantity theory that Keynes used in the Tract is fundamentally the one monetarists still use today. It connects the price level p of the economy with the supply of money, n. Prices move in harmony or conjunction with the quantity of money, rising and falling with it in the long run. In one of his most famous phrases, Keynes said that "in the long run we are all dead". What he meant here is that he rather wanted to study the connection between money and prices in the short run. The phrase still

resonates because, though he wrote this phrase in the context of monetary policy, it is not unfair to take it as an expression of his philosophy of life.

In the Tract, the relation between the quantity of money and the price level was disturbed by two variables: k, the cash balance that families and firms choose to keep as a proportion of their total assets; and r, the proportion that commercial banks keep of their liabilities k' to their depositors. Thus:

$$n = p (k + rk')$$

So, in a boom, the relation between the quantity of money n and the price level p also depended on the expectations of ordinary people, whose high hopes in a boom led them to keep a lower cash balance than usual, and on the corresponding optimism of deposit banks, little worried by the possibility of their clients running to withdraw their deposits in a panic—and vice versa in a slump. Monetary authorities had an instrument to counteract these reactions. The Bank of England, by increasing or reducing the bank rate, could cool the optimism or counteract the pessimism that reduced or increased the amount of money in circulation and its initial effect on prices.

Purchasing power parity

All this is in a closed economy. In a world of many paper currencies, the effect of monetary expansions and contractions was not reduced to the domestic price level. The policies of the different central banks affected the exchange rates. At this point Keynes introduced Gustav Cassel's theory of purchasing power parity into the quantity theory.

In equilibrium the rate at which two currencies are exchanged must be the ratio of the purchasing power of each within its own monetary zone, or the ratio of their inflation rates. This would be so because if one could buy more with one's currency in a foreign market than in one's own, one would find it advantageous to import the cheaper goods—and vice versa. This theory, says Keynes, is subject to a number of complications that make it ill advised to rely wholly on comparing relative

purchasing powers to predict exchange rates: the existence of transport charges, of import and export taxes, of goods and services not entering international trade; seasonal influences, changes in interest rates due to sudden capital movements, and especially the anticipation of all those movements by firms and speculators reflected in spot and forward markets—all these circumstances made the reliance on equilibrium exchange rates dangerous in the short run. Keynes, who speculated in currencies for the government during WWI and later on his own account, had in one instance to be rescued by his moneyed friends.

Two kinds of monetary policy

On the strength of the quantity theory and the purchasing power parity theory, Keynes debated three practical questions concerning a system of inconvertible paper currency: (1) Deflation versus devaluation; (2) Stability of prices versus stability of the exchange; (3) The restoration of a gold standard.

When he spoke of the need to choose between deflation and devaluation, Keynes was referring to either depressing the domestic price level by a return to gold at the high pre-war parity or accepting the devalued parity set by the inflation level during WWI. A return to the pre-war parity would be destabilizing and painful.

He then generalized this dilemma deciding in favor of monetary policy: what today we would call domestic inflation targeting and what comes under the name of currency board arrangements. Under the first dispensation, domestic prices are kept stable and the exchange rate fluctuates; under the second, the exchange between the pound and the dollar, say, is fixed and domestic prices in Britain must vary to adapt to that exchange rate. Keynes preferred the policy of stabilizing the domestic price level and the domestic economy as much as possible and letting the exchange rate fluctuate.

The barbarous relic

A revealing phrase can be found at the beginning of Keynes's text: "money is simply that which the State declares from time to time to be a good legal discharge of money contracts". Since money is what the state says is the legal tender, then the state has a new instrument of taxation: to wit, inflation or "taxation by currency depreciation". Two driving forces favored this hidden tax: "the impecuniosity of governments and the superior political influence of the debtor class". Public profligacy and democratic imposition would tend to continuous depreciation of the currency legally defined as the measure of value. This for me leads one to conclude that the monetary authorities or the state should on no account be trusted with the management of money. Keynes's surprising conclusion was different: (a) that the standard of value should be governed by deliberate decision; (b) that it was possible to maintain a middle course between deflation and inflation; and reading between the lines (c) that a knowledgeable public servant could always be found who would manage money in the best national interest—possibly Keynes himself.

Keynes's preference for a stable domestic price level in contrast with a fixed exchange rate is a clear signal that he would not favor Britain's return to the gold standard in 1925—and at the pre-war parity to boot! For him, the only possible reason to worship that "the barbarous relic" was that monetary authorities were currently showing dreadful irresponsibility in the management of their inconvertible moneys.

It is natural, after what we have experienced that prudent people should desiderate a standard of value which is independent of finance ministers and state banks [...]; in fact, a chief object of stabilising the exchanges is to strap down ministers of finance. (pages 135-136)266

The argument for linking the measure of value to some fixed standard has not lost its attraction even today. Despite this, however, Keynes thought that we should prefer a managed inconvertible national currency. Not that today's central banks are doing a very good job... 267

The General Theory

We now can compare Keynes's mainstream ideas in the Tract with the pathbreaking concepts of the General Theory. In the Tract, monetary authorities were exclusively charged with the task of steadying the value of money, either domestically or internationally. In the General Theory, by contrast, the task of the authorities was different and much wider. The economic market was portrayed as full of blemishes and defects, which could not be cured or alleviated by mere monetary measures. In fact in this book he showed little faith in monetary policy. The only hope for preserving the free market in acceptable order was to have the government intervene continuously to maintain effective demand and compensate the shortcomings of private investment.268

The leading ideas of this book are: the first, that he presents aggregate demand as the engine of growth instead of productive investment as the classical economists would. The second is that he introduces

expectations as a fundamental modifying element in the functioning of the economy. The third is that he suggests that money has very little to do with inflation.

266 This would lead him to write The Economic Consequences of Mr. Churchill(1925), after Churchill as Chancellor or Secretary of the Treasury led the return of the UK to gold. 267 See for example George Selgin, William D. Lastrapes, and Lawrence H. White (2010): Has the Fed Been a Failure? CATO Working Paper. December 2014. 268 Keynes's General Theory is an especially difficult book to follow. If you are tempted to read it, do not start at the beginning, with the confusing postulates of classical economics or the obscure measuring rod of 'wage units'. Start with chapter 3 on "Effective Demand", read the first three pages of chapter 5 on "Expectation as Determining Output and Employment," and then proceed straight to chapter 18, "The General Theory of Employment Restated." Finally, end with chapter 21, "The Theory of Prices" with its curious notation, where he restated and debunked the quantity theory that he had so confidently applied in the 1923 Tract.. If you think that Keynes was writing about the Great Depression be disabused by you see that he gave it a mere appendix titled "Notes on the Trade Cycle".

Say's Law, which holds that supply always find its demand, was the bugbear of Keynes. The classicists founded on it their belief that full employment was the natural state of a free economy and there could be no involuntary unemployment in a competitive labor market, barring the frictional unemployment of people changing jobs. On the contrary, for Keynes, the engine of growth was aggregate demand (the sum of consumption and new investment): and the normal situation of a free economy was one where that aggregate demand was insufficient to guarantee the full employment of resources. This shortcoming was due to the tendency of consumption always to lag behind income, leading to excessive saving; and investment depending capriciously on the animal spirits of entrepreneurs. It was necessary for the state to use those excessive savings to top up flagging investment. Laissez-faire was not the best policy.269

One of Keynes's best contributions to economics was the importance he lent to expectations. He conceived them as the principal cause of the unreliability of private investment decisions. But he thus reduced them to playing the role of a wild card that increases uncertainty, it was an idea on which much later theory was built.

As regards the connection of money with inflation, Keynes hopelessly watered down the quantity theory he had explained in 1925. In the Tract, velocity being constant, an increase in the money supply would result in a proportional increase in prices. In chapter 21 of the General Theory, however, the quantity theory only held in a situation of full employment: if there were unemployed resources, there could be no inflation. An increase in the money supply did not cause an increase in prices when there was unemployment.270

The model

For Keynes,

... the outstanding feature of our experience [...] is that we oscillate, avoiding the gravest extremes of fluctuation in employment and in prices in both directions, round an intermediate position appreciably below full employment and appreciably above the minimum employment a decline below which would

269 In 1926 Keynes had published his controversial "The End of Laissez Faire". And in 1933 he reacted to the unemployment caused by the Great Depression in an article defending national self-sufficiency, where

he wrote: "Let goods be home spun whenever it is reasonably and conveniently possible." 270 The way Keynes explained this in chapter 21 was by making effective demandthe transmission link between money supply and prices. If effective demand increased in the same proportion as money, then the quantity theory behaved as in the traditional equation: an increase in effective demand proportionate to the monetary injection would lead to the same increase in prices. However, there could be leaks in the pipes leading from money to prices. When the money supply expanded, if (a) people increased their demand for cash balances; if (b) the reward of labor rose due to when more money led to increased employment; and if (c) the marginal productivity of physical capital fell when production grew, then the effect of money on prices was larger or smaller than proportional.

endanger life. (General Theory on Employment, Interest and Money, Volume VII, page 254)

It will surprise my readers that to analyze the travails of capitalism, Keynes uses a model where the economy oscillates around a secular trend of underemployment. The profession may not have a fully convincing explanation of the economic cycle and the possible causes of depression and recession. But surely a model announced with such fanfare should have attempted something better than representing the evolution of the capitalist economy as an anemic lurch from deep unemployment to mild underemployment and back again—this when the world was going through the Great Depression of the 1930s. A damp squib?

The two objective variables the model tries to explain are the volume of employment and the growth of national income. Left to its own devices, the economy will lead a bloodless life due to four psychological laws: (a) the law relating consumption to income, whereby individuals will expand their current consumption when their employment and their income increase, but in a lesser proportion; (b) the inclination of employees to bargain to keep their relative wages stable; (c) the faltering inducement to invest as capital grows because it makes the expected return to capital diminish; and the unsteady path investment follows as partly guided by uneven obsolescence; 271 and (d) the inflexibility downwards of the rate of interest when bond holders feel the bank rate cannot be lowered any more.

These psychological laws save the model from exploding or imploding and keep it on its listless sleepwalking path. When people refrain from consuming the whole of their income and save an excessive part of it, they dampen the rate of growth of the economy.272 When employees only struggle to maintain their current wage relative to that of their mates, rather than asking for higher real wages, they help keep costs within reasonable limits. The marginal cost of capital sets a limit upwards and downwards to private investment. And the liquidity trap reduces the effectiveness of injections of money to fight a slump.

This all means that the economy, if faithfully described by this model, will show a perpetual tendency to underemployment equilibrium, a sad state that the market cannot correct of its own. There is a need for a deus ex machina in the form of public investment, especially since private industry cannot be relied upon to pursue long term projects because entrepreneurs are subject to the vagaries of their "animal spirits".

271 See VII.16.iv, page 253, on what was later called the 'accelerator' principle. 272 The effect of consumption by and individual on the income of those from which he purchases is known as the "multiplier" (see chapter 7) and passim. When private individuals save too much, says Keynes, national income and employment suffer. Fiscal expenditure can come to the rescue by filling the gap between income and private consumption. This is where the government can step in, says the Keynesian parable, by burying old bottles filled with bank notes in disused mines, to be retrieved by private initiative.

I expect to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, taking an ever greater responsibility for directly organising investment. (VII, chapter 12, page 164)

Critical remarks

Keynes's own macroeconomics have stood confuted now for a long time. Milton Friedman admired Keynes's way of doing economics because the simplicity of the assumptions and predictions made testing easier. And he tested! He was the first to show theoretically and statistically that consumption was a fixed proportion of permanent income.273Friedman argued convincingly for the importance of money in macroeconomic theory, and for the explanation of inflation in practice.274 In A Monetary History of the United States, 1867-1960, written with Anna J. Schwartz, he gave weighty reasons for a monetary explanation of the depth of the Great Contraction of 1929-32 as he called it.275 The concurrence of unemployment and inflation after the oil crisis of the 1970s just killed Keynes's re-interpretation of the quantity theory in the General Theory to show that an increase in the money supply could not bring inflation while there was unemployment. There is no liquidity trap of the kind Keynes posited, and the changes in the velocity of money can be modelled in a more useful way by including financial wealth in the model.276

Modern growth theory has moved well beyond the marginal efficiency of capital, starting with Roy Harrod in 1939. We now know that unemployment is the consequence of expectations shaped by badly designed institutions, not the effect of a psychologically insufficient aggregate demand. More generally, one should criticize Keynes's excessive attention to purely nominal or monetary data—as if individuals did not after a pretty short time focus on deflated data to act as rationally as possible. Rational expectations are the basis of the 'Lucas critique,' 277the most deadly of the arguments against Keynes's recommendations as to the conduct of economic policy: Robert Lucas showed that discretionary decisions by the authorities destabilize the policy framework, as other agents guess and discount changes of direction by those in charge. Governing by rules is best because it will stop us trying to outguess and force the hand of the crew in the cockpit.

This is not the moment to look at the modern 'new Keynesian' schools of macroeconomics that are so in fashion now. One of these schools we associate with the names of Clarida, Galí and Gertler.278 Their idea is that the monetary system does not work well in the short run, because of sticky prices and other external

273 Milton Friedman (1957): Theory of the Consumption Function. Princeton University Press. 274 Milton Friedman (1956): Studies in the Quantity Theory of Money. Chicago University Press. 275 Milton Friedman and Anna J. Schwartz (1963): A Monetary History of the United States, 1867- 1960. Princeton University Press. 276 Tim Congdon (2009): Central Banking in a Free Society. Edward Elgar. 277 Robert E. Lucas: "Econometric Policy Evaluation: A Critique". Carnegie Rochester Conference Series on Public Policy, vol. 1, pages 19-46, 1976. 278 Richard Clarida, Jordi Galí, and Mark Gertler (1999): "The Science of Monetary Policy: a New Keynesian Perspective". Journal of Economic Literature, volume 37, pages 1661-1707.

effects delay adjustments, but that this sluggishness can be used under the radar, so to speak, to slip by short term interventions in monetary markets. The other neo-Keynesian school is that represented by Paul Krugman and Joseph Stiglitz.279 What they pick of Keynes's General Theory is the importance of

maintaining aggregate demand in the economy, if necessary by an expansion of public expense financed by debt. At bottom, what unites all these neo-Keynesians is the belief that the free market will fail unless political authorities mend it and prop it up continuously.

Visions of capitalism

In a letter to Friedrich Hayek on reading The Road to Serfdom (1945), Keynes wrote the following revealing words:

I should say that what we want is not no planning, or even less planning. Indeed I should say that we almost certainly want more. But the planning should take place in a community in which as many people as possible, both leaders and followers, wholly share your own liberal moral position. Moderate planning will be safe if those carrying it out are rightly orientated in their own minds and hearts to the moral issue. (XXVII, page 387)

In a liberal society, the management of an economy could be placed in the hands of superior specialists. Keynes thought that the restraint and honorability of the servants of the state (of which he was a signal example) would endure when the limited powers of government of Victorian and Edwardian times would be hugely increased. He thus showed scant knowledge of human nature and politics.

His rejection of free markets went deeper than showing a soft spot for planning. He who had written about "the euthanasia of the rentier" paradoxically thought that a free society was one given to the enjoyment of accumulated wealth. In 1930 Keynes had written a revealing essay under the title "Economic Possibilities for Our Grandchildren". The central idea of this essay was that the advancement of science and the accumulation of capital promised a future of abundance when most of us would be free from the chore of long hours of work. The abundance of leisure would change our work ethic. "Of course there will still be many people with intense, unsatisfied purposiveness who will blindly pursue wealth." But the time will have come when we honor not them but those who live like "the lilies of the field who toil not, neither do they spin." Come that time and we shall

... dare to assess the money-motive at its true value. The love of money as a possession—as distinguished from the love of money as a means to the enjoyments and realities of life—will be recognised for what it is, a somewhat disgusting morbidity, one of those semi-criminal, semi-pathological propensities which one hands over with a shudder to the specialist in mental disease. (Vol. IX, page 239)

279 Paul Krugman (2012): End This Depression Now. Norton. Joseph Stiglitz with Bruce Greenwald (2003): Towards a New Paradigm in Monetary Economics. Columbia University Press.

I cannot but conclude that the passage of Keynes through the firmament of political economy was baneful even to our own day.

Would a Return to Conscription Substantially Reduce the Probability of War

5 de octubre de 2015

The Greek crisis has many lessons not only for the Greek people but for all of us who use money. We could hardly have asked for a more dramatic way of teaching us those lessons than the failure of a member of the European Monetary Union in the train of the Great Recession of 2007-2010. One lesson is that our monetary arrangements are defective, not only those of Greece and the EU, but those of the world as a whole; another, that the conditions for a well-functioning monetary system have been ignored by authorities, who never leave money alone; and finally, that the job of a central banker is an impossible one. Since my conclusions are decidedly unorthodox, I must declare the grounds of my reasoning:

- I believe that money is too important an institution to be left to central bankers. - I can show that allowing a currency to devalue solves nothing much, since after devaluation the country must fulfil the same severe conditions that were needed to avoid devaluation. - Given the record of unrelenting depreciation of state monies, I would like to propose ways to give ordinary people the choice of a solid currency for their savings and investments.

Three monetary systems

Let me start by classifying monetary systems in logical order. Monetary arrangements can be divided into three sets.280 The first set includes the currencies whose exchange rate is fixed to a physical standard or pegged to another currency. The second set includes the countries that allow their currency to float against the other currencies, as is the case for sterling or the euro itself. The float could be free and left to the market but very few of the group of oligopolistic central banks of the world refrain from intervening in the exchange markets, with the pretext of keeping the rate at a value they consider more conducive to the general welfare.

Some of us think that central bankers cannot be trusted with our money, either when they more or less successfully fix it or when they more or less cleanly float it. In that case there is a third possibility: to allow full monetary competition. In fact, all currencies more or less willingly compete but there is the possibility to allow people to choose the money they wish to use, for transactions, or as the measure of prices, or as a reserve of value. Only a few nations actively encourage their citizens to hold and deal in foreign currency beside the national one. Monetary choice has recently widened with the creation of digital moneys thanks to the new Information Technologies. I am not only alluding to bitcoin but also to many other experiments in private monies, which can be found conveniently analysed by Kevin

280 For more explanation of alternative monetary arrangements, see my May 2015 column, "Sound Money Through Monetary Competition."

Dowd (2008) in a pamphlet from the Institute of Economic Affairs.281 In my view, it is possible that some of these private moneys may soon successfully link to gold as a way to guarantee the holders against continuous and uneven loss of value.

The hard discipline of fixed exchanges Hong Kong is one of the best examples of a solid peg. In the case of a fixed exchange rate, six rules have to be obeyed if it is to hold.

1. The monetary authority of Hong Kong must keep a reserve of US$ in excess282 of the total amount of HK dollars in existence.

2. Capital and its yields must be free to enter and leave the country without hindrance.

3. The monetary authority does not fix the discount rate nor does it require banks to keep a reserve against deposits.

4.The state budget must always be in surplus and the state refrain from adding to the public debt.

5. No failing bank or firm must be bailed out by the monetary authority or the government.

6. Society at large will accept internal devaluation (of which more anon) when balance of payments deficits need correcting.

In sum, in Hong Kong there is no monetary policy other than maintaining the currency board, no other fiscal policy than balancing the budget without increasing taxes, in the case of a fall of exports, no other macro policy than cutting public expenditure. Let me point out something of importance for my conclusions: that these are the conditions of the classical gold standard. So, whatever comes, Hong Kong takes it on the chin—all to keep its currency out of the hands of politicians and central bankers. It is not as if Hong Kong has not prospered under a currency board.

There is no need to view these prescriptions as religious commandments: even these commandments we poor sinners sometimes disobey. Giving way here and there may not lead to inevitable decay and fall as long as the peg holds firmly. Hong Kong does have a policy of social housing. Primary and secondary education is supplied free of charge to a large proportion of the youth. There is subsidised health care for the citizens of Hong Kong. Immigration policy is too strict and is endangering economic growth (as in many other countries). It was to be expected that one of the demands of the pro-democracy movement would be that trade unions be recognised, collective agreements permitted and a minimum wage imposed by law. However, capital flight and a weakening currency will give warning signals if the drift towards democratic socialism quickens.

281 You can find an excellent analysis of these non-state currencies in Kevin Dowd's short book New Private Monies (2008). PDF file. 282 Speculators against the peg holding can always borrow more than the amount of base money, as George Soros did on September 16, 1982 to break the Bank of England. The peg had been fixed at 2.95 Deutschemark for one pound sterling. It gave way when the Bank ran out of DM. At present in HK dollar reserve are three times the amount of base money

These conditions are immediately applicable to any country that has adopted an outside currency as its own, as have the members of the Eurozone. This in effect is an ultra-currency-board. The most important condition it must fulfil to stay in the monetary union is readiness to carry out an 'internal devaluation'. You need a very flexible economy and society to accept doing all that follows in short order. Instead of trying to cheapen one's exports by devaluing the currency externally, the country must reduce its costs internally, especially social security entitlements and labour costs. Demanding that in the Eurozone as in Hong Kong there be no unemployment benefit to keep people at work may be too hard a medicine; and no 'living wage' either, as it causes unemployment among the very poor. Charges should be introduced for health services and education, for reasons of efficiency as much as economy. Maybe it is politically too costly to make pensions private and fully capitalised, but the retirement age can be adapted to the longer life expectation. Trade unions are still too powerful there and labour laws too protective. The prohibition of budget deficits should be enforced without delay. If the cost reduction and budget consolidation are resisted, the cure will take longer and be harder, which is what has happened in Greece, where the painful adaptation is lasting more than five years.

Is a flexible exchange rate better than 'internal devaluation'?

Leaving aside the mountain of private and public debt accumulated, which can and will be reduced with the well-tried procedures of the "Club de Paris" and the "London Club", why submit any country of the Eurozone to such torture as Greece has suffered these last five years? The critics of the euro insist that all this pain need not have been caused if Greece had been able to devalue its currency. I accept that an external devaluation is politically easier than internal devaluation. It takes the population by stealth and is believed to affect only foreigners.

However, a devaluation: (a) depreciates the value of assets denominated in the devaluing currency and thus impoverishes the local population; (b) impoverishes them for a second time by increasing the local price of imports; and (c) thirdly, pushes up the price of the goods and services now newly exported. In sum, a devaluation is equivalent to a once-and-for-all hike in the price level.283 The reequilibrating effect of a devaluation on the balance of payments can be quickly frittered away if those price increases become persistent, i.e., they become inflation because of the pressure applied by interest groups on the government, and of the government on the central bank to compensate their losses. There is need for devaluation after-care or 'accompanying measures', as we prudishly called them at the Bank of Spain where I lived through three devaluations: a large increase in the interest rate to rein in the money supply; higher taxes together with a sharp reduction in public expenditure to rebalance the budget; a determined resistance against trade union and civil service demands for higher wages; the hope that shops will not take advantage of the higher cost of imports to increase their prices across the board. In other words it must be followed by the same sorts of measures that should have been applied to forestall devaluation. Devaluing the

283 As Harry G. Johnson used to say, the price level in a country is the world price level multiplied by the rate of exchange.

currency offsets past mistakes but the effect will be lost unless ordinary people are fooled into believing that there has been no devaluation—or forced to act as if.

The question remains: if external devaluation is easier to put in practice than internal devaluation and in the end amounts to the same thing, why insist on keeping a fixed exchange rate? The answer is that a peg ties the hands of central bankers and governments.

Fiat money and how to control it

The expression 'fiat money' is very telling. It designs paper money created out of thin air, so to speak, in contrast with money fixed to an easily realisable outside good. The government of a country and its central bank can say fiat, 'let it be,' and print as much national money as they think fit. All is not bad with modern paper money and its companion commercial bank money: they greatly reduce transaction costs in the performance of contracts and play a useful role in the financing of families and firms. Additionally, paper and bank money have the advantage that their costs of production seem minimal if hedging costs against depreciation are not taken into account. The trouble with printing money at will is that in the end it can feed inflation.

Since the last thing we want is to have our long term plans upset by sudden changes in the value of money, we should pay special attention to the mechanisms that stop the monetary authorities from playing political games with the currency. There is a peremptory need to control the freely issued monies of the present day. Different ways of exercising that control have been devised over time. One way we have just seen when looking at Hong Kong: pegging the currency.284

If the rate of exchange is flexible, one needs to impose a rule on the central bank to stop it from reducing the internal or the external value of the currency at will. Different rules are used to make central bankers behave. Firstly, more and more central banks around the world are proclaimed to be independent of the government. Then, a growing number set themselves an inflation target. Such is the case of the Bank of England or the European Central Bank (ECB): they must keep the rate of inflation as measured by the Consumer Price Index (CPI) at or just below 2 per cent one year with another.285When the target is not met the Bank of England is required to explain, in an open letter to the Chancellor of the Exchequer, why and what will be done to make it good. The discipline for the Board of Governors of the ECB consists in calculating the inflation target for the Eurozone as a whole and not for any nation in particular.

284 The issuers of private currencies also variously have their hands tied: for example, bitcoin is issued on the basis of an algorithm or embedded rule that makes the amount of bitcoins grow at a slower and slower pace until it will reach a maximum of 21 million bitcoins issued by 2042. Kevin Dowd (2008) calculates that attrition and losses will reduce this quantity to around 18.4 million. 285 A two percent increase in the CPI is considered equivalent of a zero per cent rate of growth of the price level because the CPI is believed as not properly reflecting improvements price of the quality of the goods included in its basket.

For years controversy raged between the economists who thought it best that central bankers should react to unwanted levels of inflation and low production discretionally and those who think they should be made to obey a rule. In the end, the defenders of rule-bound central banking have prevailed in theory, mainly because a fully informed public will adapt its expectations to reality with greater speed and less cost than one kept in the dark by the monetary authorities.286 In practice, however, the world's principal currencies are nothing but discretionally floating currencies managed by a panel of bureaucrats. The result is that the world monetary system is far from delivering good money.

Friedman□s plea for floating exchange rates

It was Milton Friedman who first defined an ideal for the management of fiat money: to keep the growth of base money287 at the same rate as the secular growth of real GDP (for which nominal GDP would be a proxy if prices are stable). Money for Friedman was a very powerful instrument in setting the economy on a growth path and later in making prices rise. A well-managed currency allows us to calculate prices, and helps us set aside value for a future need, and very considerably helps production. Increasing money excessively as compared with real production ends in price increases.

Milton Friedman thought that the creation of the Federal Reserve had not been a good idea. As a distinguished historian of money, he argued that the creation of a central bank had notably increased the volatility of the American economy. Since the Fed was there, however, the best solution was to deprive it of discretionary powers or, if I may put it so, have central bankers wear a chastity belt in the form of a strictly defined rule.

In my view, Friedman defended flexible exchange rates on the assumption that a well behaved central bank would keep the increase in money supply hand in hand with the secular growth of real production. Thus the rate of exchange can look after itself if the quantity of money is increased in an orderly fashion at the same speed as output. In that case, the exchange rate would simply act as a buffer for bumps and potholes on the road, not as a weapon in exchange rate wars.

But it is not a matter of the right person heading an independent central bank and applying the proper monetary policy. The existing oligopoly of far from independent central banks paddling in a sea of dirty float cannot be expected to produce the desired good money. The combination of fiat money with budget deficits and an indebted welfare state inevitably makes for a secular drift downwards of the value of currencies, whoever may be the President or the

286 The easiest rule to apply is having the central bank keep nominal GDP stable. Perhaps more complicated is the 'Taylor Rule'. Professor John Taylor of Harvard University, after observing the actual the behaviour or reaction function of the best managed central banks, proposed that central bankers pay equal attention to deviations from intended rates of inflation and from natural unemployment. This rule is not as practical in my view as that of targeting a stable nominal GDP. 287 Milton Friedman thought that the measure of money to be watched was 'high-powered money' Mo, the money directly created by the central bank. However Tim Congdon argues, rightly in my opinion, that monetary policy should care for the widest definition of money, M4.

Governor of the bank. It is not so long ago that the dollar was worth 4.2 Swiss dollars; it now is worth 1. Perhaps it is because Switzerland does not really have a central state. Again, sound-money-Switzerland seems not to have done badly at all with regard to growth and prosperity.

Two social regularities

A. The quantity theory Whatever the monetary system chosen, two social laws or regularities govern the management of money: the quantity theory of money and the theory of rational expectations. Today no serious economist doubts that in the end an increase in the supply of money will lead to a corresponding increase in prices or loss of the purchasing power of money, both at home and abroad. I know that John Maynard Keynes said that "in the long run we are all dead," but we who have children and grandchildren have a longer time horizon than that.

The best way to get the import of this 'quantity theory of money' is to formulate it with Milton Friedman along the same lines as Irving Fisher:

$M \cdot V = P \cdot Q$

This roughly means that an increase in the quantity of money times the percentage of their income people do not wish to keep in the form of money is equal to the increase of either prices or of output or both in some proportion. When people want to keep a greater percentage of their income in the form of ready money, velocity falls, as it did in 2008-2010. But let us assume for a moment that velocity is constant. In that case, an increase in the quantity of money will either lead to higher prices or to more output. By producing more money, central bankers aim at increasing output and employment. What Milton Friedman wanted to underline when adopting this formula is that in the long run all new money goes into prices. Remember, "Inflation is always and everywhere a monetary phenomenon..." That is a very good reason for keeping an eye on politicised central bankers.

B. Rational expectations I know the phrase 'rational expectations' rubs people's fur the wrong way. It is mistakenly believed to predict that we humans are moved exclusively by a level-headed rational estimation of what the future lays in store. Rational expectations does not mean that we make no mistakes or that there are no bubbles. Regarding the money market, it suggests that no historical prices can help predict

tomorrow's prices, unless there is inside information on the part of some traders, which is precisely the case with central bankers. Central bankers have a temporary asymmetrical advantage as to the effects on the money supply, because information about monetary measures does not get into prices all that quickly. But in the end it reaches the general public.288

A lack of general information about the possible effects of monetary measures is compounded with the tendency, observed in laboratory experiments, for bubbles to occur in markets where assets are traded mainly for resale, such as the stock

288 With high inflationary expectations, as happens during a hyper-inflation, for a time prices may run ahead of the money supply—again for lack of information.

exchange and property markets.289 In the laboratory these bubbles become bigger with increases in the money supply or debt finance. As Jerry Jordan (2011) has noted happens in the real world,

Asset price increases need not be accompanied by debt increases, but when they are then the subsequent decline in asset prices has much broader implications.

So this only tells us that sooner or later we ordinary people realise that what we took for a real increase in the prices that we are personally quoted or the prices we can charge for what we sell may simply be a monetary mirage. Monetary authorities can only deal in nominal prices or nominal exchange rates—those that appear on the labels of our grocery goods or the front pages of international newspapers. They may control inflation but they do not and cannot control real values, which in the end are decided in the market. In the end the monetary injection will turn into price inflation or into burst bubbles.

One thing authorities do know: paradoxically the monetary measures they take will be more effective the more they succeed in fooling ordinary people. Authorities can count on people suffering from 'money illusion' and 'exchange rate illusion'. They know that, when they promise that higher inflation will reduce unemployment, or that a lower discount rate at the central bank will increase investment, or that a nominal depreciation of the currency will boost exports, the desired effects will follow, but only if people are taken by surprise.

Sound money

The six conditions for a successful peg (above) indicate that a currency fixed to an outside value may be the best method to keep its own value from deteriorating over time. A peg is a method of guaranteeing that politicians or central bankers cannot play games with the national money. The founders of the European Monetary Union, especially Germany, wanted to create a solid, stable currency, governed by an independent central bank and free from political abuse. Critics of the euro miss its fundamental point: that the euro was devised precisely to stop member states using the depreciation of the currency to avoid tackling the underlying problems of the economy. This is what the Greeks could not live up to. The mistake was not so much devising a stable euro as imposing it on nations unready to forsake the magic wand of monetary policy for short term advantage. In that case it would have been better to allow ordinary people a choice of currencies: in the case of Greece the use of the drachma and the euro in parallel.

I have pointed out a lesson often forgotten: that, whatever the system chosen— fixed, floating, parallel currencies—the conditions of sound money are always the

289 See Gjerstad and Smith (2014), chapter 2. They have shown in laboratory experiments that cumulative over-valuations relative to fundamentals occur in markets for long-lasting assets bought mainly for resale, such as shares and houses. The increase in money supply and credit tends to make bubbles larger, at least in the laboratory. Accepting the weak form of rational expectations does not mean that there can be no bubbles but that they can only be observed ex post. See also my April Econlib column, "Housing Bubbles... and the Laboratory."

same: if you peg you currency you must apply the six Hong Kong conditions; if you prefer the comfort of a flexible exchange rate you in the end must apply the same kind of measures in the form of devaluation after-care—as the British, who prefer a flexible-exchange-pound, have discovered. Monetary and budget 'austerity' is always advisable, whatever the exchange rate system, but sound money is not easy, for it delivers the goods only in the long term.

We economists should never have accepted the name of 'austerity' for the measures needed to rescue currencies from short-sighted political interference. An obese smoker who also drinks is sure to complain of the doctor who imposes 'austerity' on him, though he knows he will feel immeasurably the better for it. This is now clear from the work of Alberto Alesina and Silvia Ardagna, among others, well analysed by Tim Congdon in his "In Praise of Expansionary Fiscal Contraction" (2015): cuts in public expenditure rather than Keynesian expansionism is what puts an ailing economy back on the path to growth.

A monetary anchor for large countries

But pegged to what? A small country may peg to the dollar. How do we guarantee the dollar, the euro, the yen or any other big currency does not continue on a secular slide? The large central banks want to use "the wondrous tool of money to maintain full employment, price stability and moderate interest rates", all at one go. At the same time they want to "satisfy an array of interest groups"—voters who want free education for their children, free health care for their families, a generous state pension; exporters, importers, bankers, agriculturists and other producers; creditors, debtors, among which especially the government. They want their countries to be like Greece while eroding the currency to avoid paying the price.

I ask again, what will happen to our savings and investments, to our progress, to our freedom, if the dollar, the euro and the other world currencies continue to misbehave?

Two possibilities should be explored. One is private currencies, the other a return to the classical gold standard.

Friedrich Hayek was the first front rank economist who argued in favour of private monies, much to the amusement of the cognoscenti. The year was 1976 and it was a time when privatisation of national industries was being mooted by friends of the future prime minister Margaret Thatcher. Milton Friedman summed up the general criticism by alleging a contradiction in Hayek's thought: though a defender of spontaneous order, here was Hayek proposing a designed reconstruction of money. But here, I am afraid, Friedman was wrong. Hayek had in fact written what amounted to a business proposal for private firms launching a new currency for profit, which the advances in technology today have made increasingly workable. Many failed attempts will be made before decentralised private monies become

widely used, but state monies are so defective that I dare predict we shall soon see private currencies accepted by many of us.290

If private monies are a red rag to managed money bulls even more so is the gold standard to the welfare establishment. Keynes called gold a 'barbaric relic' in his Tract on Monetary Reform (1925); but in the same breath admitted that the price stability of a century had contributed to the wondrous economic growth of the world from the end of the Napoleonic wars to WWI. 291

Many an illustrious economist will reject the idea of returning to the classical gold standard out of hand. I think this is so because it is not well understood how it would function. There is no need for gold coins to circulate. Convertibility of notes and deposits into gold would be enough,292 together with the participating nations forsaking all attempts to sterilise gold inflows and outflows. The cost of the gold system could turn out to be not be much higher than fiat paper if people hedging possible depreciation by investing in gold is taken into account.293

Conclusion

It is inexcusable for the economics profession to play along with the vote buyers. We know society is not as the populists paint it. Growth does not flow from monetary trickery and income redistribution. The sources of economic growth are population and capital, of course, but more so, transformative technology, the spread of knowledge, and better institutions. The central banker simply cannot deliver the goods she pretends are within her grasp: sound money, full employment, moderate interest rates, a smoothly functioning financial system. The central banker's lot is not a happy one. Keynes spoke of the euthanasia of the rentier. Dare I speak of the euthanasia of the central banker as in Hong Kong?

290 We do not know which. See Dowd and Hutchison (2015) on the possible fall of bitcoin. 291 One of the reasons why Keynes was against returning to the gold standard was that it would put the monetary policy of the Bank of England in the hands of the Fed, because the Fed did not play by the rules and sterilised inflows of gold so as to manage its money supply at will. 292 David Ricardo (1816) proposed that bank notes be exchangeable for gold bullion rather than minted coins. 293 The costs of paper and bank money seem minimal but are not so if the opportunity cost of people accumulating gold as a hedge for paper money depreciation is taken into account. See Watts and Snyder (2015), pages 411-428.

The Poverty of Social Choice

November 2, 2015

The search for a method of collective decision-making to solve social problems in a rational manner is the Holy Grail of American liberals and European socialdemocrats. But precisely the contrary is to be desired: the fewer the decisions individuals have to take collectively the better it is. The contemporary version of this limitless rationalism, unafraid of turning everything into politics in the name of civic republicanism, is the so-called "theory of social choice", that we associate with the names of Kenneth Arrow and Amartya Sen, both winners of the Nobel Prize. In this column I wish to suggest that 'Social Choice' is at best barren, at worst dangerous.

The Old Welfare Economics

'Social choice' has its roots in the Utilitarian philosophy and in its offshoot welfare economics. Jeremy Bentham, James Mill and the young John Stuart Mill tried to define the general welfare as the sum of the net pleasure or utility of individuals in a society, under two assumptions: that each person counted for one; and that it was possible to compare the utility of one person with that of another.294 The insistence by John Stuart Mill (1861) that there were higher and lower pleasures—"better Socrates dissatisfied than a pig satisfied"—was a step in the direction away from Benthamite interpersonal comparison: people were too different to be added up, was the implicit conclusion in Mill's thought. Despite Mill's doubts, he himself and later economists insisted in their search for ways of aggregating utilities to formulate public policy scientifically. So they looked for a new criterion of general welfare that would avoid the interpersonal comparisons that Mill found so difficult to normalise.295

Thus, at the very end of the 19th century, Vilfredo Pareto proposed a welfare criterion that did not need each individual to calculate her personal utilities and

294 The object of Bentham's legal philosophy was to help societies attain the greatest aggregate happiness. For that one needed to calculate the net sum of pleasures and pains caused by laws and policies. Since the sensibility of men varies according to age, sex, education, fortune, religion and the other circumstances that influence it, Bentham created an elaborate system of utility measurement or "felicific calculus"" so that personal utilities could be added to obtain social utility. The importance of such a scale of comparison for utilitarianism was rightly underlined by the Etienne Dumont in his influential edition of Bentham's works in French (1802, 1820). For more on Bentham's philosophy, see my June, 2015 column, "Jeremy Bentham's Mistaken Universalism." 295 Mill's difficulty could not be solved by 'felicific calculus' because he could not agree with Bentham that the stuff of happiness was the same for everyone, only modified by circumstantial accident, such as intensity, remoteness of probability. He could not agree with Bentham's dictum that "pushpin is as good as poetry". At bottom Mill was saying that the happiness of different people was incommensurable. His solution was paternalistic: people who were able to feel both highbrow and lowbrow happiness could adjudicate on the real worth of different sources of happiness. It is lucky that Mill lived in Victorian times when le plaisir de la boue was inconceivable or at least not respectable.

which would allow an "outside arbiter" to compare and aggregate the measured utilities of individuals. The Pareto criterion was based on individuals classifying their preferences ordinally; and such social situations as were unanimously accepted could be taken as based on a value judgments accepted by all.296 True, the unanimity posited by Pareto was minimal, valid with whatever number of abstentions or as the Latin sentence goes, nemine discrepante. A 'Pareto' improvement took place when at least an individual bettered her situation and no one saw any worsening of theirs.297Hence, the Pareto criterion is incomplete. It does not attempt to order all possible social situations and policy changes, as it says nothing about changes where some are improved but others lose. Also, it sets aside considerations of distribution, since a Pareto improvement is to be preferred even if the person bettered is a super-billionaire and the situation of all others is unchanged. Still there is a quite large set of situations that are Pareto-acceptable: all trades in a free market make the two parties to the exchange better off, and the rest stay as before.298

A different line of defence of welfare calculus was then tried by Arthur Pigou. Mill had carefully examined the exceptions to the rule of laissez faire in his Principles of Political Economy299 (1848) when defects in the market needed correction.300Pigou progressively expanded Mill's list of permitted state interventions

in The Economics of Welfare301 (1920). Pigou started from the ideal of a perfect market, then listed the deviations from perfection in reality, and finally proposed taxes and subsidies to correct them. Every edition of that book had a longer list of market failures and a wider remit for public regulators. Thus, the Pigovian analysis looked increasingly ad hoc, as a pile of excuses for state interventions rather than a theory of public policy.

Next a devastating critique by Lionel Robbins intervened. Robbins issued an interdict on the comparison of utilities among persons that were needed for the calculus of social welfare. Strictly speaking as he pointed out (1932-35), full interpersonal comparisons of happiness are impossible. This is so for two reasons: (1) it is impossible to measure utility for each person, since that (cardinal) number will not be invariant to the chosen units; and (2) comparing the self-perceived

296 Sen, Collective Choice and Social Welfare (1970), pages 57-58. 297 As Sen (1970) put it: "x is Pareto-optimal if we cannot choose an alternative that everyone will regard to be at least as good as x and which at least one person will regard to be strictly better than x," page 21. 298 Though any trade between two persons nemine discrepante changes relative prices and thus affects the rest, the information transmitted by prices is precious and welfare-neutral. For example, if I sell my house and somebody buys it, the prices of all other house in the market are somewhat changed. A third party may feel harmed by this indirect effect on the value of her assets. But price movements simply transmit information on things as they are and as such are neither just nor unjust. 299 Principles of Political Economy with some of their Applications to Social Philosophy, by John Stuart Mill. Library of Economics and Liberty. 300 Schwartz, The New Political Economy of John Stuart Mill (1972), pages 129-142. 301 The Economics of Welfare, by Arthur C. Pigou. Library of Economics and Liberty.

states of happiness between persons is also strictly impossible, if only for differences in keenness or sensitivity of feeling.302

The New Welfare Economics

The old welfare economics, especially in its utilitarian form, was declared insufficient. Even the Pigovian 'market defects' program was seen to lack a formal basis. The Robbins critique had left the Pareto criterion unscathed because unanimity, even in its weak nemine discrepante form, demanded no cardinal measurement nor interpersonal comparisons of happiness. So welfare economics was formalised with the help of the Pareto criterion. The starting point was again the ideal of the perfect market and a new welfare economics was formulated summed up in two propositions:

I. Any competitive equilibrium is Pareto optimal II. Any optimal production plan chosen by a planner can be achieved via the operation of the competitive market. These two propositions look the same to the unwary but they are not. They set the framework for a 'scientific' theory of public policy for the following fifty years, thus:

I. A. Since the actual capitalist markets were never competitive and never in equilibrium, there was constant need for policy intervention to achieve a Pareto optimal economy.

II. B. The just society could be created by a politically defined Plan and this Plan could then be put into effect by trusting its execution to a competitive market.

The first proposition was interpreted to imply that a well-planned socialist economy could approach Pareto optimality much better than the capitalist market. The second proposition was seen as indicating the possibility of a division of labour between planner and market to create an optimal socialist commonwealth. These two theorems of the new welfare economics were first outlined by Enrico Barone (1908) and analytically proven by Oskar Lange (1942).

The title of Barone's essay has sinister connotations for the generations who have known fascism and communism: "The Ministry of Production in a Collectivist State". Barone wanted to show that a collectivist government could: (1) lead society to a productive optimum;303 and (2) redistribute what, in an "individualistic regime", the capitalists would themselves have consumed after reinvesting the larger part of the profit. The planner would attain (1) by discovering the most economical combinations of factors304 through trial and error by means of price changes. As for (2), the planner would redistribute the surplus according to the

302 This is as explained in Sen (1970). Below, we shall see Sen trying to rescue interpersonal comparisons by speaking of broad levels of utility; and in fact misunderstanding Robbins's interdictum. 303 Barone defined the collective maximum in Paretian words, as a situation where every further modification would place individuals in a worse position. 304 Following Leon Walras, he calls these combinations of factors "technical coefficients". Some of these could be varied by the planner by trial and error so as slowly to bring the economy nearer to the collective maximum welfare.

egalitarian preferences of the people. In sum, the planned economy would function exactly as a perfect individualist market economy, where costs of production are at their minimum and are equal to price, and the only two socialist traits of this economy would be the collective ownership of the means of production and the egalitarian distribution of the surplus previously consumed by capitalists.305

Of course, as Ludwig von Mises and F.A. Hayek pointed out, Barone's socialist economy relied on a number of unspoken assumptions about how well informed the planner could be. (A) The planners would know the full effects of any price changes on the current combinations of factors, actual and potential, allowing them to set, choose, or modify them for the convenience of the plan; (B) the planners would know what consumption goods individuals could want and choose and accordingly change their prices to avoid shortages or surpluses; (C) the planners could also tune the rate of interest on saving so as to guarantee investment for growth; and (D) the populace would know and acquiesce in the distribution of the surplus decided by the state. The impossibility of gathering such knowledge made Barone's proposal unworkable, as it would Lange's.

Lange, who was an admirer of Stalin, applied these theorems to formulate his own version of 'market socialism". In a planned economy, the Communist government could define the objectives of the Quinquennial Plan (including its social objectives) and then play with the prices in a mock competitive market so as to equalise the supplies of and demand for the final goods and services: the planner would ask producers how much they would supply given a schedule of prices, and ask consumers what they would pay for the different quantities supplied. After much toing and froing this would throw up the equilibrium point at which the market would empty.

As I just said, Mises and Hayek (1920 and 1935, respectively) showed the theoretical impossibility of such arrangements, for two reasons: one that gathering the necessary information about the millions of prices and their changes in a market economy was impracticable; the other, that in any case producers and

consumers would have an interest not to reveal their preferences to the planner.306 I well remember a lecture by Oskar Lange at the Old Theatre of London School of Economics a few months before his death in 1965. Lionel Robbins was in the chair. Lange explained how computers would make the calculations of market socialism workable. Robbins, who sat above Lange, could barely contain his laughter. The collapse of 'real socialism' in 1989 confirmed the accuracy of the critics' judgement.

Social Choice

It is with trepidation that I enter the field of collective choice with critical intent, a field bristling with Nobel Prize winners and knowledgeable experts in mathematical logic. As a former pupil of Amartya Sen, I aver that I have found few

305 Either making the portion equal for each individual; or equal for classes of individuals. 306 This is impossible even today with 'big data' methods: not only the gathering of the data, but interpreting them and their interconnections needs of an accurate model of the whole economy. And we know what we think of multi-equation models of large economies.

teachers as inspiring as he was. He kept the class spell-bound for two hours at a stretch while covering the blackboard with deductions and proofs of mathematical logic. He was courteous to a fault and sworn to reason and compassion. Whatever I say here about his welfare theory should not be understood as derogation of the respect I feel for him as an economic philosopher.

Finding Barone and Lange in a cul de sac, the defenders of collective choice felt the need for a method to formulate and evaluate public policies from the standpoint of methodological individualism and not as the dictates of an outsider planner. This new path was opened by Abram Bergson (1938) and Paul Samuelson (1947) who defined the general structure of ways to organise society rationally by means of methodologically acceptable transformations of individual preferences into social preferences. The transformations are usually known as social welfare functions (SWFs). The transition from individual to social should fulfil two conditions: (a) that the SWF be strictly related to the welfare of individuals, so that, when the situation of individuals is bettered, the SWF also shows an improvement; (b) that any of these SWFs arrange all resulting social states in an order going from worse to better unequivocally. Within these wide limits philosophers would able to adjudicate among proposed SWFs as to which would best aggregate the ethical demands of individuals, and thus judge the justice or fairness of a market economy.

The welfarist party then received a cruel blow from Kenneth Arrow (1952), one of its foremost champions: the "Arrow impossibility theorem". This theorem proved that no SWF could exist that fulfilled four very mild conditions: that it be applicable to all conceivable choices; that it be unanimous; that it be chosen on its own merits; and not be imposed by any one person on the rest.307 The conclusion was devastating: Arrow had proved that it was impossible for a society to agree on a welfare arrangement, even if the individuals of that society unanimously preferred it. As Andreu Mas-Collell put it (1974): a social group that may try to apply a SWF will inevitably find that "it cannot decide rationally, that is to say, as if it were an individual person".

It is instructive to follow the twists and turns of the whole collective choice school to try and salvage some part of 'rational' welfare economics, broadly understood to include public economics, planning theory, the theory of the state and the theory of social justice. To this purpose, the school showed that the rules to be applied could work reasonably well if preferences are restricted. Also, the limitations of Pareto unanimities as regard the distribution of income and wealth could be partially overcome if levels of interpersonal

comparisons were in some way allowed. And the non-dictatorship condition could be suspended for decisions

307 Sen (1970). More precisely: (1) that the welfare function in question "should work for every logical configuration of individual preference orderings" (Condition U of unrestricted domain); (2) that the SWF in question satisfy a very undemanding form of the Pareto principle, to wit, "if everyone prefers xto y, then society must also prefer x better than y" (Condition P); (3) that the decision of x over y should be influenced by no other consideration but of these two states (Condition I, of independence of irrelevant alternatives); and (4) that no one person should decide for society "irrespective of the preference of everyone else" (Condition D, of non-dictatorship). In class Sen formulated the mnemonic device "stupid" to remember these four conditions.

affecting essential liberties, when an individual had the right to veto some social injunction.

In the end and after much logical demonstration, Sen himself admitted (1970) that there can be no single golden rule to organise society along welfarist lines. His book, said Sen,

... has been concerned with impurities of one kind or another, e.g., partial interpersonal comparability [...], partial cardinality [...], restricted domains [...], intransitive social indifference [...], incomplete social preferences [...], and so on.

With a humorous turn typical of his seductive personality, he ends by saying that,

... while purity is an uncomplicated virtue for olive oil, sea air, and heroines of folk tales, it is not so for systems of collective choice.

Robbins Again

In the Preface of his 1970 book, Sen perhaps unwittingly makes what I think is a crucial separation between questions of the theory of decision procedures and questions of political philosophy. For me, the main contribution of social choice is the discovery and attempted solutions for the conundrums and contradictions of decisions taken by bodies of people; and the main danger of social choice is the attempt to define a just society and impose it on people. Of course, we do have to take communal decisions. Their structures and results are not evident. Their logical mechanisms have to be explored, as when we analyse the paradoxes of voting or the pervasive free-riding that besets public goods. But these factual studies must not be confused with the ethics of collective decisions.

Sen ingeniously rebuts Robbins's interdictum of interpersonal comparisons of utility by noting that the prohibition against comparing preferences interpersonally may be lifted if those involved are ready to take the consequences of their choices into consideration when debating whether to hold onto their preferences. They are implicitly taking those values and preferences as "nonbasic", that is to say, ready to temper them or to give them up in the name of justice. "It should be fairly obvious", he says, "that nothing much of interest can be said on justice without bringing in some interpersonal comparability". (1970, page 150). This is not the definition of justice according to Hume, as we shall see.

By outlawing inter-personal comparisons in welfare economics, Robbins precisely wanted to defend an Austrian view of justice in society. In an individualistic market system one cannot say that society is just or unjust, nor that rewards are undeserved or the distribution of property unfair. It is people who are just, not

systems. Of course in democracies we make social choices, according to the interests and the moral judgment of the different individuals concerned. These judgments can be evaluated or criticized by pointing to their effects, self-

contradictory or positive. 308 This is very different from trying to formulate and apply a social welfare function, however modified to avoid 'Arrow contradictions'. Citizens make social choices, but there cannot be a 'Social Choice'.

This refusal to make collective social judgments is clearly in the tradition of David Hume, who in (1752) defined two moral duties that men and women perform entirely from a sense of obligation, only in consideration of "the necessities of human society, and the impossibility of supporting it, if these duties were neglected."

It is thus [that] justice or a regard to the property of others, [and] fidelity or the observance of promises, become obligatory, and acquire an authority over mankind. (Hume, Essays Moral, Political, and Literary, page 480309)

If we stand by Hume, the whole endeavour of collective choice belongs to a world of collective dreams that can easily turn into nightmares. Collective choice moves in a world without institutions, without competition, without history; a rational world of decisions based on perfect knowledge of individual preferences.

The danger is that some arbiter may start acting on the basis that he knows what is best for others.310 Sen defined individual liberty as including the enjoyment of what he called "functionings"—enough food, good health, a long life, opportunities for happiness, respect for one's dignity, participation in the life of the community. There is a telling passage in which he laments the situation of downtrodden people in an unfair society, who may go hungry, die young, lose most of their children, lack education, suffer discrimination, and not even know that they are in want of the minimum capacities to function. They neither control their lives nor have a capacity for personal-choice, he says. So he defends the

... social-choice characterisation of liberty [which] compares what [in fact] emerges with what the person would have chosen, whether or not he actually does the choosing311.

I understand this as meaning that we can impose liberty on people who are too poor or too ignorant to make the choices we think are right for them. These fateful words conjure the shadows of Indira Ghandi's forced sterilisation or the 'one child policy' of Communist China.

308 Sen distinguishes between "basic values", for which we are ready to die, from "non-basic values", which we might give up if their consequences in certain circumstances are self-defeating or cause unacceptable harm to others. In the latter case, an interpersonal comparison is implicitly being made. 309 Essays, Moral, Political, and Literary, by David Hume. Library of Economics and Liberty. 310 Note the "outside arbiter" on page 100 of Sen (1970). Despite Sen's methodological individualism, which made him lay down that all social choices must be reducible to individual preferences and decisions, there is a strong whiff of an outsider above the fray adjudicating among individual choices. 311 Sen, "Liberty and Social Choice." Journal of Philosophy, 1983, page 454.

One of the objects of Sen's Collective Choice and Social Welfare (1970) is to show that it is impossible to be a classical liberal and present the free market as one of the few social arrangements where unanimity rules.

His "Impossibility of a Paretian Liberal312" encapsulates in one expression this alleged paradox. An emergent solution to this paradox and many others in social choice is an institution evolved in our societies since Roman times, namely, private property. This institution partitions the domain of Paretian rules so that for the things she owns she can exercise a veto against the decision of the rest of society, which is the essence of human liberties (or 'human rights' as they are usually called). The preservation of private property in Western societies is not only helped by its positive effects on productivity, as in the end, through purchase or rent resources will fall into the hands of the most efficient user. Property rights also help protect individual liberties.

Market Defects Corrected by Emerging Institutions

The eternal argument of interventionists and regulators against a free economy is the existence of market defects. They seem not to have read Ronald Coase or to have been taught his (1960) theorem in its static formulation. Coase in his later years moved away from the interpretation of his theorem as showing that alleged market defects dissolved on condition that property rights were clearly defined and the economy was perfectly competitive. Welfare improving trades created property rights and functioned under imperfect competition—a shining example being the growth of capitalism in con temporary China. On this point I need not repeat myself, since I argued it at length in a Letter from Europe published at the Library of Economics and Liberty in October last year, under the title "Ronald Coase, the Unexpected Economist".313 So I can refer my readers to that unconventional piece of mine.

312 For a description of Sen's Lady Chatterly example, see my July 2015 Econlib column, "Lady Chatterly's Lover, or the Poverty of Social Choice." 313 "Ronald Coase, the Unexpected Economist," by Pedro Schwartz. Library of Economics and Liberty, October 7, 2013.

A Flood of Inmigrants

January 4, 2016

Quite some years ago, when I was a very liberal young man writing a doctoral dissertation on John Stuart Mill, I asked my supervisor Lionel Robbins what he thought of the restrictions newly introduced on immigration by the then Conservative government. Robbins answered with another question: "Would you make immigration totally free?" I did hesitate but suggested immigration should be as lightly regulated as it was in the United States at the end of the 19th century— just a medical and fifty cents per head on Ellis Island. I want to consider whether I would give that same answer today for Europe, seeing the size of the displacements caused by the civil wars in Libya, Syria, Iraq, Afghanistan and the Horn of Africa. In what numbers should immigrants from the poorer parts of the world be let into Europe? Should there be limits to internal migration within the European Union? What methods are acceptable to stem the flow of people fleeing violence or seeking a job? Liberal democracies in North America and Australasia face the same general question, to wit: does the philosophy of freedom include the right of people to travel and settle as and where they want?

Mass migrations are not a new phenomenon in Europe. The end of World War II made for very large displacements, whether voluntary or not: the borders of Germany and Poland were moved westward at the stroke of a pen, with millions of people forcibly changing their place of abode. Later came the voluntary migration of thousands fleeing communist oppression and, after the demolition of the Berlin Wall, even

more people from Eastern Europe seeking new opportunities in the West. The independence of Algeria from France led the former metropolis to open its doors to people of both French and Algerian extraction. And Spain in the 1980s not only allowed many Moroccans to settle in its cities but was also very generous in granting double nationality to Latin Americans, blessed as they were with the same language, customs and even religion. (My mention of religion is not fanciful, for much heavy weather is made of the difficulty of assimilating a large Muslim population in countries of Christian tradition today.)

A further development in the European Union is that its treaties mandate the free movement of European citizens within the EU, including the full enjoyment of their welfare and social rights. This freedom is reinforced by the obscurely named "Schengen Treaty", whereby there are no inside border controls in the EU, so that you can drive or fly freely from Finland or Hungary to Portugal or Malta, just as when you travel from Maine to New Mexico. Even where border controls remain, as in the United Kingdom and Ireland, Europeans can seek employment there: 'the Polish plumber', as the catch-all phrase goes, allegedly puts the local worker out of a job. Finally, you have immigrants from outside the EU, either applying for refugee status or simply slipping in illegally—or drowning by the thousands in their attempt to come in by sea.

Let us see some numbers. The EU has become one of the regions that the rest of the world looks up to as a destination for a better life. According to the European

Commission, immigration into Europe excluding refugees and asylum seekers was from 2010 to 2014 a steady 1.4 million per year. The result is that in 2014, residents in the EU born outside Europe numbered 33 million—or 7% of its population. This may look large but not when compared with the 14% foreign born in the US, 20% in Canada or 27% in Australia, also in 2014.

Thus the immigration phenomenon is one of old standing, but the present rush to enter the EU at any cost by people coming from Africa or the Middle East is causing alarm. Asylum applicants plus people crossing illegally were 540,000 in 2013, 911,000 in 2014, and 1.5 million in the first six months of 2015. Though 40% of asylum applicants are currently being rejected, this progression will certainly increase the 1.4 million immigrants per year entering the EU that I mentioned above.314

This poses two kinds of problems for the EU. The most immediate one is the bureaucratic nightmare of dealing with unmanageable numbers of destitute people banging on its doors. According to European law, it is the country of first arrival that should check and classify the newly arrived. But the main points of entry are the minute Italian islands in the Mediterranean, the tiny member-state of Malta, and the Greek islands a stone's throw away from the Turkish coast. They cannot cope, nor can the small states on the mainland crossed by refugees and illegal immigrants heading towards Germany and Sweden, where most want to go. The second is the hopeless attempt to distinguish between 'asylum seekers' fleeing political or racial oppression and 'economic migrants' who simply come to find a job or learn a new trade. That distinction is artificial: though some are forced to move under duress, all come for a better life for themselves and their families. An indication of this is that 65% of the applicants for refugee status in the first nine months of 2015 were young men, clearly looking for employment, and that a sizeable proportion of the 'refugees' is made up of unaccompanied children who have a greater chance to be allowed in and start a new life.

The EU is being less than efficient in dealing with the immigration phenomenon as a whole. "Frontex", a European Agency for the management of external borders is just beginning to help frontline states to cope

with the refugee influx. A European coast guard is in the process of being launched. There has been an attempt by the Brussels Commission to set minimum quotas for the numbers of refugees that the different nations must accept but most are refusing the imposition. Germany is among the exceptions for it has promised to accept an even large number in 2016 on top of the 800,000 taken in last year. The United Kingdom is among the least generous of European countries, as it has limited its total intake to 20,000 refugees over the next five years. Political resistance is growing in Hungary, Poland, Denmark, and France. Even Angela Merkel is seeing dissent in her party. The antirefugee reaction in some European countries has led Peter Sutherland, the UN special envoy for migrants and refugees, to condemn it as contrary to UN principles and international law: he has reminded Hungary that free Europe accepted 200,000 refugees after Russia put down the Hungarian revolution in 1956.

314 See the detailed articles on the European Migrant Crisis in Wikipedia for the sources of all these figures. Accessed 26.iv.15. Most of the figures mentioned come from Eurostat.

The debate on an open door policy

Ted Rall is not my kind of liberal but he recently drew a cartoon for the Los Angeles Times that goes to the heart of the immigration problem. A poor white man sitting before his TV screen sheds a tear for the drowning Syrians and wonders aloud why Europeans do not let in all those refugees; but he calls for his gun when his wife cries 'Mexicans in the garden'.315 This 'not-in-my-backyard' attitude to immigration of so many otherwise generous people may be understandable, but is misguided.

As Peter Sutherland has put it, "locals in destination countries believe that migrants are stealing their jobs, depressing their wages, or exploiting their welfare systems". A widely unionised and protected workforce will indeed complain that enterprising, hungry-for-work entrants unfairly compete with them. It is true that in the short run immigration exerts downward pressure on local wages, especially of the less well prepared. But over time competition forces progress, which can be painful but will in the end be for the good of all concerned. This resistance is on a par with the attitude of trade-unions in Europe when they resist legal changes to allow older people to prolong their working lives: they fear this will reduce jobs for the young. Behind these arguments lurks the fallacy of believing that the total number of jobs is a fixed quantity. Much to the contrary, the greater the number of people in gainful employment, the more jobs are created, both directly by increasing productivity and indirectly by demanding labour inputs from other suppliers.316

On the same lines, the middle classes in Europe and in America complain about their lost status compared with the famed 1% at the top and blame it on globalisation and its concomitant, immigration. But surely accepting immigrants must be seen as a reduction of inequality. It is only human that people should squint up the earnings scale and reject more equality with those below them.317 To quote Peter Sutherland again: "Migration—when it is safe, legal, and voluntary—is the oldest poverty reduction and human development strategy".318

Then there is the pressure on public services, especially schools, health care, and eventually pensions. The concern under this heading has two elements. One is that limitless benefits granted in welfare states are a powerful magnet for immigrants.

315 You can see the cartoon on Rall's blog at http://rall.com/2015/05/13/african-vs-mexicanimmigrants-get-my-gun. 316 Dr. Raúl Hinojosa-Ojeda

(2010) has noted a counter-productive effect in the United States of the refusal to legalise unauthorised immigrants. Paperless workers tend to accept, and employers to pay, lower wages, thus depressing the wage level. Their emoluments increase as soon as they are legalised. "Raising the Floor for American Workers: The Economic Benefits of Comprehensive Immigration Reform," Center for American Progress. Available online at: https://www.americanprogress.org/issues/immigration/report/2010/01/07/7187/raising-thefloor-for-american-workers/. 317 As regards the United States of America, from 1970 to 2013, median real income per head has been growing in the US by 1.70% one year with another, which puts inequality figures in perspective. (Bureau of the Census). 318 Peter Sutherland and William Lacy Swing (2014): "Migration on the Move", Project Syndicate https://www.project-syndicate.org/commentary, March 17, 2014.

The other is that entitlements for immigrants increase the cost of public services for existing taxpayers. I have indeed witnessed abuses of the free National Health Services in the United Kingdom and in Spain by immigrants with a short history of Social Security contributions, who then bring in their families for expensive operations. But immigrants, as I said, tend to be young, healthy, and eager for work. If they are legal, the present value of their taxes and contributions will cover their social costs, except for schooling—but this can be seen as a beneficial investment for the host country in the long term. The positive effect is even greater when one notes the importance of young workers for alleviating the finances of noncontributory pensions. Also, this cost benefit analysis is not complete unless one takes into account the more than off-setting contribution of immigrants to the national product.319

Finally there is the question of the cultural shock that the arrival of large numbers of immigrants from societies with different traditions, habits and religions may cause to the countries accepting them. Under this heading we can include a number of points. One is the treatment of women by immigrants from different cultures, not only the more conservative Muslims but also the less cultured among Latin-Americans: in fact, in Spain much of the violence visited on women and children comes from immigrant men. However, if one looks carefully, sexist violence is not the monopoly of migrants from alien cultures. In Britain much cruelty to women and their children comes from men who are not married to the mothers and who are not the biological fathers of someone else's offspring. The real danger comes from their 'partners', British or immigrant, who father children with one welfare reliant woman after another.320 This kind of behaviour is not limited to immigrant men, be they Muslim or Mexican. Immigrants always face resistance when they arrive in an established society. 321 The crucial point is that they and their offspring should have no excuse not to look for work and have the opportunity to find it.

319 In the United States, the federal budget gets more from income tax paid by immigrants than it spends on Medicaid, Medicare and pensions for the same group, while states and municipalities incur a net loss due to the weight of public school costs. Daniel Griswold (2012): "Immigration and the Welfare State", Cato Journal, 32, 1(Winter), pages 159-174. [Available online at: http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2012/1/cj32n1-11.pdf.] Apart from helping considerably with the pensions burden Griswold mentions different studies in states of the Union, where the supply of goods and services added by immigrants more than outweighs the cost of social services, especially that written by Dixon and Rimmer (2009): "Restriction or Legalization", Cato Trade Policy Analysis, number 40, August 2009. [Available online at: http://www.cato.org/publications/trade-policy-analysis/restriction-or-legalization-measuringeconomic-benefits-immigration-reform.] 320 See James Bartholomew (2004, 2013): Chapter 6, The Welfare State We're In. Biteback Publishing, London. 321 Friedman was lucky that he suffered no discrimination as a Jew except once in his life, in his failed

appointment for tenure at the University of Wisconsin in 1941, expressed by the chairman of the Economics Department, a gentleman who later repented his attitude. However, in an interview after being awarded the Nobel Prize he did remember his surprise on hearing his Jewish colleagues at Columbia and more generally New York students complain about anti-Semitic attitudes. (Academy of Achievement, "Milton Friedman, Ph.D." accessed 18 December 2015). This is the fate of all immigrant stock: yesterday the Jews, today the Muslims.

More recently, there is the drift of some young Muslims of both sexes towards radical positions and even participation in terrorist groups.322 In the opinion of many, this is the result of the failure of Islamists fully to integrate in the societies that so openly accepted them: they resist Western values of respect for the ways of others and separation of State and Church. This stress on religion does not go deep enough. Education systems are blamed for failing to teach the young these values. One should rather say that on the whole public education does not teach, full stop. Public education simply does not deliver the service expected of it. Two simple indicators: in Europe and America from 15 to 20 per cent of adults are functionally illiterate, let alone proficient in arithmetic; and many families are led to changing their domicile to place their children in the catching area of decent schooling. Public housing has created ghettoes of destitution and lawlessness in France, Germany and even Britain. These young drifters and their families often lead effortless lives under the dispensation of the welfare state. If school had to be paid for; if health care were mainly based on private insurance; if the young did not automatically have access to unemployment benefits; and if the labour market were truly de-regulated: then immigrants and their families would have to base their lives on steady work and personal effort, free of the incentive to sponge off the state.

There have been many attempts in Europe to make public assistance compatible with poverty reduction, less unemployment, greater self-reliance, and renewed family life. Free public schooling is being extended to include nursery at one end and apprenticeship at the other. Austria makes pensions portable from one job to another and adds whatever the individual has not spent in unemployment benefits to their future pension entitlements. Denmark has made the labour market fully flexible while having government actively retrain the unemployed. In the United Kingdom there are fewer limits to dismissal than is the norm in the EU, but the state demands firms pay a 'living wage' over and above the minimum wage. And there are small charges for public medical services in France, Germany and other EU nations. These minimal changes are clearly not enough. As Michael D. Tanner has written (2003), "it is time to end Welfare and replace it with an invigorated system of private charity".323

Milton and Rose Friedman In their charming book Two Lucky People (1998) the Friedmans told us how they and their families came to be Americans. Rose was born in the Jewish part of what today is a Ukrainian village. Preceded by her father, the whole family repaired to

322 The horror of the terrorist crimes at the beginning of the present century has made us forget that terrorism is an old and repeated occurrence in Western societies. We need only remember Joseph Conrad's novels The Secret Agent (1907) and Under Western Eyes (1911). Terrorism must be prevented and fought decisively but we must not forget it is a price we pay for liberty. 323 Michael D. Tanner, The Poverty of Welfare: Helping Others in Civil Society,(2003), Preface. Tanner examines in that book the 1996 Personal Responsibility and Work Opportunity Reconciliation Act signed into law by President Clinton. He shows that the Act had good consequences critics at the time of its framing did not expect, such as the shrinking of welfare rolls and the reduction of poverty, especially for children. But he laments that one cause of poverty,

out-of-wedlock childbirth, has not abated, and that government assistance is still tying down many recipients to a life of dependence. (chapter 4)

Portland, Oregon. She moved east to study at the University of Chicago, where she came to share a desk with Milton at Jacob Viner's economics course. Milton was born in Brooklyn but his parents came from the Jewish quarter of Berehovo in today's Ukraine. The Friedmans, when they arrived in America got no help from the state. They were helped by relatives and made their way up by hard work. Milton's parents met and married in New York. His mother worked in a cloth-making sweatshop and his father tried his hand at business. Young Rose and Milton both worked in their free time.

Children of immigrants, and in Rose's case an immigrant herself, we are rather typical of our contemporaries, though less so of our successors, as the melting pot has increasingly been replaced by multiculturalism, and rugged individualism by a welfare state. (Two Lucky People, Preface)

Milton wrote the following words of another immigrant, Arthur F. Burns, but they apply equally to the Friedmans: "What a testament to the benefits that a policy of free immigration has conferred on the United States!" (page 31)

Friedman himself pointed out later in life how big an obstacle a policy of free immigration was to the welfare state. David Cameron, the British Prime Minister, wants to exclude EU migrants from all entitlements for four years after their arrival. He thus falls into the trap of tarring all immigrants with the brush of exploiters of the welfare system. I would put it another way. Since immigration seems to be incompatible with the welfare state, a flood of immigrants, be they political, economic, or stowaways, could be a blessing in disguise: it may have the effect of proving what we suspect: that the welfare state is unsustainable.

Karl Marx, the Perennial Prophet

March 7, 2016

Shall we never be rid of Karl Marx? It is not fashionable any more to be a full blown Marxist, but writers, politicians, and popularisers find that showing their sympathy or respect for Marx is a way to proclaim that their heart is on the left side. It does not matter if historians have argued that his analysis of capitalism does not fit the facts and that his predictions of the inevitable evolution of society have been falsified. His theories are re-interpreted, reformulated, and transmogrified, until made immune to counterexample and refutation. The first reason for his perennial presence that springs to mind is that he was a powerful thinker and a masterly writer—when he set aside his Hegelian prose. A deeper reason was that he instilled hope in people dismayed by the disorders of the time by casting socialism into the role of a lay religion, complete with dogmas, heresies, and excommunications. A third reason, which is now seducing some French egalitarians, is the quest to discover the mechanism that will make capitalism self-destruct. But even for those who would not call themselves Marxist, he proposed a materialist methodology that many see as an especially fruitful way of studying society.

A prickly fellow

Political philosophy depends much more on the personality and biography of its framers than is usually thought. Plato's aristocratic origins and his resentment at the execution of his beloved master Socrates can be read in palimpsest in The Republic or The Laws. The gentle character and rational disposition of Thomas Aquinas made for the inclusiveness of the Summas. Machiavelli was a discarded and over-intelligent civil servant of his beloved Florence, yearning for an Italy free of the French and Spanish "barbarians". Hobbes attributed his timidity and insecurity to his early upbringing and clearly wrote for times of civil discord. And Hegel was very much the professor at a Prussian State University, marked by the unfolding of history in Napoleonic times.

Karl Marx (1818-1883), as many commentators have noticed, showed the traits of an Old Testament prophet, in that he proposed a doctrine of salvation and of the end of history akin to that of the great religions of the Book and fundamentally different from the rationalism of the Enlightenment, especially the Scottish Enlightenment.324 He led the hazardous life of a conspirator. Endlessly persecuted by the Prussian police, he was repeatedly forced to change his abode on the Continent, only to find some peace as a refugee in Victorian London, where he and his fellow revolutionaries were totally ignored in a supremely confident and prosperous society.

Marx had the good luck to be befriended by Friedrich Engels (1820-1895). After they met in Paris in 1844 they welded an association which would last for the rest of their lives and beyond. The development of Marxism, indeed of socialism, would

324 Kolakowski (1978) called this the soteriology (the doctrine of salvation) and eschatology (the doctrine of judgment at the end of time) of Marxist theology.

have been very different if these two friends had not worked together untiringly and in full harmony for so many years. Not only did they co-author books and articles; not only did they jointly launch and organise associations to promote the cause of communism; they also conspired and fought against what they saw as their misguided rivals in working class politics. Marx was the more spiteful (remember "The bourgeoisie will pay for my boils", which he suffered after long sitting hours at the British Museum). Engels, on the other hand, was a sunny character full of curiosity and generosity. He even financed Marx and his family during their spells of poverty and adopted the boy believed to have been fathered by Marx with the family's housekeeper, Helen Demuth. All in all, he was the more likeable figure. Still, they were both full of scorn for their political rivals and merciless in their battles against them. Their vitriolic attacks on Feuerbach, Proudhon, Bauer, Lasalle, Dühring are extreme examples of the well-known savagery of political battles among exiles. The ultimate explanation for their uncivilized behaviour was their unshakeable belief that they were in full possession of the truth: their hard-headed socialism was "scientific"; their rivals in the workers' movement, misguided or illintentioned; the cruelty of their hoped for revolution, merely "the birth-pangs of history"; all was justified in the march towards a human and happy society.

The Communist Manifesto

The most read of Marx and Engel's writings is The Communist Manifesto. They were asked to compose it by members of a London secret communist society, "The League of the Just". Engels had convinced them to merge with the "Communist Corresponding Society" set up by Marx and himself in Germany. The Manifesto was presented to the members in 1847 and published in 1848, just before France erupted in a revolution that toppled the monarchy and turned it into a republic. The flames then spread over whole of Europe and for three years it seemed that a new democratic era was born. Another attempt at socialist revolution, The Paris Commune, followed in 1871. The next revolutions did not come until after the havoc of World War I.

Though the Manifesto was written by Marx, he relied greatly on Engels' book The Condition of the Working Class in England published in 1845, a scathing denunciation of life in Manchester factories, presented as an anticipation of what the whole capitalist system was to become. Nearer to what was the final text of the Manifesto there are two drafts of Engels' in 1847 that served as a starting point for Marx's composition. One was "A Communist Confession of Faith"325 and the second has been called "Principles of Communism"326. The "Principles" text clearly

325 June, 9, 1847. Published in Gründesdokumente des Bundes der Kommunisten. Accessed January 2016 at http://www.marxist.org Engels wrote to Marx: "Think over the Confession of Faith a bit. I believe we had better drop the catechism form and call the thing Communist Manifesto. As more or less history has to be related in it, the form it has been in hitherto quite unsuitable. I am bringing what I have done here with me. It is in simple narrative form but miserably worded, in fearful haste." As published of all places in the Chinese edition of Marx/Engels Selected Works, Peking, 1977. 326 October-November 1847. Published in 1914 by Eduard Bernstein. Accessed January 2016 at http://www.marxist.org.

shows how aligned in thought the two friends were. It is right after all to call the Manifesto a joint work.

A comparison with Engels' sketchy drafts shows Marx's great rhetorical gifts when he shed his crypto-Hegelian garb. The first phrase of the pamphlet is justly famous:

A spectre haunts Europe—the spectre of Communism. All the powers of old Europe have entered into a holy alliance to exorcise this spectre: Pope and Czar, Metternich and Guizot, French Radicals and German police spies.

The claim was exaggerated but it instilled confidence into the dispersed groups who called themselves communist or socialist in that their aim was the abolition of private property.

The Manifesto was divided into five parts. The first is a short introduction. Then came chapter I, titled "Bourgeois and Proletarians", a panegyric of the productive powers of the capitalist economy, you will be surprised to hear, but really the eulogy in the funeral service of capitalism. Chapter II was a call for the communist elite to open the eyes of untaught proletarians to the exploitation they suffered under capitalism, and eventually to lead them to join the ranks of the revolutionists. Chapter III damned reactionary and utopian socialism with faint praise, as they would luckily be superseded by their own scientific brand. The last chapter proclaimed the readiness of the communists to back workers' parties across Europe, as long as they accepted the aim of getting rid of private property "by the forcible overthrow of the whole social order".

The starting point is proclaimed in chapter I: "The history of all hitherto existing societies is the history of class struggle". Throughout history, human societies were divided in a variety of social classes but modern bourgeois society "has simplified class antagonisms [...]. Society as a whole [is] dividing itself increasingly into two great hostile camps, into two great classes, directly facing each other: the Bourgeoisie and the Proletariat." The essential engine of transformation is "a series of revolutions in technology and the modes of production and exchange". Here we are being introduced to a fundamental element of Marxian sociology, 'historical materialism', that social change is driven by the modes of economic production embodying new technologies. This idea, especially as developed in Das Kapital327 (1867) has caught the attention of historians ever since. It was a call not to be content with mere political history. This is not to say that there was no economic history before that book—for example, Adam Smith's An Inquiry into the Nature and Causes of the Wealth of Nations—but nobody up to then had presented the modes of production and exchange as the moving forces of history. In the case of modern capitalism, Marx was saying, the transformation of technical and commercial conditions had led to an unprecedented upheaval in society. The idea of "revolution" has become commonplace to describe profound changes in all spheres of society, when up to the writings of Marx the term had been limited to politics, to the English or French Revolutions of the 17th and 18th centuries. Now

327 Available online at the Library of Economics and Liberty, http://www.econlib.org/library/YPDBooks/Marx/mrxCpA.html.

Marx applied it to the changes wrought in society by the bourgeois mode of production and attributed the evolution of history to the working out of necessary economic laws—a highly controversial idea.

Then came one of those paradoxical turns of phrase that must have shocked many of his fellow revolutionists.

The bourgeoisie has played in history an eminently revolutionary role. [...] The bourgeoisie cannot exist without constantly revolutionising the instruments of production, and thereby the relations of production, and with them the whole relations of society.

Thus, the capitalist class, he said, has torn through the fabric of traditional societies and is now in the process of creating a globalised economy of huge productive force.

The bourgeoisie, during its class rule of scarce one hundred years, has created more massive and more colossal productive forces than have all preceding together. Subjection of Nature's forces to man, the extensive use of machinery, the application of chemistry to industry and manufacture, steam-navigation, railways, electric telegraphs, clearing of whole continents for cultivation, canalisation of rivers, whole populations conjured out of the ground—what earlier century had even a presentiment that such productive forces slumbered in the womb of social labour?

It's all there: even the powerful sexual metaphor.

Then came what made the Communist Manifesto such a stirring piece of political propaganda: its description of the moving mechanism of capitalist society and the historical prediction based on this analysis.

For Marx, capitalism unleashed powers that took on an independent life and turned against the very system of private property on which it was based. Over the previous thirty years, the history of industry and commerce had been a succession of crises that "progressively threaten the existence of bourgeois society". Epidemics of over-production repeatedly struck, when it seemed that "society has too much civilization,

too much food, too much industry, too much trade", so that existing products and resources for future production were destroyed.

The reaction of the bourgeoisie was two-fold: the said temporary destruction of productive forces; and the extension and deepening of the exploitation of their markets. On the one hand the capitalist mode of production was extended to more primitive peoples and societies by the creation of colonies and the extension of trade. On the other hand, capitalism turned workers into proletarians.

Competition and the division of labour destroyed the societies of old. Slowly all workers amalgamated into a single downtrodden class. The condition of small shopkeepers, artisans, farmers, and wage earners slowly deteriorated into

proletarian conditions. The very gathering of hands in huge factories was a step in the agglomeration of the subject classes into one body.

Far from prospering with the progress of industry, the modern worker falls ever further down, underneath even of the standard of his own class. The worker becomes a pauper.

When these proletarians unite they will become a force for revolution. They are helped by "the bourgeois ideologues who have raised themselves to the theoretical comprehension of the general movement of history"—a highfalutin' way of explaining how it happened that a doctor of philosophy and a factory owner presumed to tell the poor downtrodden masses how they should organise their lives and action. Marx ended the chapter as the supremely effective deviser of slogans that he was: "what the bourgeoisie mainly produces is its own gravediggers."

As I say, the Manifesto went on to disparage other writings on socialism and to offer full collaboration to already existing workers' parties in England, the United States, France, Switzerland, and above all Germany, so that they all started to think of the coming downfall of capitalism. Do I exaggerate when I extol Marx's gift for the telling phrase? He ended with a final call to aim at a communist revolution: "proletarians risk to lose nothing but their chains; they have a world to gain. Proletarians of all lands, unite".

The hungry forties

Engels's The Condition of the Working Class in England (1845) and the Communist Manifesto (1848) are very much the books of a particular period, the twenty years from 1835 to 1855, usually known as the 'hungry forties'. As explained by George R. Boyer (1998), those years were especially hard for textile workers, especially in and around Manchester. Their hardship multiplied during the crises of 1837, 1842 and 1848, and during the 'cotton famine' of the American Civil War, when textile labourers bore with fortitude the effects of the Northern blockade on Southern maritime exports. However, the growing prosperity of the English labourers in the 1860s put paid to socialism in the British Isles for years to come, if not for ever.

It is easy to see how Engels and Marx were led astray by the political and social conditions of middle and Northern England during the 1830s and 40s. The reward of labour, the conditions of work in factories, and the exploitation of women and children in the workshops of England shocked not only Engels but also many humane observers of factory work and industrial cities. Indeed, Parliament was led to use the law to forbid the worst abuses, after compiling detailed reports on these ills—the Blue Books that Marx so effectively used in his later writings, especially Das Kapital (1873).328 These cruel conditions led large numbers of working men to

328 See in Capital Section 3, "The Production of Absolute Surplus Value". (Available online at http://www.econlib.org/library/YPDBooks/Marx/mrxCpA16.html.) This section of the first book of Capital must be read to see how hard Marx worked at getting his facts right, how effective his

stage general strikes, and to take part in the Chartist movement demanding a more democratic Constitution, so that it seemed Revolution was nigh.

Friedrich Hayek edited in 1963 a collection of essays under the title of Capitalism and the Historians which helped overturn the widespread view, taken from Marx and Engels, that the modern productive society was built on the accumulation of capital forcibly extracted from a downtrodden working class by heartless capitalists. Hayek's collection showed that the evolving conditions of the working classes in England were not based on the worsening of living standards under industry compared with life under subsistence agriculture. During the Victorian era, pace Engels and Dickens, the people's living standards clearly bettered. Later economic research has shown that the 1830s did see some worsening, especially due to the deplorable hygienic conditions in the great factory towns: the incidence of cholera and tuberculosis made for a shortening of life expectations after the hopeful of the 1820s.329

Boyer usefully summarises the data. There seems to be little doubt that in the hungry forties there was a fall in real wages for all workers, and especially so for workers in the cotton industry of South Lancashire. Especially hard hit were manual cotton workers who weaved at home and faced the competition of mechanical production in factories. In Manchester, where Engels was in charge of his family's factory from 1842 to 1844, cotton workers as a whole suffered a very hard ten years after 1832, when their real wages declined by 15 per cent. To this must be added the effect of high rates of unemployment except for the better years of 1845-46; at the low points of the downturn before and after this peak in prosperity, unemployment among the mill workers was as high as 15-20 percent. (Boyer, pages 165-6) To this was added the discontent caused by the New Poor Law, which forced temporarily destitute families to demand relief at "well-ordered Poor Houses", where inmates were separated by sex and age.

Historians have spent much effort to pair these undoubtedly patchy economic data with biological indicators of welfare. There is much dispute about life expectancy, which seems to have declined from 40.8 years in 1829-33 to 39.5 in 1849-53. Another measure used is the height of military recruits, which "increased from the mid-18th century until 1840, declined during the 1840s, and then rose again after 1850". (Boyer, page 167)

But the Victorian boom of the 1850s and 60s showed Marx and Engels's predictions to have been wrong, concludes Boyer. GDP growth per man hour from 1856 to 1873 grew annually by 1.3 percent. Wages clearly increased; Boyer recalls a study showing that real wages grew by 38 per cent from 1851 to 1881. Neither

sarcasm was in debate, how genuine his indignation at the uses of manufacturers, and how excessive the hopes he lay on the Chartist movement. 329 Before Engels published his book, Edwin Chadwick, the great Utilitarian public servant, had written a critical Report on the Sanitary Condition of the Labouring Population of Great Britain (1842). It was that self-same Chadwick who connected the contaminated water supply of London with the prevalence of cholera. The discovery of bacteria by Louis Pasteur was still in the far future, but the causal connection was made by statistical induction. See Schwartz (1966).

did cyclical downturns become more severe in the second half of the century. Unions changed their character to trade associations. Legislation increasingly favoured working class interests, starting with the repeal of the Corn Laws and other free-trade measures to make food cheaper.

Alienation and the New Man

The Communist Manifesto is an excellent introduction to Marx's great work on Capital but three fundamental elements needed deeper development: alienation and the new man; historical materialism; and the economic engine driving the capitalist system.

In 1846, before writing the Manifesto, Marx and Engels finished book that they were never able to publish and which was partly lost: The German Ideology. There they laid down the philosophical foundations of their system, to which, as Leszek Kolakowski (2005, chapter VIII) rightly notes, Marx faithfully stuck during his whole life. Humanity was the sorcerer's apprentice. Men had created money and commodities, but these took on an independent life and lorded over them. Man became "alienated", so that his creations made him incapable of the all-round development of his aptitudes and talents. The cause of such alienation was the division of labour driven by technology and competition, portrayed by Charlie Chaplin in his caricature of "Fordism", Modern Times—as if competition were not a form of social cooperation. The degradation of humanity would proceed relentlessly under capitalism, until the yoke of private property was forcibly lifted and communism emerged. In a communist society nobody would have

[...] one exclusive sphere of activity but each can become accomplished in any branch he wishes, society regulates the general production and thus makes it possible for me to do one thing today and another tomorrow, to hunt in the morning, fish in the afternoon, rear cattle in the evening, criticize after dinner, just as I have in mind, without ever becoming hunter, fisherman, shepherd or critic.

One does not know whether to laugh or cry at such nonsense. This passage is a most telling sign of how Marx and Engels conceived the economy. The power of the productive system was such that, once private property was abolished and the state had disappeared, the machinery of production could be left to work of its own accord, like a sort of perpetuum mobile. There was no need to decide what to produce. Scarcity would have disappeared and at the touch of a button all wanted goods and services would appear. And every man, woman and child would live like rentiers!

The materialist interpretation of history

Marx stood Hegel's philosophy on its head by making material conditions rather than the Idea the motor of history. "It is not consciousness that determines life but life that determines consciousness." It is the non-intellectual part of society that governs thought. Whatever Kolakowski may say, history for Marx is governed by laws that link social evolution with modes of production, as he would expound in

Das Kapital. This does not leave individual people and their ideas without any role in history. Though most peoples' ideas are distorted by the interests of the social class to which they belong but, as we saw in the Manifesto, some bourgeois thinkers heave themselves over their circumstances and can help the revolution along.330

As Karl Popper showed in The Poverty of Historicism (1944-5, 1957) philosophies of history that seek laws of historical evolution are untenable. Marx did accept that men's ideas had a return influence on society.331 There is little doubt, however, that he also believed he could prophesy the unavoidable downfall of capitalism and the inevitable coming of socialism. Such certainties are very consoling but lead to dangerous ethical conclusions, namely to totalitarian excuses for imposing suffering on the present generation in the full expectation of a glorious future for the whole of mankind.332

The true nature of capitalism: appearance and reality

We saw when commenting on the Manifesto that Marx and Engels despised the current forms of socialist thought of their time because they were not "scientific". The science bit in their social philosophy was a combination of Hegelian determinism and classical political economy. The relentless destruction of capitalism and the march towards communism could be prophesied because of a mechanism in society that could be understood with a modified version of classical economics.

Marx only published the first volume of Das Kapital in his lifetime. Engels put together volumes II and III after his friend's death. Marx studied David Ricardo and Adam Smith with great care. From Ricardo he took the model of the functioning of a capitalist economy, where prices could be explained by the relative cost of producing the goods and services people exchanged. The profits of entrepreneurs came from the difference between costs of production, mainly wages, and the prices with a margin obtained by entrepreneurs. But this analysis of the economy did not satisfy Marx because it appeared to be just and fair: prices and profits arose from equal exchange. Was it right that the system should treat labour as a mere commodity? If labour created value, as Ricardo appeared to say, why should anybody profit from the effort of labourers? Marx's solution was a very Hegelian one: beneath the fair appearance of the market there lurked exploitation. Prices and profits were the appearance; value and exploitation the underlying reality. No matter if the rate of profit was one for the whole economy and the rate of exploitation varied among firms depending on the labour intensity of their

330 Some commentators jokingly call Marx's philosophy of history an "escalator theory": the movement of history takes us up effortlessly towards communism but we can always help by climbing steps. 331 Kolakowski (2005), page 130, says: "Clearly Marx cannot be saddled with the view that all history is the effect of historical laws, that it makes no difference what people think of their lives, and that the creations of thought are merely foam on the surface of history [...]." 332 Popper was especially discerning in his treatment of Marx in The Open Society (1945, 1957).

productive techniques. This would be explained in volume III.333 Neither Ricardo nor Marx analysed demand, the ultimate reason for the productive efforts of humanity.

Capitalism in History

From Adam Smith Marx took the secular fall of the rate of profit, which traced the future path of capitalism, as we shall see. Das Kapital volume I is principally a work of history: of how and why humanity has evolved along the times and where this march is leading us all. To start with, the Marxian theory of economic growth does not fit the facts of the industrialisation of the West. For him, the "primitive accumulation of capital" extracted from agricultural serfs and slaving workers was a necessary condition of the industrial revolution. Of course there was a great deal of fixed capital invested in coal mines and canals, but in fact it all started with public finance and applied science, the new modes of mass production being set up away from limiting city guilds. That Marxian misrepresentation had grave real consequences, when in the Soviet Union it was applied by Stalin's rush for growth on the backs of ordinary people, by positing that industrialisation had to start with heavy industry on the back of forced agricultural labour. The path to development is not forcible expropriation but new ideas freely sought and applied and new institutions to protect the property of the new productive classes.334

At the heart of Das Kapital is the trend of the evolution of capitalism towards monopoly brought about by cyclical recessions. The tendency of the rate of profits to fall secularly Marx took from Adam Smith. To restore the rate of profits to the accustomed level, capitalists were forced to increase their investments. Since, as investment intensified, wages would tend to increase, there was a need to keep a sizable number in a "reserve army of the unemployed" and substitute even more capital for labour. This made for periodic over-investment and under-consumption, destructive crises, mergers and take-overs. Wages would become more and more depressed and small-firm owners demoted into the working class. Miserable workers became proletarians when they realised the alienation of their nature caused by the division of labour. The proletariat would be forced or led to bring

333 Das Marx Problem, that value and exploitation do not coincide with price and profit, has exercised many later socialists, such as Professors Desai and Morishima. Values and rates of exploitation cannot be observed. The value method of calculation cannot be used to explain actual prices (or as Desai puts it, page 65, "Marx's theory is a tool for the critical study of capitalism, not an operational tool for socialist planning"). Desai and Morishima take the escape that in the aggregate total value in a capitalist economy is equal to total prices, and total surplus value is equal to total profits—but not for each and every commodity. As Luis A. Rojo (1984) put it, what Marx wanted to show with the identity of total surplus value and total profits is that "a capitalist economy is like a great corporation set up to exploit wage labour, where each capitalist receives the part of profits corresponding to his share of total capital invested". Where is competition among capitalists, then? All this is a purely theological excogitation about the original sin of capitalism, of no practical or philosophical interest. 334 See Deirdre McCloskey's Bourgeois Virtues, for example, for a very un-Marxian view of capitalism.

down the capitalist system with a revolution. So strikes "the last hour of capitalist private property. And the expropriators are expropriated."335

Events have not unfolded the Marxian way.336 Increases in capital will reduce the marginal productivity of machinery and necessarily increase the productivity and the reward of labour. So it has been: the deepening of capital investment has led to a high and secular growth in wages. Also, Marx took no account of human capital, the investment in education and on the work training in capitalist societies, though Adam Smith had broached the question.337 Indeed, when Marxist writers of today discuss the distribution of income between capital and labour they often forget that the most important capital of a nation is not machinery but that embodied in people and institutions.338

Marx Redux: Why?

The histories of both capitalism and socialism have been quite different from what Marx and Engels predicted. The attempt to give birth to the New Man has resulted in unworkable utopias drowned in seas of blood: such is the experience of Stalin's Soviet Union, of Mao's China, of Pol Pot's Cambodia and Castro's Cuba. While the individualist societies damned by our two socialist dreamers have multiplied the productive capacities of mankind, thanks to the division of labour and competition, an increasing number of people on this earth can enjoy a Standard of living that includes ample time free from the drudgery of work.

Historical materialism still attracts many social scientists. Economic historians see Marx as the founder of their lore, though they forget that Adam Smith and the whole Scottish Enlightenment preceded him. It is true that Marx used statistics and historical evidence as few had done before. But if I ask myself the

question whether the economic interpretation of history should be preferred to wider, more encompassing points of view16 my answer would be in the negative. I will leave the analysis of such reductionism for another day, when I will call on the help of Deirdre McCloskey and Niall Ferguson.

335 Historical necessity of this sort is again seducing today's critics of capitalism. Thus Piketty, in his revealingly titled Capital in the 21st Century(2015), posits a tendency of the return to capital growing more quickly than the return to labour, until inequality becomes so extreme that the capitalist order will implode, unless private property is taxed out of existence—the same kind of idea as that of Marx. 336 Anybody wanting to examine Marx' and Engels's view of capitalism, its past and its future should not fail to see the two volumes titled The Cambridge History of Capitalism, edited by Larry Neal and Jeffrey G. Williamson (2014, Cambridge University Press.) 337 In chapter I.x of the An Inquiry into the Nature and Causes of the Wealth of Nations Smith studied the causes of differences in wages among employments he analysed the cases of the disagreeableness of the work, the investment needed to learn it, the trust in those who perform it, the likelihood of unemployment, and the probability of success—what we would call differences in human capital. 338 In his monumental study of inequality in the return to capital and labour (2014) Piketty only mentioned human capital once in a single footnote, thus forgetting its importance among the assets of the working class.

The principal reason why people with democratic convictions still pay attention to Marx is that he was that arch-critic of social inequality. Inspired by him, some would impose an equality of results, whereby individuals would not have very different assets and incomes, whatever their ability, hard work, or capacity to answer the demands of the rest of society. Social Democrats would swear by an equality of opportunity fostered by the state, so that we should all compete on a level playing field. Only a small number of thinkers and politicians have the courage to defend free competition and equality before the law, and call Marxism and socialism by their name: the politics of envy.

The Erosion of Political Economy and the Retreat from Freedom

April 4, 2016

Classical liberalism is being attacked on many fronts. Its individualism is seen as fundamentally alien to the social nature of man. Differences of income and wealth are said to show that equality before the law and other formal liberties are pure sham. The natural love of one's country is confused with a chauvinistic rejection of foreign ways. No limits are recognized to the democratic vote. And even basic, economic freedom, the domain where the beneficial effects of liberty can be more readily felt, is treated with suspicion or downright rejected.

More fundamentally, classical liberalism is presented as a narrow economic ideology of doubtful scientific validity, lacking political and philosophical depth. This travesty is symbolized by the moniker of 'neo-liberalism' widely used to disparage the party of freedom.339 It may turn out that in the end, 'neo-liberal' comes to be accepted as the rightful name of liberals of a more coherent kind than the American variety.340 Indeed, William Coleman has flaunted the banner of 'neoliberalism' to signify that market economics is the mainstay of any liberalism worth its salt. Though I might be ready to be called

'neo-liberal' if that shocks lukewarm social-liberals out of their dogmatic slumber, I prefer the name of 'classical liberal' because it recalls the illustrious pedigree and wide compass of our philosophy.

Reducing classical liberalism to economics, especially of the emasculated kind cultivated by the technicians of the economics profession would make the task of those critics too easy. One need only attend to the list of 'market failures' which today's economists lengthen day by day. Let me name only a few of these. At the top of the roll of infamy is money and finance, whose recent breakdown is attributed to unbridled laissez-faire and uncontrolled greed, though it was principally due to mismanagement by central banks and regulators, who now impudently demand ever larger powers. Next in line is climate change—formerly global warming—for whose catastrophic consequences the free market has no remedy, so they can only be avoided by a world-wide political agreement to prohibit the use of fossil fuels and to subsidize clean energy. Then there is the idea that competition left to its own devices will result in widespread oligopoly, demanding the untiring vigilance of anti-trust authorities. The mantra of the day is that the rich are getting richer and the poor poorer, a trend only to be remedied by

339 The appellation of 'neo-liberal' is currently used to asperse the Mont Pelerin Society, founded by Friedrich Hayek in 1947 to reinstate individual and political freedom as a leading principle of human society. Thus, Daniel Steadman Jones (Princeton, 2014) in his Masters of the Universe: Hayek, Friedman and the Birth of Neoliberal Politics, holds it that a sensible return to free markets was started by politicians of the left like Jimmy Carter in the United States or James Callaghan in the United Kingdom before Margaret Thatcher and Ronald Reagan, who put capitalism at the centre of their social philosophy and so opened the floodgates to the crisis of fear and greed in which the world finds itself. Daniel Mirowski and Dieter Plehwe, in their Road from Mont Pelerin. The making of the Neoliberal Thought Collective(Harvard, 2009) write an even more biased book where they present neoliberalism as a secret conspiracy to impose capitalism on the world, along the lines of the Templars or the French Free Masons.
340 Statement of Aims available online at: https://www.montpelerin.org/statement-of-aims/.

extortionate taxation. Finally, it is taken as evident that the free market is incapable of delivering indispensable social services, from health and pensions to education and full employment. It sometimes seems that the professional economists who sedulously devise remedies for these flaws are the principal source of skepticism regarding the efficiency and fairness of capitalism.

I have never avoided a close examination of the functioning of markets and democracies. After all, the motto of my alma mater, the London School of Economics, is Rerum cognoscere causas, 'Discover causes'. I have never proposed that malfunctions of the economy should not be scrutinized, abuses never corrected, communal needs not addressed. We do not live in the best of all possible worlds. What I do say is that the reaction to these possible defects should not bear an implicit condemnation of economic freedom and an immediate call for some authority 'to do something about it'. Often such heedless activism makes things worse, when there always is mileage to be got from free competition and institutional evolution.

Indeed, economic analysis is woefully shortsighted when not grounded on a solid basis of liberal political philosophy. And conversely, political philosophy will be buffeted by the currents and crosswinds of mere fashion if it is not kept on course by the keel of economics. I therefore propose that we revive political economy, as a joint effort of liberal philosophy and economic research to rescue classical liberalism from its present parlous state. Political economy takes into account both the regularities discovered and policies proposed in the narrower field of economics and the teachings of political philosophy when considering

the wider consequences for society, present and future, of such discoveries and proposals. Political economy as a joint effort of political and social philosophy with economics should be the outworks, so to speak, of the citadel of freedom.

The founding of the Mont Pelerin Society

The question immediately poses itself how it is that during the last century and a half the economics profession appears to have progressively given up the philosophy of freedom that was its hallmark during the classical period. During World War II Friedrich Hayek had published The Road to Serfdom (1944), a clarion call to warn the public of the danger posed by collectivist thought from the inside of the Allied nations ostensibly fighting for freedom. Countering the slide into collectivism and the attrition of liberalism became a paramount preoccupation of his, so that in 1947 he organized a gathering of a group of economists, historians, philosophers and other students of political affairs in the Swiss village of Mont Pelerin. Those pilgrims of liberty concluded their meeting by founding a society named after the village where they had met. The Official Statement of Aims3 of this Mont Pelerin Society gives an indication of the breadth of their intent. There was a point the original pilgrims of the MPS did not need to make in their Statement: they took it as given that the free market was best. Instead they concentrated on other points where the liberal philosophy was in need of repair. The Statement began with the need to analyze and explain the crisis of the time by bringing home "its essential moral and economic origins"—note the 'moral'. They went on to demand

a redefinition of the functions of the state in a liberal order, including the establishment of minimum living standards "not inimical to initiative and the functioning of the market". A question of much importance for them was the repair of the rule of law, badly eroded during the 1930s. They also expressed the need for an international order "conducive to peace and liberty [and...] harmonious international economic relations". However, among those aims I want to underline another one of Hayek's preoccupations reflected in that Statement: the urgency to combat "the misuse of history for the furtherance of creeds hostile to liberty". He thought it important to reverse the growing disinterest of the profession for matters historical, both regarding economic history (the history of man's great escape from hunger, premature death, slavery, and ignorance); and intellectual history (the development of the doctrine of individualism in its economic and political dimensions).341

John Stuart Mill at the watershed

It was around the middle of the 19th century, just when free trade was triumphant, that classical liberalism took a turn in the wrong direction. Though one of the foremost philosophers of liberty and a remarkable contributor to the advance of economics,342John Stuart Mill (1806-1873) was instrumental in the erosion of the liberalism he so much cared for. His view of the place of the individual in society was decidedly paternalistic and elitist. When Mill lamented that the great American Republic was a society of dollar hunters given to breeding dollar hunters, he was not in the spirit of Dr. Johnson attributed saying that "seldom is a man more innocently occupied than he is engaged in making money".

Also, his proposal fundamentally to change the institution of private property was the first step down the primrose path. Mill believed he had made a most important contribution to political economy with his distinction between the laws of production and the laws of distribution. For him, the laws of production were akin to the laws of nature, in that they necessarily governed the actions of men in society: these were

such as the Malthusian law of population, the declining productivity of land, the role of capital in productive activity, or comparative cost in the flows of international trade. But

[i]t is not so with the Distribution of Wealth. That is a matter of human institution solely. The things once there, mankind, individually or collectively, can do with them as they like. They can place them at the disposal of whomsoever they please, and on whatever terms. (Mill, Principles of Political Economy, Book I, Ch. I, par. II.1.2.)

In distribution, society could make its own laws.

341 This had a positive and negative intent: positive was the need for a renewed cultivation of history to understand the progress of prosperity and freedom; negative, the need to criticize the travesties of the past aimed at disparaging capitalism.See for all of these points the Official Statement of Aims of the Mont Pelerin Society. Hartwell (1995), pages 41-2. 342 See an impressive list of Mill's contributions to economic theory in Stigler (1965).

He did not mean that the consequences of new distributional arrangements should not be examined before reforms were made, but that there was no natural limit to new experiments in distribution. He studied, and found fault with, the proposals of the various socialist groups of his time. But nonetheless he proposed deep reforms of the institution of private property. The changes he proposed were based on John Locke's justification of property by labor: one should have a right only to what one had produced with one's work. 343 As no one had a fundamental right to accrue wealth by inheritance or by the occupation of the productive powers of Nature, he wanted to limit what one could inherit and proposed to reform property in land. He also favored cooperatives and the increasing participation of employees in the profits of the firm.

The unraveling of classical political economy

This is but an example of the growing attraction of socialism both for the general public and the politicians. Writers and artists, who rued the legion of dark satanic mills on England's green and pleasant land, also started their war on capitalism at that time. In parallel, nationalism was growing in strength, increasingly used by politicians to harness the free economy to state-creation and expansion.

The erosion of classical liberalism proceeded during the seventy years from 1875 to 1945 (or more precisely, to 1947!). The new phenomenon of industrialization demanded a theoretical effort that the classical economists did not on the whole undertake.344 The positivistic philosophy fostered by the Great Exhibition of 1851 and the later Exhibitions in France, Germany, and America were felt to be superficial or incomplete. The pseudo-scientific hubris of some Neo-Darwinists, who interpreted competition at the individual and racial level as the lording of the strong over the weak, rather than as a form of social cooperation, repelled the friends of humanity. And at the end of the century it became fashionable to contrast the competition of the market, 'red in tooth and claw', with the cooperation of socially harmonious society. Intellectual and political opinion increasingly inclined towards collectivism as the century proceeded. As A.V. Dicey (1905) lamented, an increasingly powerful and interfering administrative state grew in England out of the utilitarian philosophy. Whatever the reasons, by the

343 Though the principle of justifying property by labor has enjoyed wide popularity over the centuries, it is too narrow to explain the observable features of that institution. A better principle is 'finders keepers', especially regarding the property of natural resources, of the gains from speculation and of discoveries and inventions, whose benefits are only remotely connected with labor. The 'finders keepers' principle principally justifies pure entrepreneurial profit. See Israel Kirzner (1989). 344 One great exception was

Nassau William Senior, who, against the grain of the his fellow economists re-interpreted Thomas Robert Malthus's theory of population by limiting the decreasing returns of this model to agriculture and posited increasing returns for industry. His description from personal observation of the growing productivity of water and steam machinery in the textile industry is an early and striking description. (Senior, 1850). Karl Marx also understood the creative powers of capitalism but saw them as catastrophically limited by the institution of private property, the essence of bourgeois society.

turn of the century liberalism had changed its spots and become 'socialliberalism'.345

On the Continent, the productive capacities of capitalism were put at the service of the nation states, new or old. Africa and Southeast Asia were carved up among the colonial powers. Rearmament picked up speed. Bismarck's Social Insurance System of the 1880s spawned imitations around the world. New Zealand had its Pensions Law in 1898, Australia created Old Age Pensions in 1908. In that same year of 1908 Lloyd George made a famous visit to Germany, where he was won over by the Bismarckian social reforms and on his return to England launched the People's Budget of 1909. Spain instituted a welter of social reforms in 1910.346 The United States was not totally free of these nationalistic and welfarist fashions. America picked up large chunks of Mexico and the whole of Cuba, Puerto Rico and the Philippines. And Teddy Roosevelt was nearly successful when he launched the idea of a nanny-State at the 1912 Convention of his newly founded Progressive Party.347

The upheaval of World War I deepened the reaction against classical liberalism. Soviet Communism and Italian Fascism became respectable in many quarters of Europe. In America, Franklin Delano Roosevelt, elected President in 1932, bought back Progressivism and barefacedly called his program "liberal," when it was fundamentally contrary to what had been taught by classical liberals from Adam Smith to Frederic Bastiat.

After WWII the 'miraculous' recovery of West Germany and Italy gave capitalist economics a respite, in contrast with the parlous results of semi-planned Britain and France. The ruination that met the eye when the Berlin wall was pulled down gave free economics another lease of life. But in the 21st c. the tide is again turning against economic liberty. At present private property and laissez-faire are made to carry the burden of proof; markets and corporations are under constant scrutiny; legal means to avoid taxation are considered less than respectable; the size of government has expanded to the point where no more surplus can be extracted from taxpayers, present or future; public action has become discretionary rather than rule-based; and more generally, the belief has spread that the individual is not to be trusted with his own life and decisions.

345 The luminaries of Social Liberalism, as Freeden (2015) calls it, were T.H. Green, L.T. Hobhouse, and J.A. Hobson in England and John Dewey in the United States. When I first arrived in the LSE my tutor K.B. Smellie tried to bring me over to the Hegelian idealism of Green, but Popper was there to keep me on the straight and narrow. 346 Hay (1975) is a useful introduction to the New or Social Liberalism in the practical politics at the turn of the 19th century and the beginning of the 20th. 347 The Platform of the Progressive Party founded by Theodore Roosevelt for the presidential election of 1912 is eloquent evidence of the spreading of this trend to the United States. The whole document bears careful reading but I will only quote the paragraph on social insurance: "The protection of home life against the hazards of sickness, irregular employment and old age thorough the adoption of a system of social insurance adapted for

American use." Theodore Roosevelt lost the election against Woodrow Wilson. Downloaded from www.PBS.org, 08116.

Ideas matter. It is no mere coincidence that the retreat from freedom coincides with the dismal science coming under increasing suspicion.348 A century of social change and theoretical criticism has put economic liberalism on the defensive and has led to the ideological rejection of the economic point of view among droves of well-meaning people. Part of the blame for this demotion must be laid at the door of economists themselves, who have shown growing political and social agnosticism and today see economics as a kit of technical tools and not as a central part of the liberal world-view.349 The economic conception of human nature is considered unrealistic, economic growth is seen as prodigal, any and all inequality denounced as unjust. Clearly, a reformulation of the system of economic freedom, holding out no concessions to the enemies of the market, is urgent. The thesis of this series of essays is that only a return of the tenets of the great classical economists will help undo the damage caused to liberalism by a century of faltering conviction. In my next column, I will explore the continued onslaught against the market economy in the first half of the 20th century, the macro assault beginning with John Maynard Keynes, and the micro with Arthur Pigou.

348 The moniker of the 'dismal science' was coined by Thomas Carlyle in his polemic with J.S. Mill about the bloody repression of Governor Eyre to put down a Negro rebellion in the island of Jamaica: Carlyle resented Mill's participation in the attempt to impeach the Governor and attributed his humanitarian stance to his being a dismal economist. See The Secret History of the Dismal Science. Part I. Economics, Religion and Race in the 19th Century, by David M. Levy and Sandra J. Peart, Library of Economics and Liberty, Jan. 22, 2001. 349 An indication of this attitude is that Joseph Schumpeter called his great history of thought a History of Economic Analysis, that is to say, a history of the discovery of ideologically neutral analytical tools to be used by economists of all persuasions.

Continual Erosion and the "General Equilibrium"

May 2, 2016

In my column of last month, the beginnings of classical liberal political economy were exposed. Were that the end of the onslaught, perhaps the picture today would be very different. Yet the assault continued into the 20th century, where we pick up this month.

Three biased economists

The onslaught against the market economy in the first half of the 20th century was launched on two flanks, micro and macro.350 The micro attack was itself based on the proposition that perfect competition was a necessary condition for markets to work satisfactorily, and that equal distribution was a necessary condition for markets to be just. This led to the conclusion that, since perfect competition was nowhere to be found and just distribution could only be defined by social choice, the free market should not be trusted to maximize welfare. This conclusion was shared both by anti-market 'literary' economists (as Paul Samuelson called them), and by mathematical economists partial to planning.

The macro attack was led by John Maynard Keynes, after the Great Depression had thoroughly undermined confidence in the free market system. Indeed, a few years before he had proclaimed "The End of Laissez Faire" (1926) [emphasis modified]. As was to be expected, in his General Theory of Employment, Money, and Interest (1936) he would propose the theory that modern economies tended to find themselves in the doldrums of unemployment equilibrium, and that the remedy lay in the hands of governments, in their role as saviors of bourgeois civilization.

The two forces, micro and macro, were finally gathered under the banner of the neo-classical synthesis, championed by Samuelson. Thus the last nail was planted into the coffin of classical liberalism... or was it?

To answer this question I now intend to arraign a representative group of three economists who had a hand in the hibernation of economic liberalism in the first half of the 20th century. Of the literary sort I will take on Arthur Pigou and leave aside Joseph Schumpeter for I have written a past column on this seductive antibourgeois socialist.351 Of the mathematical planners I will concentrate my fire on

350 he separation of economics into micro and macro is in fact not sustainable. For this I have the authority of Samuelson, who in his Foundations (1947, 1971) extended his fundamentally microeconomic analysis of consumer behaviour, cost and production, to the study of macroeconomic questions, such as money, welfare, capital theory, the business cycle, and the Keynesian system; he foresaw the development of analytical economics "even to the majestic problems of economic development". He thus mended Keynes's macroeconomic model, built on weak microeconomic foundations, for it lacked a labor market; presented businessmen's decisions as irrational; and described expectations in the investment markets as unpredictable. 351 "The Riddle of Schumpeter," published September 13, 2013, is available online here: http://www.econlib.org/library/Columns/y2013/SchwartzSchumpeter.html.

Oskar Lange, who tried to establish 'market socialism' in Soviet Poland. Finally, I will dare take on Paul Samuelson, the supremely gifted eclectic, the mathematician who helped dress soft liberalism in scientific garb. In my column next month I will play State's Attorney and try to censure their ideas with the help of the luminaries of the great scientific revival of liberalism of the second half of the 20th century.

Arthur Pigou (1877-1950)

Arthur Pigou's The Economics of Welfare352 (1924) is one of the most successful books in political economy and one of the most harmful. Pigou followed in the footsteps of John Stuart Mill, who had been the first to classify market failures as derived from imperfect knowledge, defective market mechanisms and capital indivisibilities. 353 It was logical for Pigou to show that these three kinds of failures resulted in positive and negative 'social' effects and to propose state interventions to correct them. In Part II, chapter VIII of his work he made the crucial distinction between the social net product and the private net product of a nation and proposed diverse public interventions to bring them together.

By the "social net product" is meant the aggregate contribution made to the national dividend; by the "private net product" the contribution (which may be either greater or less than the above) that is capable of being sold and the proceeds added to the earnings of the person responsible for the unit of investment.

Pigou posited the inequality between the social and the private product as the norm. Only public intervention could fill this chasm.

It is evident that, in general, industrialists are interested, not in the social, but only in the private net product of their operations. Clearly, therefore, self-interest will not tend to bring about equality between the values of the marginal social net products of investment in different industries. (Page 151)

Pigou then proceeds to list a number of cases in which private net product falls short of social net product "because incidental services are performed to third parties from which it is technically difficult to exact payment". His examples were, among others, light-houses, private parks in cities, roads and tramways, private forests, smoke abatement, scientific research. Then he listed investments whose private product is larger than the social, such as game feeding on neighbours' lands, nuisance from factories in residential quarters, overcrowding in cities, financing wars abroad or having women work in factories before or after childbirth. He finally mentioned the psychological loss of consumers from seeing others consume better or newer goods than they. For Pigou, almost any production or consumption had a public dimension that needed correction with "bounties and taxes". (Page 170) Pigou nowhere mentioned competition as a possible corrective force to equate social and private net product, in contrast with later economists of the

352 Available online at: http://www.econlib.org/library/NPDBooks/Pigou/pgEW.html. 353 Mill was inclined toward the use of legislation rather than administrative interventions to correct market failures. See the analysis of Mill's article on "Centralization" (1862) in Pedro Schwartz (1972), chapter 6, "Laissez Faire", pages 146-150.

mathematical school who posited that these unwelcome phenomena would disappear with perfect competition. Barring this, the reader will be struck by how modern Pigou's list is and how up to date the suggestion that taxation and subsidies be ready to hand to correct the failings of the market. Except for the mention of the possible failures of the state which a present day interventionist might add, the Pigovian doctrine has become the accepted doctrine of the profession (until Ronald Coase proved it wrong, as I will show in my next column).

Adam Smith and General Equilibrium

Let me now turn to the mathematical school of economists, who tried to be neutral with regard to the respective advantages of the free market and the command economy and so in effect undermined the system of economic liberty.

It is ironic that the more elaborate proposals for collectivist planning were based on the General Equilibrium theory of Léon Walras (1834-1910), a theorem that showed how right Adam Smith was in his intuition that all the different parts of an economy continually tended to be in harmony.354

Walras was himself a man of deep socialist convictions. Once he was able to model a purely competitive economy in equilibrium, that is to say an economy at its optimum because there was a perfect fit of all demands and supplies, he concluded that one did not need a real market to reach a social optimum—a lesson soon learnt by Walras's disciples, including Oskar Lange.

The great discovery of Adam Smith was that in human societies a most improbable and unintended order emerged, with nobody designing it or governing it. This elevates him to the same scientific level as Charles Darwin, who generalized this idea of emerging order by applying it to nature as a whole.355 Smith sees selfinterest as giving the necessary impulse: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from the regard to their own interest".356 (I, ii) Thereby and unknowingly,

[...] every individual necessarily labours to render the annual revenue of the society as great as he can. [Though he] generally, indeed, neither intends to promote the publick interest, nor knows how much he is promoting it [...] he is in this, as in many other cases, led by a hidden hand to promote an end which was no part of his intention. (IV.ii).

Not only is the individual mostly unaware of the general order that he and his likes are promoting; but he cannot follow how this order functions in detail because the division of labor and the use of money hide the connecting pathways from his sight.

354 See Walras (1926, 1953). It was principally Arrow and Debreu who proved mathematically that a perfectly competitive economy was logically possible. David Warsh (August 2015) led me to the story of this proof by Düppe and Weintraub (2014). 355 Darwin was helped in this by reading Malthus's theory of population (1798). See Darwin's Autobiography (1887). 356 Available online at: http://www.econlib.org/library/Smith/smWN1.html.

Given the immense complexity of the economic system, it seems a miracle that we live in societies so improbably ordered: for Smith's intuition implies that demands and supplies should tally, that investments should find the necessary savings, that the institution of money should help tide people over when their planned income does not arrive in time for their planned expenditure—all this spontaneously.

Smith's vision, however, was not based on the belief that there was a metaphysical harmony in society, as say some of the critics of classical liberalism. Dr. Smith was not Dr. Pangloss. What would have been the point of writing the An Inquiry into the Nature and Causes of the Wealth of Nations if everything was for the best in the best of all possible worlds?

In 1926 Keynes wrote an essay tellingly titled "The End of Laissez-Faire". He there wanted to set aside 'the metaphysical principles' on which laissez- faire had been grounded.

It is not true that individuals possess a prescriptive 'natural liberty' in their economic activities. There is no 'compact' conferring perpetual rights on those who Have or those who Acquire. The world is not so governed from above that private and social interests always coincide. It is not so managed here below that in practice they coincide. It is not a correct deduction from the principles of economics that enlightened self-interest always operates in the public interest. Nor is it true that self-interest generally is enlightened; more often individuals acting separately to promote their own ends are too ignorant or too weak to attain even these. Experience does not show that individuals, when they make up a social unit, are always less clear-sighted than when they act separately. (1926, pages 287- 288)

A passage less in accordance with Adam Smith (and with the reality of markets) could scarcely be imagined.

Two traditions of "General Equilibrium"

Let me leave Keynes's anti-market metaphysics aside and see in what way General Equilibrium theory can contribute to a Smithian view of the economy. Order in market economies is far from perfect, but it would be a great advance to show that it was possible in principle and at the limit. It was Léon Walras (1834-1910) who opened the way to proving mathematically that such a system was indeed consistent. With the help of a model based on the assumption of perfect competition, he showed that a market economy could reach a state of general equilibrium, where all those Smithian equalities (demands and supplies, savings and investments, money in measure and transaction) held stably.357

357 Walras's model consisted of a system of simultaneous equations representing the different markets of an economy. He showed that those equations could be solved for all prices and quantities because the number of unknowns was the same as the number of equations, with one exception: that the supply of, and the demand for money as the measuring rod of relative value had no own equation to solve for it and was therefore indeterminate. This for Walras meant that money should be seen as a veil, with no influence (in equilibrium) on the real economy over which

Now, out of this Walrasian model and its proofs two very different traditions developed. One was to use the idea of perfect competition, unrealistic though it was, as a foil to discover real life distortions: the model helped diagnose unexpected repercussions and feedbacks of any policy change or institutional reform if restrictions in the rest on the economy subsisted and could make the change or reform backfire. For example, not every removal of a tariff on imports would make overall trade freer, because this partial liberalization could increase the degree of protection of the rest of the economy.358 This line of tradition, known today as 'applied general equilibrium', follows the Popperian methodology of making observable predictions and falsifying them by observation or experiment. It has been used by Milton Friedman, Gary Becker and their many disciples of the Chicago School. Thus, Friedman (1957) presented a statistical model which falsified Keynes's theory of the consumption function; and Becker (1981) was able to devise economic explanations of demographic changes that set aside the usual sociological musings.

The other tradition is that of the abstract mathematical school. The paradoxical conclusion of the General Equilibrium economists of this school is that Adam Smith's intuition of emerging order is inapplicable to the real world because perfect competition is missing; hence unceasing intervention is necessary to have the market work for the welfare of the people and indeed to function at all. Those economists suffer from tunnel vision. The point of Adam Smith's idea of the 'invisible hand' had been that decentralized markets, even in the context of imperfect competition, resulted in a more orderly and more efficient organization than that imposed by centralized control.359 So I find it downright depraved (to coin a word favored by Samuelson)360 that General Equilibrium theory should be used to show that real world markets will prove inferior to a planned economic system. According to that theory, the social optimum can only be reached via perfectly competitive markets with equality of income distribution. Given that real markets are neither perfectly competitive nor egalitarian, it follows that they must either be replaced by a designed and purified replica or at least continually invigilated, so as to maximize some social welfare function favored by the critic. The theorists of

it was drawn. Walras (1874, 1926). Later authors completed the proof that the resulting equilibrium in this mathematical model was not only determinate but also unique and stable. 358 For example, it is now commonplace to point out that the lifting of the tariff on a single good by a large country may not turn out to be a move in the direction of free trade but may result in an overall increase in protection—all other restrictions to trade staying put. When to expect 'general equilibrium feedbacks' such as these and how to reach at least a 'second best' were first formalized by Lipsey and Lancaster (1956). To find out how important these 'general equilibrium feedbacks' will turn out to be depends on how connected with the rest of the economy the liberalized good is. It can be shown that the smaller the cross-elasticity of the previously protected good with goods in other industries; the greater the own-price elasticity of the said good; and the smaller the market of the previously protected good compared with rest of the economy: the less the feedback of a single tariff reduction will be. Schwartz (1979). 359 Mitchell Resnick (1997), page 7. This is a general pronouncement that can have exceptions, of course. But one of the points of an

evolutionist view of society in general and the economy in particular is that we should not despair that decentralized solutions for perceived market defects will in the end emerge. 360 Samuelson (1947), Introduction.

planning, like Lange, would have some Planning Authority use a model economic market to facilitate their calculations and to help impose an equal distribution. Non-socialist soft liberals like Samuelson would allow the market to subsist but continually regulate it and correct it. They all see the market as a mere planning mechanism, rather than as a self-standing social institution; and they enthrone perfect competition as an attainable goal instead of seeing it as a mere analytic instrument. When it comes to judging the free market from the point of view of organization or results, the General Equilibrium chapel of the mathematical school turns out to be full of true red socialists or at best Pontius Pilate agnostics.

I am no Luddite. The formalistic advances of 'scientific' economics in the 20th century associated with the names of John Hicks, Paul Samuelson, Kenneth Arrow, Amartya Sen and many other distinguished theoreticians, do afford us instruments to avoid common theoretical or logical mistakes. However interesting their negative results, their positive results are limited, mainly because they dwell in an atmosphere of mathematical abstraction and philosophical neutrality fundamentally averse to Adam Smith's "system of natural liberty".

Oskar Lange (1904–1965)

Oskar Lange, a Polish mathematical economist of communist persuasion, got all the mileage he could from these excogitations and advanced even further. In his article "On the Economic Theory of Socialism (1936-7) he expressed not a doubt that a socialist economy would be far superior to a capitalist one.

Lange's opening shot was a heavy attempt at humor. He named Ludwig von Mises the advocatus diaboli in the cause of socialism for having posed the problem of "economic accounting to guide the allocation of resources socialist economy" and proposed a statue should be erected in his honor "in the great hall [...] of the Central Planning Board of the socialist state." (Page 53) Mises had explained in (1920, 1935) that without money prices and private property, it was virtually impossible for the socialist commonwealth to take decisions about what mix of consumption goods to supply, let alone how to value and apply production goods, given the different possible combinations of productive services for the supply of consumption. So he contended "that a socialist economy cannot solve the problem of the rational allocation of resources". Lange saw the need to face these objections of Mises to prove that socialism was a workable social arrangement.

He started with an explanation of "the determination of equilibrium on a competitive market". As one can see, he used the Walrasian ploy of a situation of perfect competition to explain how in a free economy all markets emptied, i.e. all demands and supplies tallied. That is because consumers maximize their total utility; producers minimize costs to obtain a profit; and owners of productive resources auction their services. The prices that result in equilibrium prices are found by a process of trial and error.

A planned economy, he says, can function quite like a market economy.

The rules of consistency of decisions and of efficiency in carrying them out are in a socialist economy exactly the same as those that govern the actual behavior of entrepreneurs on a purely competitive market. (Page 123)

The Central Planning Board would initially set a schedule of accounting prices, which would be corrected at the end of the accounting period if there were a surplus or a shortage of whatever commodity. (If the accounting period is a year, the system would move rather cumbersomely!) But it is not consumer choice that guides production: the preference scale is "fixed by the Central Planning Board while the price system is used to distribute the consumers' goods produced". (Page 70) For instance, the Board would assign

... to a hat the valuation of ten monetary units, when 100,000 hats are produced monthly, whereas it would assign a valuation of eight monetary units to a hat when 150,000 hats per month are produced. (Page 68)

(Bowlers or trilbies? For women or for men?)

By induction from consumer prices resulting from trial and error, the prices of productive services would be set so that the hat factory had enough machines, felt and bands. Lange did not say how the Board would prove to have the requisite knowledge of technology to relate resources to final production. Also, as Mises (1935) points out, there would be complicated technical interconnections between resources in a production process that have to be chosen; and there will also need to be choices as to where to apply multiple-use resources, such as whether to building a bridge or a canal or digging a coal mine.361Finally there was the problem of the interest rate. In the short run it would be set by supply and demand for credit at the socialized banking system. In the long run, the Board would decide how much it wanted capital to accumulate and so deduct the requisite savings before meting out the disposable income to the citizens. (Is the accumulation of capital the main engine of growth?)

These questions are scarcely answered by saying that

[...] the Central Planning Board has a much wider knowledge of what is going on in the whole economic system than any private entrepreneur can ever have; and consequently, may be able to reach the right equilibrium prices by a much shorter series of successive trials than a competitive market actually does. (Page 67)

I must say that the more I hear about this kind of market socialism the less attractive it is compared with our homely market, with all its blemishes. But Lange seems to be satisfied that they are of the same family and so he asks the obvious question:

361 Amartya Sen used to point out in class that a Lange planning system could be organized by asking producers how much of a good they would produce at a schedule of various prices; and the consumers at what prices they would be ready to pay for a schedule of products. Then, by trial and error consistency would in principle be attained.

Why change the whole economic system if exactly the same result can be attained with the present system, if only it could be forced to maintain the competitive standard? (Page 123)

(Not perfect competition, I hope.) The answer is: "Only a socialist economy can distribute incomes so as to attain the maximum social welfare" by establishing real equality. The Authority would be right to assume "the marginal utility curves of income to be the same for all individuals". The ground for such an extraordinary supposition is that "differences in 'sensitiveness' existing in present society are chiefly due to social barriers between classes". Equality of income without affecting efficiency would be achieved by paying all citizens an equal money income and then charging a price for "leisure, safety, agreeableness of work, etc." for jobs having those advantages.

Also, the socialist system can set prices so that private cost converges with social cost, to the satisfaction of Professor Pigou; it can fine-tune the propensity to save so as to leave room for consumption, to allay Mr. Keynes's worries; it is capable in a depression of restoring employment via a "a bold programme of public investment"; and "the business cycle theorist would lose his subject of study in a socialist economy."

On one point Lange did accept a possible argument against socialism: that "the efficiency of public officials" would not compare with "private entrepreneurs as managers of production". He dismissed these fears by saying that "this argument belongs to the field of sociology rather than of economic theory".

I hope the reader will have formed an opinion not too dissimilar from mine on the feasibility of proposals for a socialist commonwealth. Lange was unfazed by any possible difficulties and confidently concluded that there is only one policy that an "economist who is called to advise a socialist government can commend: "a policy of revolutionary courage."

Seen from today, the respect with which the profession treated Lange is astounding. Lange taught not only in Poland but also in some of the most prestigious universities of Europe and America. His technical ability blinded him and his admirers to the real world effects of his doctrines. At the end of his life Lange did advise the Communist government of his native Poland in the application of his kind of market socialism. It did not work well. He could always say that it was not carried out to his specifications. But there is no hiding the fact that this benighted and supremely intelligent economist was complicit in the sufferings imposed by Communism on his poor native country.

Paul Samuelson (1915–2009)

It is with some trepidation that I undertake criticism of the political economy of Paul Samuelson, a giant among the cultivators of economic theory. His work in the field of high theory, especially in mathematical economics, will leave a permanent

mark on our subject.362 He did very little work in applied economics: apart from a number of non-scientific debatable obiter dicta, he concentrated his practical efforts on writing and revising his Economics textbook, the supreme introductory textbook of the 20th century. The general appreciation for his life-work was crowned with the Nobel Prize in Economics in 1970.

His call to arms was Foundations of Economic Analysis (1947). The quotation on the frontispiece of the book, "Mathematics is a language" indicates his approach to economic theory: mathematics not only allows a succinct presentation of economic theorems but also helps guarantee internal consistency, discover analogies, and generalise results.

In chapter VIII on "Welfare Economics" Samuelson tried to solve the problem of how to base welfare policy on economic theory with the help of mathematics. His starting point was that most economists felt that "in some sense perfect competition represented and optimal situation". By 'optimal' he meant 'being in a state of equilibrium'. But perfect competition was not enough: one had to see that "perfect competition is optimal when the distribution of income is appropriate".

So here we have three elements for a maximum of social welfare in a (closed) economy: perfect competition, stable equilibrium, and ethical distribution—all of them highly artificial conditions in any conceivable situation. Of course, the improbability of these conditions being achieved in any real market situation led Samuelson quickly to demand correction, intervention, regulation.

1. Perfect competition implies: that no dealer can influence prices, that goods and resources are perfectly divisible, and that there is perfect information. (In fact, the construct of perfect competition was not observed in reality but slowly defined as an analytical instrument along the years.) 363

2. Maximum welfare will be attained when the economy is in stable equilibrium. (The last thing we want is an economy in stationary state. For the explanation of social phenomena, it is actors tending towards equilibrium that is interesting.)

3. A just distribution is difficult to define even for Samuelson. We saw Lange get into the most peculiar contortions trying to devise a method of equalising incomes without affecting efficiency. (Samuelson used another construct to solve it: A Social Welfare Function.)

Let me look at condition 3. A social welfare function (SWF) that would embody a general ethical view of the kind of welfare a society should aim at—given a number of economic and non-economic variables desired, and subject to real world restrictions such as the limitation of resources. Different people will give the SWF

362 Samuelson rebuilt the theory of consumer behaviour and welfare economics. He transformed the theory of international trade. His contributions to capital cum growth theory were pathbreaking. He laid the ground for later advances in the theory of finance and capital markets. He distinguished with precision the differences and links of statics and dynamics. And his synthesis of classical and Keynesian macroeconomics (unfortunately) became dogma. 363 Stigler (1965) pages 236-7 and 257-8.

different forms or shapes: for example, one should aim at the greatest possible equality among the members of the society. Now, the idea that there must be a SWF so that the justice of the arrangements of a society can be evaluated from the outside by an ethical observer is objectionable for a true individualist. (In my next column we shall see James Buchanan insist that 'playing God' is not the role of an economist.)

If we take a look at Samuelson's practical politics, the dangers of his eclecticism become obvious, not so much because I may disagree with his beliefs and opinions as because I do not see the connection between his scientific analyses and his political conclusions. There is a wealth of articles to choose from in the seven volumes of the monumental Collected Scientific Papers of Paul A. Samuelson. Let me name a few, since I will have occasion to delve more deeply in them in my next column. In volume 2, in an essay called "Modern Economic Realities and Individualism" he just dismissed the "principle of unanimity" as "of course, completely impractical". (The free market is a unanimous process). In volume 3 we find a long essay on "Personal Freedoms and Economic Freedoms in the Mixed Economy" where he presents Friedrich Hayek'sRoad to Serfdom as a "grossly oversimplified view" between the lack of economic freedom and the future of political freedom. (He may have been over-optimistic as to the future of our Welfare democracies). In volume 4, in an essay titled "Liberalism at Bay" he implies that Adam Smith was wrong in stating that "a competitive market system, concerned with atoms only pursuing their own narrow self-interest, would be led 'as if by an invisible hand' to achieve the good of all". (He obviously had not read The Theory of Moral Sentiments, 1759). In the 1948 edition of his Economics textbook still presented a Lange-like explanation of 'market socialism' with a straight face. And I will say nothing (now) of the egregious assertion that the Soviet centralised economy could function nearly as well as the capitalist economies of the world—until just before the Berlin Wall was demolished.

Hayek, Coase, Buchanan, Friedman and Becker

My kind readers will have to wait until next month to see how, in their different ways, these five economists helped reestablish the philosophy of economic freedom on a more solid basis than in classical times and thereby undo some of the harm caused by the nay-sayers of the first half of the 20th century.

The Rebirth of Classical Political Economy

July 4, 2016

In their diverse ways, Friedrich Hayek, Milton Friedman, Gary Becker, James Buchanan and Ronald Coase can be seen as leaders of the group of economists who helped reestablish the philosophy of freedom, economic and political, after the drift of the first part of the 20th century. I could bring more names into the fray but I will take these five champions as the representatives of different ways of restating the philosophy of the free market. They did not see eye to eye on everything, especially in matters of methodology. But this group of Nobel laureates is rightly seen as having brought about real progress in economic theory and policy. They were not the clique of 'neo-liberal' ideologues that market haters say they are. Indeed, one could follow William Coleman in glorying in the 'neo-liberal' moniker, so as to show pride in what they and their many followers have contributed to the science and application of political economy.364 I still incline to saying 'classical liberals'.

Friedrich Hayek (1899-1992)

The first contribution I want to note among the many made by these classical liberals is that of Friedrich Hayek in the field of the economics of knowledge. The story opens in 1935 with Hayek's edition of a collection of essays under the title Collectivist Economic Planning, which I mentioned in my last column when discussing Oskar Lange's market socialism. As I said there, Ludwig von Mises in 1920 had written a seminal article on the impossibility of centralized economic calculation. Hayek decided to republish it, together with studies of central planning by other authors and an introduction and a conclusion from his pen. In a gesture of unwonted fairness he as an appendix added the prime essay of the pro-central planning community, Enrico Barone's "The Ministry of Production in the Collectivist State" (1908). 365 Nobody believes in a centrally planned economy anymore, but then it was quite a discovery to show that the market was much more efficient than a central board in setting prices, because the dynamic of their movements reflected the knowledge of millions of different people, when a single person, be he planner or individual participant, could only know a minimal fraction of reality. What Mises and Hayek had explained in theory in the 1930s was proven right in fact when the protecting screen of the Berlin Wall was dismantled in 1989 by Germans thirsting for freedom. It was the planned economy, not the market economy that proved to be chaotic.

364 Coleman (2013). 365 Enrico Barone (1859-1924) was a disciple of Leon Walras and Vilfredo Pareto, a distinguished member of the Italian school of mathematical economics, and a political economist of fascist tendencies, who proposed "producers' syndicates to supplant cut-throat competition, rationalise production, and resist [socialist] labour demands". This was despite his inclination for free trade. (Cardoza (1982), pgs. 190-191). Paul Samuelson (1947, pg. 214) called it a "masterly article", which says a great deal

about the biases of the great Samuelson himself. The writing an essay with Marxist overtones by a person who tended to sympathise with Fascism indicates how right Hayek was to dedicate The Road to Serfdom (1944) "to the socialists of all parties".

Hayek retook the central idea of that book in his 1945 essay "The Use of Knowledge in Society"366—since selected as one of the top twenty articles published by the American Economic Review in the hundred years of its existence. Hayek's object was to amplify his rebuttal of Oskar Lange's and Enrico Barone's proposal of a socialist society that would use a replica of the market to facilitate the calculations of the planner. He now widened his criticism by adverting to the dispersed role of all knowledge in an economy.

Hayek not only showed that the economic data needed by a central planner could not be accessed centrally, he rejected the conception of the economic market implicit in "many of the uses made of mathematics" by economists. He did not mention by name Lionel Robbins's famous definition that "Economics is the science which studies human behavior as a relationship between given ends and scarce means which have alternative uses" (page 16); but he in essence rejected the concept of the economic problem encapsulated in that definition. The ends are not given or generally known and neither are the scarce means and their alternative uses. Both aims and resources will only be discovered through the market process itself.

This led Hayek to distinguish two kinds of knowledge in the functioning of the economy: the scientific knowledge that can be summarized in statistics and the kind of personal and local knowledge that can only be gathered and used individually and practically, like the knowledge of a realtor about the local housing market or that of a speculator about disequilibrium prices. Now, this latter kind of knowledge is difficult to generalize and in perpetual flux and is only made generally available through the price system. One of the conclusions to be drawn from Hayek's theory of information in society was that the perfect knowledge of perfectly competitive markets could only be assumed as an analytical tool, as an approximation to the study of some markets but not as a full representation of reality. We would have to wait for Ronald Coase to understand that the market itself was far from a costless institution, so that frequently pyramidal organizations such as corporations were substituted for the horizontal dispersion of market processes.

Also important for helping redress the negative view of the free market prevalent during the first half of the 20th century were Hayek's efforts to retell the economic history of capitalism and of economic thought. This was a necessary condition of the re-founding of liberalism, as he had said at the first meeting of the Mont Pelerin Society in 1947. In 1954 he edited Capitalism and the Historians, where he put together a collection of essays by different authors, with the aim of changing the then accepted picture of the Industrial Revolution. The false picture of an idyllic life of plenty in the countryside and the misery of exploitation in urban factories and dwellings was negated by evidence. 367 Of course, life is hard for the poor at the

366 Available online at "The Use of Knowledge in Society. 367 Later work by economic historians on mortality in cities, and soldiers' and male prisoners' height, in the 1830s in Britain has shown a step back in living standards during those ten years. Water sanitation and greater abundance of food after the abolition of the Corn Laws and the

beginning of industrialization. Even today the harsh realities of urbanization in developing countries seem to tell against capitalist development, though they themselves imply progress: thus in China today, where the miserable masses of inland peasants move to the coast, whose living standards are a step forward for them despite the poor conditions of Chinese workers in Western eyes. Finally, it has become commonplace today to underline the extraordinary transformation of human society wrought by capitalism, of which the

recently published Cambridge History of Capitalism (2015) bears witness, but this was certainly not the accepted view during the dark years between the two World Wars.

Milton Friedman (1912-2006)

Milton Friedman's contribution to the defense of free market economics showed a different emphasis and a less philosophical bent compared with Hayek's, but it turned out to be just as important in the battle for freedom. As a well-trained statistician, Friedman launched the more empirical way of approaching economic questions that became the hallmark of the Chicago School. He showed special attention to measurable data, both in his macroeconomic and monetary studies, and in his historical research. For him, statistics were not a way to gather comprehensive knowledge about society but, more modestly, a way to show that a theory was mistaken because it was contrary to fact, as Karl Popper had taught.368

It is all very well to show that John Maynard Keynes's theories are incompatible with the more correct view of human nature presented by economists of the Austrian School, but such fundamental reflections will not convince dyed-in-thewool Keynesians. Facts and their interpretation are essential in scientific discussion. Keynes based his claim that the market system could not selfequilibrate on, among other things, his "fundamental law of saving and consumption", whereby people save more proportionally the larger their income. In 1957 and in A Theory of the Consumption Function Friedman showed that this assumed psychological law was based on deficient statistical work. Individuals did not, as Keynes thought, consume less and less as they became richer and richer, which lead to a perpetual shortfall in aggregate demand. Backed with proper statistical analysis, Friedman showed that individuals made their consumption and saving decisions on the basis of their perceived long term prospects; so their propensity to save stayed proportional to their income: there was no necessary law of growing capitalist under-consumption.

Again, in his work on the quantity theory of money (1971-74), Friedman showed that the demand for money was much more stable than Keynes had assumed and that nominal income and the price level were functionally related to the supply of money. By presenting money as an asset in the portfolio of individuals and showing that people chose the amount of real liquidity they wished to keep as a proportion of their real assets, he was able to show precisely why "inflation is always and

reduction of tariffs explains the turn-around towards more prosperity from 1860 onwards. See Williamson and Neal (2015). 368 See Friedman's recall of his meeting with Popper at the founding Mont Pelerin meeting in Milton and Rose Friedman (1998), pgs. 214-6.

everywhere a monetary phenomenon", with no relation to (real) aggregate demand and supply, as Keynes believed.

Then came his contribution together with Anna Schwartz in A Monetary History of the United States (1963), especially the chapter on the "Great Contraction" of 1931-1940, as they called it. There they showed that, whatever the causes of the recession of 1929 may have been, it was the mistakes of the Federal Reserve that made it much worse. The empirical analysis of monetary policy during the Great Depression allowed them to reject the Keynesian conclusion that the whole dreadful episode was due to a failure of capitalism. So ended the pretense of Keynes to have written a general theory of the macro-economy.

Finally, Milton and his wife Rose proved to have a genius for popularizing the political and economic philosophy of classical liberalism. Their first and widely successful foray into this field was the publication of Capitalism and Freedom in 1962. They also joined forces in producing the films titled Free to Choose

and the companion book. In sum, together with his wife Rose, Milton did sterling work to spread the idea that capitalism is the true fount of prosperity.

Gary Becker (1930-2014)

Gary Becker went to the extreme of the Chicago method of doing economics, with extraordinarily fruitful results. "The combined approach of maximizing behavior, market equilibrium, and stable preferences, used relentlessly and unflinchingly, form the heart of the economic approach as I see it", said Becker (1976). In his view, there need be "no separate theorizing for micro problems, macro problems, nonmarket decisions, and so on".369 In other words, by assuming that individuals try to maximize their personal welfare; that their fundamental preferences are part of human nature; that the household functions like a small factory with inputs of goods, market services and time—and outputs of personal services; and that the endeavors of people taken together tend to match out in the market: one can frame predictions of social states that can then be tested with actual statistical data. Especially interesting is the attempt to give some content to the empty concept of changes in tastes that economists tend to overuse.

Education and other environmental variables enter the demand function for goods, not because the tastes change [...] but because they change the efficiency of household production. [...] Their effects on demand cannot only be described statistically, but can also be predicted.

This approach of Becker's and his disciples is illuminating for the analysis of a number of economic and social problems. He applied his method to build theories of racial discrimination, of marriage and divorce, of the number of children in different strata of the population, of immigration, of crime rates, of drug and alcohol addiction, or of the wages of university graduates—and checked these models against facts.

369 Becker (1971), Introduction.

James Buchanan (1919-2013)

Another important contribution was the attempt of James Buchanan to solve the often observed incompatibility between individual freedom and democracy. As I have written in a previous column,370Joseph Schumpeter was the advocatus diaboli against the proposition that democracies will be pro-market. He well understood the essence of capitalism but saw it as necessarily bound for selfdestruction. In his Theory of Economic Development (1912) he had characterized the free market system as moved by "creative destruction," where progress is based on new procedures that bring about the obsolescence of existing modes of production. But in his notorious Capitalism, Socialism and Democracy (1943) he arrived at the shocking conclusion that creative destruction would come to a grinding halt in a democracy because the people would not willingly bear its cost. Only a more or less hidden socialist dictatorship could force the people to accept the sacrifices demanded by economic progress.

Instead, Buchanan proposed to solve the conflict between democracy and individual freedom in a thoroughly individualistic way. First, in a democracy,

... each man counts for one, and that is that. [...] A situation is judged "good" to the extent that it allows individuals to get what they want to get [...], limited only by the principle of mutual agreement.371

To the end that collective decisions were not taken on the basis of protecting losers or shackling innovators, Buchanan laid down that collective decisions be taken in two separate steps: one, in the constitutional

mode, when the basic rules of the game should be decided unanimously or nearly so; the other, in the political mode, where decisions can be taken by some form of majority vote. The starting step would be the selection of rules; then came political action within those rules. You do not change the rules of poker during the game, he would say. People would be careful to draft a constitution that guaranteed their basic rights of personal freedom, private property, the rule of law, and the free market, so that they would not suffer oppression if their future situation in society might weaken compared to their present one. The rules would be based on what he (and Hayek) called "the Generality Constraint" 372 or the rule that no social group or individual should be discriminated against in law or by the administration of the state: thus, no progressive income tax or positive discrimination or subsidies to firms or industries.

For Buchanan, markets are institutions born from repeated exchanges between individuals. No outsider observing economic activity from above can adjudicate on the social welfare of these exchanges. It is the people who engage in them who decide to trade because it satisfies them. And if both sides are not wholly satisfied with the outcome they will together try to reform the institutions of that market so

370 See Schwartz, "The Riddle of Schumpeter". Library of Economics and Liberty, September 13, 2013. 371 Buchanan and Congleton (1998). 372 Buchanan (1975).

that future outcomes are more gratifying for both of them. For Buchanan, political processes cannot be imposed or judged from the outside. He especially directed this prohibition to political philosophers, who should never "play at being God." Buchanan would not himself presume to tell voters (as social welfare economists do) what they should prefer. In this, he treats the political game as another market where consumers and producers will not be told what to prefer or what to do. It is for people themselves to vote, trade, and decide how to arrange social matters concerning them, as long as they tied their hands against changes in the constitution when they were in a position of power. As in the economic market, he hoped institutions would emerge that better reflect the wishes of voters in the long term. Democracy can be learnt.373

Ronald Coase (1910–2013)

As I said in my last column,374 Arthur Pigou's case against free markets was that they were inefficient due to an endless and growing number of external effects, both positive and negative. This has become the mantra of all orthodox economists, especially those who look askance at the free market. Ronald Coase effectively turned the tables on Pigou with two arguments: that people and firms in the market often corrected externalities by mutual agreement, and that solutions imposed by government often led to a worse outcome than the starting situation.

In a famous 1959 dinner at the home of Aaron Director, where Milton Friedman and George Stigler were present with another seventeen skeptical economists, Coase presented his case that, absent prohibitive transaction costs, the parties confronting a situation beset by external effects would find an optimal agreement with no need for government intervention. He also showed that solutions imposed by authorities as self-evident could often be shown to have little or no justification. Coase had overturned a majority of twenty against his theorem by the end of the dinner. What should be noted by the traducers of neo-liberalism is that Coase did not take it for granted that markets functioned perfectly. High transaction costs made it difficult perhaps to come to effective agreements. After Coase, the case for liberty came to rest on the high probability of government failure—something that is more often than not overlooked in economics textbooks and political discussion.

Coase's theory has often been misconstrued, however. The way in which such an admirer of Coase as George Stigler involuntarily emasculated the Coasean principle is revealing. Following Stigler, the Coase theory is usually presented in the form of a theorem, as follows: "Given well defined property rights and zero transaction costs, all so-called externalities can be solved by agreement between the affected parties, if one leaves aside changes in distribution resulting from such agreements". This almost reads like a tautology. It implies that property rights have to be defined before externalities are solved. It makes the questionable assumption that transaction costs can be zero. And it overlooks the difficulty of

373 It is interesting to compare the voting record of the Swiss in their referenda with the way that majoritarian democracy is applied in some Latin American countries. 374 See Schwartz, "Continual Erosion and the 'General Equilibrium'". Library of Economics and Liberty, May 2, 2016.

sharing the benefit obtained by cooperative agreements that move the economy nearer the optimum desired by all the people implicated.375

However, in many cases property rights change during negotiations. Also, any Coasean bargain often overcomes transaction costs of three kinds: (1) information and communication constraints; (2) free-rider costs; and (3) strategic behavior of the parties involved. And the re-distributions of gains can be used to co-opt parties resisting change. Many of these complications disappear under perfect competition, but the last thing we want is to reduce the application of the Coase theorem to situations where all parties are price-takers.376

Fully to understand Coase we need to read the book he published with Ning Wang, How China Became Capitalist (2012) when he was 103 years old. In post-Mao China Coase's theorem unexpectedly worked in the most fluid of situations. Property rights were in the making while the economy was moving towards capitalism. Information and communication had to overcome huge political obstacles. Negative free riding was transformed into positive imitation. Redistribution often had to take the form of bribes to side-step senseless regulation.377

As Coase and Wang noted, "China did not first delineate property rights and then allowed market forces to allocate rights to the highest bidder". The state continuously changed and modified those rights under the entrepreneurial pressure of local authorities, firms, and individuals. Agreements were reached and contracts performed under unpropitious legal circumstances. And the resulting prosperity was so great that distributional conflicts, though not inexistent, were minimized mainly with bribes.

The main lesson to be drawn from Coase is that market failure is often corrected by improbable bargains and by the spontaneous emergence of new institutions, such as corporations. The nature of the firm and its role in the reduction of the cost of markets is another great contribution of Case's: firms appear to substitute partial centralization for impractical horizontal pricing in markets.378 (Coase, 1937)

The experience of Chinese capitalism demands a recasting of the Coase theorem, to make it less static and more dynamic than it appears in misguided reductions such as Stigler's that are at bottom unfaithful to its spirit.

375 Again, the Coase theorem is formulated on the basis that some outsider knows what the optimum should be, in this case a Pareto optimum. But Buchanan clearly showed that it was for the people concerned to decide whether the trades arrived at were optimal for them. If they were not fully satisfied they would try to modify the institutional framework of the market. 376 As usually formulated it is open to the criticism of Robert Cooter in "The Cost of Coase" (1982), that it only holds under perfect

competition. 377 Improbably China was taking the path described by Buchanan in "The Irrelevance of Transaction Costs" (1984). 378 Outsourcing an activity may be too expensive in time and money when the function is governed by a not fully specified contract, such as the arrangement binding a CEO with her executive secretary or assistant.

Classical liberalism and political economy

There is little doubt that a reconstruction of liberalism was needed by the middle of the 20th century. The efforts of these classical liberals of the 20th century have been decisive for this work of repair and restatement. Their fruitful intuition was that liberal philosophy could only be revived by the strict and untiring application to social problems of free market economics.

They are a varied group of thinkers with sometimes widely different approaches to political economy. In my view, however, differences of method among defenders of market economics have been overblown. The essential starting point for us liberal economists is individualism and its defenses—the rule of law, private property economic liberty and the free market. Note that I say 'individualism', not 'methodological individualism'. This latter expression reflects the reductivist method applied by those many welfare economists who construct 'social welfare functions' and 'welfare criteria' according to their preferences, from which they then deduce to guide economic policy; and then then try to validate these criteria by basing them on assumed individual behavior of the cut and dried sort. Such welfare economists are in fact ethical collectivists, who try to transfigure their aggregate pronouncements on social justice with the wand of factitious individualism. It was Buchanan who most forcefully rejected this kind of alchemy in the pronouncement I quoted above, that we economists 'should not play at being God'.

I am no eclectic in questions of method nor indeed in matters of economics. I do think that social reality is many-faceted.379 I do not see why studies of aspects of social life by economists such as Gary Becker or Milton Friedman should be excluded on principle by strict followers of the Austrian School. Economists should be free to make the assumption they think most productive to explain social phenomena and see how many miles they can run with them. The basis should be individualistic and the object to find the truth—if possible. The choice I have made of the five rescuers of freedom economics shows that I deny that there is a single orthodox methodology in social questions: philosophical reasoning as in Hayek, statistical criticism and historical revision as in Friedman, microeconomic explanation and prediction as in Becker, democratic individualism in Buchanan, or the new institutional theorizing initiated by Coase should not be ruled out of court just because they do not fit our methodological preconceptions—as long as they hold to strict individualism and give fruitful results.

379 Karl Popper, who was the outstanding theorist the hypothesis and falsification methodology of science [as Milton Friedman recognized in his (1998), pages 214-6], did on no account propose the excision of all metaphysics from scientific inquiry.

Brexit!

September 5, 2016

The result of the Brexit referendum held on June 23, 2016, whereby the United Kingdom voted to leave the European Union, took most pundits by surprise. This was not so with me, I must say, perhaps because I am an old hand at British affairs. I even bet on the result and made some little money. Still, on the Continent the pro- Brexit vote exploded like a bomb; and in the UK it wrong-footed many. The general feeling among those who see the world in terms of power and large organisations is that Brexit is bad for the EU but a catastrophe for the UK. Not necessarily so. I believe that the UK, free of the ties that bind it to the EU, may become an example among countries that do not seek shelter in some narrow political harbour but dare ride on the open seas and confide in their good fortune and abilities.

Brexit could harm the UK if the new government seriously tries to apply public policies that reduce productivity and protect great swathes of the country from competition. But whatever the new Prime Minister may have said on the first day on the steps of 10 Downing Street, the need to survive on its own in a difficult world will hopefully keep the UK from committing the worst mistakes. The pride of newly gained independence will sweeten the initial sacrifices. Drake has singed the beard of the King of Spain.380 The resulting prosperity may in the end reconcile a generally anti-capitalist popular opinion with the advantages of the free market.

Many see Brexit as another example of the spread of populism in our democracies. They present the result as the reaction of a boorish majority of foreign-haters against globalisation, who should have listened to the good advice of the metropolitan experts who were telling them to remain. There is no doubt a measure of disillusionment with our political and economic arrangements, but it is crucial that we should diagnose it properly. Liberal democracies have promised too much. We have failed the people because the welfare state that the liberal intelligentsia have built in the countries of the West in the 20th century is just not sustainable.

Along the same lines, the European community that the experts have been putting together since the Treaty of Rome in 1953 is perpetually in danger of breaking up. The remedy proposed by the elites is always the same: higher taxes to finance what is broken, more centralisation to glue together what is falling apart. No wonder ordinary people are suspicious and rebellious. Of course populist solutions will not work, but we, the so-called liberals, should have had the courage to explain that a democracy cannot rest on the illusion that people can be free and irresponsible at the same time—schooled, cared for, and governed from afar by a bunch of allknowing administrators. An independent UK could show the 'populists' that a social system based on individual self-reliance can give a prosperity and freedom that paternalism and centralisation cannot.

380 This derisive phrase refers to the attack by privateer Francis Drake against Spanish naval forces at the Bay of Cadiz in 1587. Much of the Spanish fleet was destroyed or captured, delaying Spain's plans to invade England by more than a year.

Politically correct in Rome

Is it conceivable that the EU, at the sight of a British economic success after their divorce, would move away from ever growing centralisation towards variety and competition among its members? A meeting of the Italian Aspen Institute in Rome in which I took part a few days after the referendum disillusioned me. A more disappointing gathering could hardly be imagined. There was much wailing about the British trying to scupper the EU project again and some hope that in the end a way would be found to bring the UK back into the fold.

Hearing the sixty or so participants gathered round the table I clearly saw how different the conception of democracy is in Italy from the UK: in Britain it is just unthinkable that a decision like the Brexit referendum be quickly reversed or slyly changed through back-door manoeuvres.381 When my turn came to speak, I pointed out that the continental authorities had been very ungenerous to Mr. Cameron. He was serious enough to put his job on the line. He needed effective concessions to bolster up his bid to keep the UK in the Union. The concessions were not forthcoming because, I added, demands for more variety and competition in the EU are simply impossible to grant, as they go against the grain of what the EU has become—an inchoate state. However, what really struck me is that what I said about the good reasons for Brexit and the hopeful future for the British on their own, fell on deaf ears: there was not a single comment in response. In essence, the discussion never came round to economics. It was all about power. The assembled experts saw Brexit as a disaster all round because it made Europe weaker and the UK puny, in a world where what counts is not individual freedom and prosperity but gaining weight to elbow a place at the High Table of world geopolitics. The possibility that economic competition between the UK and the EU could be positive for both sides and for the world did not seem to cross anybody's mind.

Cross Currents

This referendum and the reactions to it evidence the clash of two different conceptions of society: one is the grassroots view that the nation must regain a measure of its sovereignty and return to a more direct way of governing itself; the other is the cosmopolitan view that the world should be better off if rationally administered by transnational organisations, properly designed by enlightened minorities. This divide, observable in the UK, in Europe, and in the United States, is sowing discord in the foundations of liberal democracy. One of the seismic waves has been the popular discontent that surfaced in the UK with the Brexit referendum. Another is the backing garnered by Donald Trump in his race towards the American Presidency. In the EU we also have numerous instances of revolts against the 'Establishment', to use a word launched by the 'angry young men' of

381 The EU has a history of reversing referenda: Denmark rejected the Lisbon Treaty in 1992 and approved it in 1993; Ireland rejected the Treaty of Nice in 2001 and approved it in 2002; France and Holland rejected the draft European Constitution but approved it by Parliamentary procedure after transmogrifying it into the Lisbon Treaty; then Ireland rejected the Treaty of Lisbon in 2008 and approved it in 2009.

England in the sixties: Spain and its large Leninist Party; Italy, with a comedian on the brink of heading the government; Hungary using barbed wire to stop the refugees from Syria; nationalist parties in Austria, in the Low Countries, in France especially. Condemning these movements as 'populist' and hoping they will go away will be of little help. They may be undefined and contradictory but they well up from a general disillusionment with our political and social arrangements in the West. The conflicting troops are badly arraigned: nationalist underdogs against metropolitan left-liberals, when it should be self-governing

individuals versus both the communitarians and the paternalists. The effective antidote would be to reexamine the aims of our liberal democracies and purge them of make-believe.

First reactions to Brexit in Britain seem to be communitarian rather than individualistic. Much of the Brexit vote seems to have come from a disgruntled part of the population, resentful of the presence of hard working, high saving immigrants from Europe, unhappy with the financial prosperity of London, and disgusted with globalisation and free trade. The new Prime Minister Theresa May, in her first declaration, sounded a tithe more egalitarian and nationalistic than David Cameron, her predecessor in the office. She spoke of restoring social justice, stopping the influx of EU immigrants, and re-industrialising Britain. She even mentioned putting more worker representatives on company boards and limiting the emoluments and perks of corporation bosses. She seemed to echo populist protest against aloof professional politicians, foreign workers, cheap imports, financial wizardry—anything that makes society 'unfair'. This seems the voice of a 'Little Englander' to use Cameron's expression to define Brexit Leavers, though Cameron there was being unfair to historical 'Little Englanders'.382

If we attend to the reactions in the EU, the snapshot is also disheartening. The call to a Europe in crisis is 'More Europe!' The President of the European Commission, Jean Claude Juncker, on seeing new cracks in his Lego house, immediately declared that it would not be a friendly divorce since it had not been a love marriage: the separation from the UK should be swift and hard, he implied, so that it did not stand in the way of an ever closer union among the peoples of Europe. He has lately softened his tone, perhaps after seeing Germany's Angela Merkel take a more accommodating stance. However, François Hollande, the President of France, has turned out to be far more intransigent, for good domestic reasons: he does not want the leader and voters of the far right "Front National" to think that leaving the euro and the Union is easy and costless. The reactions in the EU, hostile or not, show that the lessons of the exit of such an important member as the UK may be lost on the rest.

382 The expression 'little Englander' was coined during the Second Boer War of 1899-1902 to lambast those who opposed the war of conquest in South Africa. It harkened back to the time of the start of the expansion of the British Empire in the 1850s. The Manchester liberals headed by free-traders Cobden and Bright considered colonies to be an expensive hunting ground for scions of the aristocracy. This Free Trade, Retrenchment and Peace faction of the Liberal Party had the sympathy of William Gladstone, the Liberal politician and Prime Minister, whose reluctant imperialism however added the protectorate of Egypt to the Empire to keep the Suez Canal open. The Boer War with its scorched earth policy and concentration camps was not one of the most glorious moments of British imperial history. At least it was investigated and the object of an allwomen official Commission headed by Dame Millicent Fawcett.

Economics to the rescue

On the Continent, officials are usually off the mark about Brexit because they do not start from good economics. They mostly discuss reversing or watering down the British referendum, changing treaties to make them more encompassing, creating a European Confederation, turning Europe into a great-power, or reforming the Commission, the Council, the European Parliament, the Court of Justice, the Central Bank—whatnot. All are matters legal and political, which indeed can be of some import but which ordinary people do not connect to their personal lives. There are two main ways to bring Europeans together: harmonisation and competition. As the project has proceeded, uniformity has been gaining the upper hand. The possibility that different ways of doing things may unite us better than regulation does not seem to occur to our European regulators. One outstanding example is how the euro was forced on willing and unwilling member countries, only to fail signally. The EU proposals on questions of employment, productivity, wealth creation, trade, the environment, are usually all about the authorities doing something: launching investment funds for public work, keeping a level playing field by controlling 'harmful competition', breaking up (private, not public) oligopolies, stopping tax avoidance, protecting the environment, managing globalization, or redeeming the euro from its original sin. It is all about faire faire, make do, rather than laissez faire. They seem not to know that fighting unemployment, increasing social mobility, managing the cycle, and using money to restart the economy are simply unfeasible through direct political action. Their point of view in all is mercantilist and constructivist—how to tame markets and how to help Europe confederate.

It always surprises politicians and bureaucrats to see how economic incentives cut across the best laid out administrative plans. The 'remain' camp and expert opinion in Europe made much play of the likelihood of a recession in the UK if it left the EU. How did they know? This prediction was based on the idea that, with the UK out of the Union, a number of negative reactions could be expected: foreign demand for real estate would fall; tariffs would be charged on British exports to the Continent; banks domiciled in Britain would be deprived of their 'passport' to operate freely across the EU. More generally, the City of London, would lose large chunks of its insurance and financial business and all its euro business in favour of Frankfurt or Paris. Individuals and companies react in strange ways. After a clean cut with the EU, Britain could become a Norway or Switzerland, or rather a Singapore or a Hong Kong writ large.

I am arguing against friendly negotiation to 'contain the damage' caused by Brexit. Imagine sitting down to play games with the movement of people between the EU and the UK; the permanence of the UK in the Single Market, especially for financial operators; fisheries and agricultural policy; climate control; defence and diplomacy; not to speak of the unwinding of forty years of legislation. All this could only mean the postponement of Brexit, much to the anger of all parties. There is danger for both the UK and the EU in lengthy negotiations over complicated demands for mutual concessions. This kind of diplomatic disposition has caused endless delays to the signing of the Transpacific Partnership and equally is now

making the discussion of the Transatlantic Trade and Investment Partnership between Europe and the US interminable. With either Donald Trump or Hillary Clinton in the White House both agreements seem to be dead in the water. British freedom to build and to sell could end constrained and shackled.

Furthermore, a clean cut might be best for harmony across the Channel and prosperity all round. The British economy could surprise if the new government allowed it to spread its wings. Brexit can be for the good for both the UK and Europe as a whole if Brexit is not watered down or taken hostage by socialists

and if the shock of separation wakes up the rest of Europe to the benefits of legal, monetary, and commercial competition. We may then all come out better from the June referendum.

The UK on its own

The question is, why are people disenchanted with liberal democracy? After World War II we in the West built an ever more encroaching state, with the assurance that it will deliver the goods people want. Individuals are told that they are free to lead the lives they prefer but their most important decisions are taken in their name by the powers that be. Health, education, old age pensions, unemployment insurance, and working conditions are all out of their hands. Also, their expectation of living an ever more prosperous life without much effort are disappointed by competition from faraway lands, by the arrival of immigrants, and by unforeseen crises in the economy. Will these widespread feelings be used by the Theresa May government as an excuse to turn Britain inwards after Brexit?

Two forces are pulling the UK Government, one toward an accommodation with Europe, the other away from the EU. It would be best in my view if the call to accommodate European conditions was downright ignored. A clean cut would allow the British and the Continentals to find spontaneous solutions to problems that crop up. As an economist I will add that the best policy should be to forget about reciprocity and choose unilateral free trade as was done in the 19th century. Of course there will be protests from people having to adapt to domestic and foreign competition, but trade protection in the end harms the country imposing it. So much the worse for the people on the Continent if they make British goods more expensive there,383 and so much the worse for them if they cut themselves off from one of the three world financial markets.

The danger is that a combination of communitarian nationalism and 'one nation conservatism'384 will condemn the UK to becoming a backwater of the world economy. The temptation will be to keep existing regulations of working hours, health and safety, genetically modified foods, fracking, and such likes at the pre- Brexit level. It is all very well to try and heed old hat community feelings but there

383 A protective tariff on imports also diminishes the domestic degree of competition and makes one's exports more expensive, in as far as the exporters need foreign inputs. 384 It was Benjamin Disraeli (1804-1881) who called himself a 'One Nation Conservative'. David Cameron tried to move the Tory Party from being 'the nasty Party' to 'One Nation Toryism'. Theresa May appealed to 'one nation conservatism' again immediately on taking office.

comes a point when imitating German co-determination or Mitbestimmung will undermine what a middle size country like the UK with lots of talent and energy can do in the world.

The composition of Theresa May's cabinet indicates that she does not intend to let things linger. She has organised a strong team of eurosceptics to deal with Brexit.385 The UK should not feel forced to pay a high price for staying in the Single Market. Luckily, Theresa May could find it close to impossible to attain. Catastrophe is not round the corner. Brexit need not bring another recession to the UK. Out of the Single Market, the British will have to sell their goods and services to the whole world. The trade weighted tariff of the EU which Britain would have to face is variously calculated at 4 to 5 per cent, a mark-up British industry can easily digest. Europeans may try to close their doors to financial services originating in London but the City will gain attraction if it escapes the regulating mania of the Continent.386 It would not be the first time. In the 1960s and '70s the US government put a cap on interest paid on domestic checking accounts as a means to decouple interest rates and inflation; this led to American companies depositing their dollars in London to side-step the regulation: thus was born the 'Eurodollar' Market (no relation of the present day

euro) which grew into a trillion dollar net size. Frankfurt and Paris will not displace as experienced a market as that of the City. There is nothing more convenient than a large "black market" when regulators lose their bearings.

Soon the British Government will be led by foreign competition to lower company, value added, and personal income taxes. Elementary budgetary responsibility will then lead to review public expenditure and avoid Keynesian public works. The welfare state will have to be reformed, at least along the lines of the Swedish voucher system. It may even happen that the British will set up a sensible immigration policy to better their productivity. All this is not wishful thinking: it is simply my belief that reality will force Britain to be a success.

385 Boris Johnson Foreign Secretary, David Davis Brexit Secretary, and Liam Fox International Trade Secretary. She has put them on the same footing—to the point that the three share the use of the 'Grace-and-Favour' country house of Chevening equally for their weekends! Boris Johnson may be the most visible in his dishevelled way and Liam Fox not especially conversant with complicated trade agreements. But of the three, the imposing personality is the Brexit Secretary David Davis. The son of a single mother, brought up in a subsidised housing estate, up from a comprehensive school to the Universities of Warwick and London, he is an upright conservative who resigned his seat in Parliament in opposition to measures of increased surveillance against terrorists and was subsequently re-elected. As a legendary defender of civil rights, he favours the death penalty for serial murderers. A long term defender of Brexit, he will be no pushover in the negotiations. 386 The possibility of financial houses working in the whole of the EU goes under the name of 'passporting'. The granting of such permits by the European Commission was really a recognition that the different financial centres within the EU abided by the regulations guaranteeing good financial practices for clients served by them. Passporting is no protectionist barrier, as can be seen by the wide granting of permits to firms domiciled outside the EU under 'equivalence provisions' incorporated in commercial treaties. There might be no difficulty in granting 'equivalence' to City firms if they do not find those rules too onerous.

The Spread of Populism in the World at the Start of the 21st Century

October 3, 2016

Aristotle denounced demagoguery many centuries ago as being a degeneration of democracy. This is true but is not all. Populism is a flood to which four currents contribute: the beguiled voters; the power-hungry intellectuals; the short-sighted politicians; and the appeasing elites.

The fault of the people?

It is usual but unfair to put all the blame on the people. In fact demagogues have it so easy because the people have been fed with unfeasible promises of welfare. They have been promised good free education, quality free healthcare, ample free pensions, with no attention paid to cost or incentives. They have even been promised the end of the business cycle and unemployment. When voters discover they have been tricked, they grow angry and turn to even more irresponsible dreamers.

The anger is there all right. During the American election campaign, we are hearing angry demands for total protection from competition or of money poured into pharaonic infrastructures. Many Britons voted for Brexit from a disillusionment with a fancied European Union imposed by politicians in London and Brussels. The egregious failings of the French way to socialism may result in Marine Le Pen becoming the National Front President of France. Similar populist revolts can be seen in Austria, in Germany, the Netherlands, and Italy on the right; and in Portugal, in Spain, and in Greece on the left.

As regards the people, not all is gloom and doom, however. Voters in Argentina, Brazil, Peru, Colombia, Guatemala, Mexico, seem to have had enough of Populism and have been throwing out vote-buying politicians. Not that the new ones have proved an unmixed success in every case but still the fight for liberty is present on that Continent. So, if a gullible people are not wholly to blame for the dangerous flirting with utopia that we are witnessing in so many lands, who is?

The clerisy

A group deserving blame are the professors, philosophers, sociologists, economists, and journalists who have committed la trahison des clercs, as Julien Benda called it, or the treason of the clerisy, to use the name given them by Deirdre McCloskey. For more than a century mainstream intellectuals have done nothing but extol the virtues of socialism, harp on the defects of the market, lament the alleged exploitation of the poor, and denounce the immorality of capitalism. Marxists, socialists (whether Christian or not), Fabians, progressives, radicals, New-Dealers, Beveridge liberals, and Keynesians have in effect done nothing but inspire or condone the fattening of Leviathan and the servitude of the individual. Intellectuals, undeterred by the failure of socialism, now speak of fairness, social

equality, and wicked bankers. I call this 'Pikettying'387 holes in capitalism. They are always silent on the magnificent results of the capitalist economy and the free market, especially for the poor. We see with dismay that the universities of Europe and America have been transformed into places where the philosophy of freedom has no place and is even forcibly expelled. Thus, Alan Kors has more than once explained what it means to be a believer in academic freedom in the liberal arts faculties of the United States or the social science programmes in Europe.388 Those unfaithful teachers and students shamelessly follow the recommendation of Antonio Gramsci that the way to make the socialist revolution is to monopolise the field of culture. The paradox is that we the classical liberals and libertarians do have in our midst the outstanding thinkers that can help us push back the tide of politically correct intellectual dishonesty but they are not heard in society as they deserve. The battle of ideas is as important as it was at the birth of our Society. It is a battle that especially concerns us here.

The politicians

The treason of the clerisy deeply influences politicians. We know from the work starting with Gordon Tulloch and James Buchanan that politicians maximise just like any other human being. They maximise votes but they could try to maximise votes also by helping maintain the institutions of freedom. However they do not want to appear as cynical seekers of personal gain. They need justification for what they do in the name of the common good. They also need public opinion support. It may be too much to ask them to be far-sighted and ask to strike out for freedom when the philosophers justify an inflation of rights and the media perpetually call for state action. Jose Pi–era, in his crusade to save democracy from the disaster of failed public pension schemes, has shown how crucial it is that we change the atmosphere in the media and the social networks. Why do the traitorous clerisy have such a wide hearing and the demagogues such a large following?

The rich and the media

To put it bluntly, it is because 'the rich' have a bad conscience. For the socialists 'the rich' is the likes of us here in the professions, in business, in gainful employment, and also the captains of industry and finance. Not us in the Mont Pelerin Society, of course, but many in the more affluent part of society are prepared to compromise, to take the middle road, to curry favour, especially in Europe and Latin America. The well-to-do seem to be always ready for compromise with the enemies of liberty. I sum their position with the symbol of an umbrella—the umbrella Neville Chamberlain carried to his meeting with Hitler in Munich. He thought he could face the monster with sweet reason, by showing his willingness to compromise—at the cost of Czechoslovakia!

The role of the Mont Pelerin Society

387 For more on the influence of Thomas Piketty, see my June 5, 2014 column, "Piketty Fever." 388 For more on Kors's work on academic freedom, see his page at FIRE.

Is there no hope? Of course there is. Nearly seventy years have passed since Hayek gathered a small group of thirty eight thinkers around him in the small village of Mont Pelerin, overlooking Lac Léman in Switzerland. The contribution of those pilgrims of liberty to building a better world, and the work of the many of us who have followed in their footsteps, has been crucial—I affirm without false modesty. But there is still so much to be done. We must always be ready to Battle for Freedom and to open new ways for the progress of our societies. We are still very much needed.

We must do so while preserving the 'broad church' spirit proclaimed by our founding members. Let me echo the Statement of Aims of our Society, agreed at the founding meeting of 1947. Ours is not a political intent. We want to join in the battle of ideas because the central values of civilisation continue to be in danger. The position of the individual and the voluntary group are being undermined by administrative power. That most precious possession of Western Man, freedom of thought and expression, is threatened by the spread of creeds whose object is to supress and obliterate all views but their own. We are unfairly presented as extremists to dismantle our defence of private property and the competitive market. Economic nationalism is rearing its ugly head again in the programs of those who would resist change and progress. Let me read in full the last paragraph of that Statement:

The group does not aspire to conduct propaganda. It seeks to establish no meticulous and hampering orthodoxy. It aligns itself with no particular party. Its object is solely, by facilitating the exchange of views

among minds inspired by certain ideals and broad conceptions held in common, to contribute to the preservation and improvement of the free society.

The latest danger for freedom is the spread of populism in our democracies, be it of the democratic kind or of those who use our liberties to try to destroy our freedom. We pilgrims of liberty have much to contribute to the fight against this new plague, because much of it originates in the realm of ideas.

We have the best ideas to win the battle against the treacherous clerisy. The battle of ideas is as crucial as it was in 1947, when Hayek founded the Mont Pelerin Society. Not only in the media and the social networks. Never forget: truth will prevail if the seekers for truth do not falter.

Capitalism and Its Name

Novmeber 7, 2016

Nothing is more fashionable than to run capitalism down. Capitalism is said to be gravely unequal and to have been based on the exploitation of the weak. It divides society into warring classes. Its progress has destroyed communities and even whole civilizations. It is turning out to be unsustainable, since it pollutes the atmosphere, depletes the seas, and endangers biodiversity. Its unbridled consumptionism undermines the ethics of work and of saving and investment that allowed it to flourish. It has substituted covert regimentation for the natural freedom of the individual. It has poisoned the higher human faculties by reducing them to mere instrumental reason. It sees society as a conglomerate of individual atoms rather than as a harmonious whole. At heart, it is deeply immoral, as it fosters antisocial greed and war-like competition, thus undermining the more fraternal and collaborative inclinations of humankind.

I will leave the defence against such accusations for another day. In this column I want to move on the attack. I do not see the history of capitalism as a tale of unalloyed progress untainted by cruelty: thus, for a number of centuries the merchant societies of Europe and America traded in slaves and exploited them; they were finally emancipated, not for economic reasons but by moral and religious impulse.389 But whatever its blemishes I want to show one of its undoubted achievements. I want to show what capitalism has done for the poor.

The name adopted by all The name ‘capitalism’ is well established by now and has been adopted even by the friends of individual freedom. The term was initially used as a pejorative for free market economics, coined by no less an enemy than Karl Marx and his friend Friedrich Engels. But slowly it has become a term of appreciation of the motley historical process that is delivering achievements in human well-being that even the blindest dogmatist must recognise.

An example of that newly found respectability is the publication of the two volumes of the Cambridge History of Capitalism in 2014; they are an unexpected scholarly contribution, a welcome ray of light amid the anti-liberal murk discharged by the Great Recession of the beginning of the 21st century. Thus, in the second volume of this collective work, Professor Leandro Prados de la Escosura has written a paper on “Capitalism and Human Welfare,” where he starts with the following assertion:

[In] a longer run comparison, encompassing the last half millennium, [...] the evidence suggests that industrialization and globalization had long-term positive effects on well-being, not only because higher income levels, but because inequality declined. (pg. 504)

389 Fogel (1989),"Afterword".

This is a handsome recognition of the powers of capitalism. However, 'the capitalist mode of production' (to use the expression of Marx, its arch-critic) should not be reduced to industrialization and globalization. First, as to the causes of the birth and spread of capitalism, one should dig deeper into the conditions whereby it came into existence. A purely materialistic interpretation of the progress of capitalism, as was that of Marx, is not only incomplete but can even be dangerous; the examples of Imperial Germany, the Soviet Union, and perhaps tomorrow's China warn us that the authorities may want to deflect the market economy in the direction of heavy industry and exports at all costs because they see capitalist development as an instrument of state power.

Second, as to the social results of the growth and extension of capitalism, highlighting 'well-being' and 'equality' is again superficial and may also lead public policy in an undesirable direction. Of course, higher income levels all round are one of the welcome consequences of capitalism. Of course, a free and competitive market economy reduces inequality much more than in traditional or planned economies can do. The analysis, however, should go deeper. These welcome results flow from a greater liberty of opportunity under capitalism. With welfarist and egalitarian measures, the authorities may unwittingly blind the road to further social progress. Public policies that suspend the working of competition to enhance well-being and equality may turn out to come at the cost of growth and of individual freedom. We must never forget that it is from individual freedom that all these goods flow—scientific advance, technical progress, capitalist production, reduction of poverty, social mobility, health and longevity, and also political representation— all the traits reflected in the United Nation's "Human Development Index".

Definitions of capitalism

Political discussion has traditionally been blighted by an insistence on a previous definition of terms. Aristotle, despite being empirically-minded and observant, thought that knowledge is advanced by the definition of essences of things and by the analysis of the distinctive traits summed in the definition of each essence. Essence chasing is a forlorn pursuit. So-called 'definitions' of capitalism should be seen as hypotheses about the conditions for the birth and development of this mode of organisation of society.

In practice, 'definitions' of capitalism by historians and institutional economists, under the guise of seeking to clarify the term, really highlight those of its diverse institutional elements that have brought about the obsolescence of traditional or command economies. Thus, when Deepak Lal (2001, pages 71 ff.), when defining capitalism, underlined the traits of individualism, of inquisitive curiosity, of social and legal environments favourable to merchants, and of the recognition of private property by the state, he was implicitly contrasting capitalist traditions and institutions with those of more stagnant societies. When Larry Neal, in his Introduction to volume I of the Cambridge History of Capitalism (page 2) added "markets with responsive prices", he was contrasting this with the instinctive rejection of market speculation and the hankering after 'just prices' of regulated societies. Neal's addition of "supportive governments" to his conditions for

capitalism is distinctive, in that it may surprise more than one free-marketeer, an idea Neal developed in the same book when presenting mercantilism as the historical matrix of free markets and free trade.

More unconventional still is Deirdre McCloskey's portrait of capitalism. (2006, page 14) To the typical definitions she adds free labour, markets responsive to prices; she substitutes the rule of law for supportive

government; and she crowns it with a reminder of the ethical consensus that prevents the sins of envy and of anger from killing innovation. This last element especially is distinctive of her emphasis on the moral and intellectual side of the capitalist revolution. She speaks of "bourgeois rhetoric" as a decisive element in the change towards a hardworking, prudently-saving, for-profit-investing society—first fully deployed in the merchant republic of the Low Countries. Those 'definitions', therefore, show some telling differences. So-called 'anarcho-capitalists' would reject out of hand Larry Neal's need for a favourable government as a condition of capitalism; and the same for Lal's conditions of "supportive governments". And this last condition clearly becomes a demand for state enforcement and intervention in Prado's essay, if one reads it in full.

Still, the contrast with the view of capitalism in the above 'definitions', with Marx and Engels' (1848) could not be starker. For those two communists it was the bourgeois class as a whole, not individual people, who created "productive forces more massive and colossal than the sum of all previous generations did in the past". And for them the accumulation of physical and financial capital was a self-moving engine driven by irresistible historical laws, not as for McCloskey the result of a change in moral values.

All this shows that we are not dealing with definitions but with contending historical hypotheses about the necessary institutional conditions and intellectual and ethical beliefs for the progressive establishments of free markets.

How the poor fare under capitalism

Let me start the debate on possible explanations by recording present-day progress. In the year 2000, the United Nations set the world the task of attaining the "Millennium Development Goals" (MDG). Those goals were:

1. Eradicate poverty and hunger; 2. Achieve universal primary education; 3. Promote gender equality and empower women; 4. Reduce child mortality; 5. Improve maternal health; 6. Combat HIV/AIDS, malaria and other diseases; 7. Ensure environmental sustainability; 8. Develop a global partnership for development.

On all of them there has been progress, as noted in the 2015 Report on MDGs. Let me focus on the eradication of poverty and hunger.

Using dollars corrected for inflation, the first Millennium Goal was "halve, between 1990 and 2015, the proportion of people whose income is less than $1 a day". In fact, taking the even higher cut-off limit of $1.25 a day, the goal of halving the proportion of the very poor compared with total population was reached five years in in advance, in 2010. For the period 1990-2015, the actual results (illustrated in Graph 1) were:

- Extreme poverty has declined significantly over the last two decades. In 1990, nearly half of the population in the developing world lived on less than $1.25 a day; that proportion dropped to 14 per cent in 2015. - Globally, the number of people living in extreme poverty has declined by more than half, falling from 1.9 billion in 1990 to 836 million in 2015.

Graph 1. Number of people living on less than $1.25 a day worldwide, 1990-2015

A reduction of the extreme poverty rate from 47% to 14% is a development to be hailed. And so is a reduction of the number of the very poor by 2.44 million. But the authors of the report fairly remark that

"despite enormous progress, about 800 million people still live in extreme poverty" (UN 2015, Overview, page 8).

Angus Deaton (2013, pages 249-255) takes World Bank figures and dates: $1.25 in 2005 dollars, which for a family of four means $1,825 a year. On that calculation, the number of those extremely poor people fell from 1.5 billion in 1981 to 8.05 million in 2008. Given a population increase in those years of almost 2 billion people, the proportion of a smaller number of the very poor on a larger population must have fallen even more quickly: so it was—from 42% to 14%.

These figures necessarily must be approximations, given the difficulty of obtaining them across the world and referring them to people in so many different social situations. Poverty can be measured by estimating total income or total spending by two methods: one is by household surveys, by asking families and counting how many live in the home; the other is by national income accounts, which should have figures for the per capita income and spending for each country.390 Whatever their accuracy as regards absolute numbers, these two sources can be used to check each other and, as Deaton underlines, they are more reliable for showing trends. Further, one needs to decide what exchange rate to use when comparing expenditures or incomes between countries with different currencies. Market exchange rates are volatile and reflect many different circumstances, so it is better to define the exchange value by comparing the purchasing power of moneys in their respective countries. Even so, Purchasing Power Parities (PPP) give disputable results. A last thought (Deaton, page 255) is that in countries where the poor make up a substantial proportion of the population, there are millions of people who are just above or below the poverty lines, so that a small change in definition increases or reduces the numbers substantially.

Still, the large and encompassing result is that, despite their approximate character, the numbers do give a reliable indication of betterment. The increase in income per household together with the increase in population is a clear indication of better standards of living. As McCloskey (page 16) recounts, from 1830 to 2000 the population of the world increased "by a factor of six". Meanwhile, she adds, "[t]he amount of goods and services produced and consumed by the average person on the planet has risen since 1830 by a factor of about eight and a half." This last means that total production per capita must have increased fourteen and a half times—not by 14.5 per cent but by 1,550 per cent. Thomas Malthus refuted by capitalist productivity!

Individual well-being under capitalism

390 Pinkowskyi and Sala-i-Martin (2009) merge both survey and national income data—a cross check that makes their results more reliable. Also they present their results in the form of bell curves, which allows one to see their results intuitively in as far as they differ from a (log)-normal distribution shape.

The phenomenal increase in productivity per head from the time of the merchant city-states of northern Italy in the 13th century to the present day has been the main engine of the betterment of the human condition during the last five centuries. In the explanation of the late progress of humanity, That is why I wish to separate the element of echt Kapitalismus from the social welfare admixtures of our time.

No doubt the welfare capitalism created in the West during the last century has directly or indirectly increased the well-being of mankind. In the above-mentioned essay, Professor Prados follows the example of many other distinguished economists in preferring to measure the progress of capitalist societies by 'wellbeing' rather than by productivity per head.

Well-being he defines as does the United Nations with their above-mentioned Human Development Index (HDI), which apart from national income per capita includes life expectancy at birth and schooling and literacy. In some versions HDI is corrected for inequality, thus insensibly affirming the superiority of socialdemocratic capitalism over laissez faire capitalism.

In no way do I mean to say that well-being as measured by the HDI is not important. Also, the progress of GDP per head is in any case partly influenced by advances in the dimensions reflected in the metrics of the HDI; there is feedback from health, education, 'agency', and equality to productivity as measured by the GDP per head.

But in greater part these developments are uses rather than causes of growth of the national product. One could even see these redistributive social policies mostly as detractions from the growth brought about by the free market.

The growth of production per head

In sum, we should take the gross domestic product per head as the best indicator of the phenomenal progress of our societies during the last seven centuries. With all its defects as a measure of income391 and the imprecision of the data for remote periods, GDP per head comes nearest to measuring the effect of the capitalist system on society, as if it had been throughout a laissez faire system.

The classical source of the evolution of per capita GDP is the great economic historian Angus Maddison (1926-2010), who died after a life of unremitting research. His disciples and friends have decided to continue his efforts in the "Maddison Project: collaborative research on historical national accounts", one of which is illustrated in Graph 2. GDP per capita, inflation adjusted:

391 See Angus Deaton (2013), pages 169-173. GDP per capita includes income generated in the country for the benefit of foreign parts, undistributed company profits, and budget surpluses of the federal state and local government. From the point of view of personal progress we might want to use personal disposable income or even consumers' expenditure.

Graph 2. GDP per capita, inflation adjusted

Source: M Tracy Hunter.

Graph 2 sufficiently justifies me when I speak of 'the economic miracle of capitalism'.

The anti-capitalists out in flight

Though born in Scotland, Angus Deaton, 2015 Nobel Laureate in Economics, is by inclination an American liberal rather than a classical liberal. In his nuanced analysis of what he calls The Great Escape (2013) he shows that advances in health in part independent of the market have contributed to improve the fate of humanity.

The containment of illness and the extension of life we have witnessed during these last two centuries are no doubt due, at least in part, to government intervention and international policy. I myself many years ago wrote a piece on Edwin Chadwick and John Stuart Mill, where I told the story of their defence of administrative intervention to fight the spread of cholera in some London quarters by having local authorities clean contaminated drinking water. (Schwartz, 1966). Deaton grows eloquent on the contributions of states to life-transforming health care.

Here I call again on the authority of McCloskey when she underlines the spiritual and moral elements in the history of capitalism.392 The purely materialist view of the development of capitalism presented by Marx and Engels is still excessively influential. It is not just that the health improving measures eloquently recounted

392 Deepak Lal (1998) also underlines the element of individualism and scientific curiosity, as added to factor endowments and politics, for the explanation of then 'Promethean' growth of capitalism.

by Deaton would have been out of reach for the majority without the economic productivity of free markets. More importantly, the advances in knowledge on which the health miracle is based are at bottom the result of freedom of thought and discovery. And so is the free market. Capitalism is but one of the forms of individual liberty.

Tunnel Vision

December 5, 2016

Those of us who have seen The Bridge on the River Kwai will never forget the upright character of Colonel Nicholson, blindly intent on building a railway bridge for the Japanese to the best specifications. He wants to do a superior job, so as to restore the morale of the prisoners he commands and to show the Japanese what the British are capable of. It is only at the last minute that he sees the larger picture wherein his work fits. The broad frame is the war that the Allies are waging against the Axis nations in the Far East. He blows the bridge up unwittingly when falling dead with the words "What have I done?" A man intent on doing a good job to the best of his capacity may be causing much greater harm, which he cannot see for his blinkers.

The danger of eclecticism

During the 20th century and the early years of the 21st the positive effects of the free market and globalisation on the welfare and equality of the poor of the world have been spectacular, as I mentioned in my previous column.393

- Extreme poverty has declined significantly over the last two decades. In 1990, nearly half of the population in the developing world lived on less than $1.25 a day; that proportion dropped to 14 per cent in 2015. - Globally, the number of people living in extreme poverty has declined by more than half, falling from 1.9 billion in 1990 to 836 million in 2015. -

Such a fall in the number of the poor must by itself have meant a drastic reduction of inequality (unless you know no arithmetic). However, nothing is more fashionable than to run capitalism down. Capitalism is said to have been based on the exploitation of the weak. It divides society into warring classes. At heart, it is deeply immoral, as it fosters anti-social greed and war-like competition, thus undermining the more fraternal and collaborative inclinations of humankind.

I shall have much to say to rebut those accusations and praise capitalism in future columns, but my kind readers will have to wait to see me shift this heavy load of accusations. Today however I want to grapple with a different problem. First, I do not see the history of capitalism as a tale of unalloyed progress untainted by cruelty. And secondly, there are indeed occasions when the market could be supplemented by administrative and legal intervention.

Does this mean that we are right to shut out from our vision the negative side of capitalism? Or does this mean that we ought to take a middle stand and wade in the bogs of Franklin D. Roosevelt-style liberalism instead of moving up to the clear waters of alpine freedom? I remember Karl Popper once saying to me about a middle-of-the-road speaker: "Pedro, this man is an eclectic. What can we do with

393 Pedro Schwartz, "Capitalism and its Names.". Library of Economics and Liberty, Nov. 7, 2016.

an eclectic?" With Popper looking over my shoulder, let me explain how I understand the limits of the market and of administrative intervention, while steering clear of eclecticism.

Health and the free market

Angus Deaton (2013) has posed a fundamental difficulty for us defenders of market capitalism. In a most challenging book he respectfully criticizes Robert Fogel (2004) for putting excessive weight on nutrition and human growth for the explanation of economic progress in the 18th and 19th centuries in the Western World, and too little on those measures of public health that were taken even before improvements in medical knowledge and technology entered the scene. They both agree that "the great escape in human history is the escape from poverty and death". (Deaton, page 23) But for his part, Fogel thinks that the greatest cause of the increase in the life-expectancy of populations, and of the height and weight of individuals in those centuries, is explained by food, the production and consumption of food. Deaton does accept that poor nutrition was the trap that kept populations in ill-health, but he holds that the great increase of life expectancy from the middle of the 19th century, and more clearly in the 20th century, are not the exclusive effect of increased productivity. Since the progress and the application of medical technology are largely due to publicly subsidized research and administrative intervention, this means that a great part of the progress in the well-being of humanity in the West and now in underdeveloped countries happens outside of or beside the operation of the free market.

In defence of Deaton, one can adduce an observation of Samuel Preston's (1980), who in the upward march of human health sees not only a correlation between income per capita and life expectancy, but an unexplained upward shift, which indicates that "some systematic factor other than income must be responsible". That cause must surely have been changes in hygiene and public policy in the 18th and 19th centuries, and in the 20th advances in medical knowledge—only partially connected with capitalist productivity per head. To the health factor Deaton gives the whole of Part I of his book. He there recounts the huge extension of lifeexpectancy, especially after 1945, due to steep falls in child mortality and maternity deaths, by the conquest of infectious diseases; and to the prolongation of life in middle and old age. The question for us arrant pro-capitalists is that the advances in epidemiology and public health that have had such a large effect on the length of life were not launched and delivered wholly through the market and by the private sector. This demands a recasting of the argument for free markets. Such is the question I want to face, and if possible solve, in this column. To solve this whodunit I want to explore whether we can find a value to which both the market and public administration are beholden.

Foreign aid as a counter-example for interventionists

A spotlight can be shone on that awkward question by recalling the disappointing results of most forms of international aid to developing nations. William Easterly is

a widely-known critic of foreign aid to developing countries. He has lately summed up his lifelong experience in the 2015 Hayek Memorial Lecture at the IEA.394

First, according to Easterly, the dispensers of aid mostly lack the local knowledge needed to reach their humane goals. Their aid-and-advice kits are as useless as the Five Year Plans of Real Socialism before 1989 and for the same reason. Secondly and from hard experience, Easterly laments how experts who manage aid programs despise poor people and dictate to them, as if they had no rights. He reminded us in his lecture of the inhumane campaign of coerced sterilization imposed by Indira Gandhi and carried out by her son Sanjai in 1975-76 on thousands of men and women, with the World Bank and other International Aid Agencies turning a blind eye. The need to control word population (in any case misplaced) seemed to excuse impositions on 'poor, ignorant people' who did not know what was good for them. Easterly gives other examples of overbearing behavior by authorities aided and abetted by aid donors, when private landholdings were consolidated at gun point with total disrespect for individual rights in the name of efficient agriculture.

Of course, the 'rights' Easterly has in mind are the fundamental freedom-rights or 'negative liberties' that Isiah Berlin defined. He does not mean the 'positive liberties' or capabilities and functionings of Amartya Sen and other social-liberals of the aid community, to be fostered by means of entitlements, subsidies, free health, free education, and public pensions. As Easterly well says, the first condition for international aid to attain the hoped for results is respect for the personal, legal, and political liberty-rights of the inhabitants of less developed (and indeed welldeveloped) countries. He concluded that the problem "is not a shortage of experts but of rights".

Indeed, Angus Deaton would, I think, fully agree with Easterly when passing judgement on international development aid. The third part of his book deals with the unexpectedly negative consequences of foreign aid on the countries that receive it: the funds do not reach those in need, foster political corruption in recipient countries, displace local humanitarian efforts, result in the satisfaction of the donors rather than the progress of the poor... He chastises the "aid illusion", that increasing the amounts given would solve the problem of poverty; he decries the "hydraulic view of aid", whereby the aid process consists only of letting. He warns against the misuse of funds because "aid is fungible" in that it can be used to substitute for existing investment and so wrongly appropriated. Especially mischievous, he adds, is the poor record of foreign aid to undemocratic regimes. Even medical and health aid, so much easier to evaluate for its results, can misfire. Deaton concludes that much of what Peter Bauer said in his (1972) Dissent on Development was right when he traduced government aid and pointed at the counterproductive effects of well-meant development plans.

So, in the matter of foreign aid it is rather counterproductive to underline the political and expert side as an example of what can be done in correcting market

defects. The market would say 'Trade, not Aid'. And in any case political and expert intervention clearly does not help absent a framework of freedom-rights. Deaton should ask himself why it is that expert aid programs that are successful in advanced democratic and a few developing countries, such as Botswana, can fail dismally in needy societies that need them most. My answer in this column is that experts are short-sighted when they ignore the matrix that makes both capitalism and public administration work best, to wit, the respect for individual and political freedom.

Historical blemishes and by-ways

It would not do if I left the inhumane parts of the story of capitalism out of this chapter. I have made an allusion to the domination of extractive rather than productive government in Iberian America. First was the contagion of the natives with smallpox, diphtheria, varicella, and other illnesses unknown in the Americas, then the harsh serfdom imposed by the Castilians took a cruel toll among the indigenous workers and imported Negroes. From the point of view of economic growth it caused in Castile what could be called 'the silver curse', since the precious metals extracted from such mines as Potos' in today's Peru and Zacatecas in today's Mexico allowed the Spanish King to engage in fruitless religious and political wars in Europe. I do not need to say that this was not the first nor the last 'extractive' conquest in the history of humanity

The Portuguese and Castilian feats of discovery in the Far East and Americas did contribute signally to the development of capitalism in Europe. Spices and silk came round the Cape or from the Philippines to slake the thirst of white men for luxuries. Goods from Flanders and Italy were purchased with American silver to be transported across the Atlantic. The monopoly of the trade with the 'Indies', as Latin America was called then, imposed by the Castilians, was an incentive for the violent exactions of pirates and privateers, whose silver booty went into the monetary bloodstream of the world. So did legal smuggling, since foreign powers were variously allowed one trading ship a year and additionally profited from the slave trade. Still, the language, the religion, the laws, the architecture of the Iberian Peninsula left their mark on large expanses of the world. One must not forget the 'Columbian exchange' of plants and animals, from horses, vines, and corn one way, to tobacco, maize, and tomatoes, the other. All in all, the 'discovery' of America had large commercial, financial, and inflationary effects on the world economy, from Europe to China.

More generally speaking, the drive of capitalist states to establish or impose colonies on parts of the world unable to defend themselves against the military might of the West was often seen as a necessary ingredient of the accumulation of capital for the growth of capitalist economies or their survival. Vladimir Lenin published a pamphlet titled Imperialism, the Highest State of Capitalism in 1916, as an attempt to explain why the great powers were immersed in "the first world imperialist war" and why the capitalist system needed to conquer colonies to suspend the necessary law of its demise. For Lenin, capitalism had reached the 'monopoly stage' when the exploitation of national markets had reached a limit and

surplus capital was forced to be invested in colonies, with the indirect effect of buying the subservience of the domestic working class by granting it a share in the colonial booty.

Lenin was wrong on both counts. Industrialisation need not start with the primitive accumulation of capital invested in heavy industry. And the capital needed for industry was not dependent on the exploitation of colonies. Indeed, the capital needed for the Industrial Revolution in Britain was principally domestic; and the largest part of its capital exports went to non-colonised regions. Often the opening of markets at gun point was followed by the opening of markets to free trade. Another reason for rejecting Leninist theories of colonization was that the exploitation of subservient regions did not turn out to be for the benefit of the metropolis, though it may have profited individual politicians, civil servants, and interest groups. A final reason is that in most colonising countries, the moving cause was nationalistic assertion, especially after the Congress of Berlin and the 'Scramble for Africa' and the Far East. By 'scrambling for power' capitalist nations were taking the path that led to World War I.

Marxist critics especially have often insisted on a tendency of the capitalist system to engage in war as a solution for its internal contradictions, just as they said that exploiting colonies were a necessary late phase of the system. Mark Harrison (2014) has written a balanced essay on this hobby-horse of the anti-capitalist left. The main evidence proffered in favour of this thesis is the reduction in unemployment in Germany under a rearming Hitler, and the reduction in United States unemployment due to the World War II effort. Budget deficits and military expenditures in Nazi Germany were too small to explain a trend that had begun before Hitler became Chancellor. (Harrison, page 358). In the U.S. case, the government of course reduced unemployment by pulling "the equivalent of 22% of the pre-war working population into the armed forces". More importantly, the evolution of employment in both Germany and the United States in the aftermath of WWII goes against those assumptions. The 'economic miracle' in the Federal Republic starting in 1947 and its attendant new employment happened with the total demobilisation of its military. And the cut in military expenditures in the US from 1944 to 1947 by over 37% did not stand in the way of the creation of 3.9 million civilian jobs in those years. Harrison's conclusion is that compared with other systems "liberal capitalism seems to have least in common with war". (page 376)

The end of slavery as a counterexample for materialists

Slavery is 'natural', in the sense that it has been widely imposed and practiced in most human societies in history. The idea that men are equal, that labour should be free to move from one employment to another, and that persons could not be owned by others is very recent and still not recognised in some societies.

Aristotle is often invoked as evidence of the acceptance in history of this 'natural' practice. He did discuss the conditions under which slavery would be ethical. But the aspersion is not quite deserved. True, he explained the existence of slavery in

Greek poleis so that they could perform their social and political activities. True again, he did speak of 'natural slaves' and 'natural freemen'. He was, however, much nearer to today's view of things than that of many politicians and slave owners in the antebellum society of the American South. For him a slavish nature was social in character, not genetic. The slave could progress and be redeemed by cultivating the ability to reason and deliberate. Only foreign or barbarian slaves, unaccustomed to the ways of a civilised polis, were better kept in servitude.

The ideology and practice of slavery under capitalism became much harsher than Aristotle accepted. Slaves were taken in war. The victors, after the sacking of an overrun city, often slayed all males and kept women and children in servitude. In more modern times, the crew, troops, and passengers were taken back by pirates to Barbary and enslaved or freed for a ransom. A new practice was that instituted by the Portuguese, Spanish, and then French and English traders, who bought slaves from African kings who in their turn took them by force.

The basis for the supply of Negro hands to the New World by the cruel slave trade was called forth by the demand in Europe for sugar principally, and then cotton and tobacco. That trade and the use of forced labour was typical capitalist business in search of profit, only in this case based on the forcible seizing of indigenous people in denial of the property of their persons, Without Consent or Contract as Fogel has branded it. In all, from 1500 to the 1860s when the trade came to an end, "some 9,900,000 Africans were transported across the Atlantic"—this without counting those that perished in the crossing. (Fogel, 1989, page 18) Surprisingly for us today the largest single importer was Brazil with 41 per cent, the next the

English, French, and Spanish colonies taken together with 47 per cent, and the present-day US last with 7 per cent.

The first step on the road to the abolition of slavery was the prohibition of the slave trade by Britain in 1807, a triumph of non-conformist Protestants led by William Wilberforce and other radical humanists. It was then enforced by the Royal Navy. The prohibition did not fundamentally weaken the 'peculiar institution'. The reason was a technological innovation in agriculture, namely the spread of 'the gang system'. This consisted in applying the division of labour within slave gangs in the production of sugar, cotton and tobacco. Families worked as teams, the strong men forging ahead with the heaviest duties, the women following to pick up the product laid by the men, and the children following up with ancillary tasks. This resulted in a large increase in productivity, directly through specialisation, and indirectly through ease of control of the slaves; farms were consolidated, the labour force disciplined, and production streamlined. Not only did that transform the states south of the Mason-Dixon Line, but it also revived the sugar and tobacco industries in the Spanish possessions of Cuba and Puerto Rico.

Now comes a most important point made by Fogel. The peculiar institution, far from decaying and imploding, was increasingly profitable. The demands of the slave-owners to extend slavery to the new territories and states was not due to the need to stave bankruptcy but to a desire for more profit. Capitalist production and

profits multiplied the economic viability of slavery. The slave system was not on the wane through loss of productivity.

Fogel, with the help of Stanley Engerman, and other 'cliometricians' (or historians compiling and modelling economic statistics) found however that "slave plantations were more efficient than free farms"; that the "food, clothing, and shelter provided to slaves were far better" than they had imagined; that whipping, though widespread but combined with was meant to help with productivity; that "slave breeding [...] was neither general policy nor a major source of profit"; and that there was "more scope for the development of slave family life, occupational skills, and a more distinct culture than convention dictated" (Fogel, 1989, pages 390-392). Fogel concluded with the following unconventional thought:

Suppose [...] every claim of the planters regarding the benevolent treatment of their slaves was confirmed; suppose slaves were better clothed, fed, and housed than proletarians. Would that be enough to quash the moral indictment, to relieve masters from the charge of profound injustice? [...] While physical abuse compounded the immorality of slaveholders, good treatment is insufficient to free them from condemnation. (Fogel, 1989, page 392)

In the Afterword to Without Consent or Contract titled "The Moral Problem of Slavery", Fogel listed four counts against the slaveholders of the South, which I proceed to summarise. The first was the unlimited personal domination of one group of people over another, including the abuse of physical, sexual, and spiritual power. The second was the denial of economic opportunity, especially galling at a time of rapid technological progress. The third was the exclusion from citizenship. And the fourth, the almost impassable obstacles to cultural self-identification (pages 394-400). There were some derogations of these abuses, especially those obtained by the slaves themselves in their defence of family values, in their cultivation of religion, in their acquisition of artisan skills, in their musical achievement. But the general panorama was abysmal, unredeemed by the fact that capitalist productivity was so much better than in free farms and activities.

The story of the demise of slavery I take to have great significance for our evaluation of capitalism. The system is not to be judged purely by its material consequences. Relative or temporary happiness brought about by productive efficiency or growth cannot be the last word. Absent liberty and self-government, the situation would be inexcusable. We now can see that capitalism has as its essence individual freedom-rights. Without respect for these rights the system is in danger of turning into a monstrosity, as it would have in an unchecked antebellum South. It did so in Wilhelmine Germany and could do so still in cryptocommunist China. Again, as in the case of the developing regions of today, libertyrights are of the essence of capitalism as an improving force for humanity. If we do not see this we run the danger of suffering from the same tunnel vision of colonel Nicholson at the River Kwai.

George Bernard Shaw and Creeping Socialism

February 6, 2017

The absorbing biography of George Bernard Shaw (1856-1950) by Michael Holroyd, which lay in my library since 1988 among my books on political theory, has opened my eyes to the dangers of what I call "creeping socialism." This is a species of soft collectivism that was born at the end of the 19th century, lay half dormant during the interwar years, flowered under the guise of the welfare state and social democracy after World War II, and is now rampant in the 21st century. The real nature of this far from innocuous infection was hidden to western eyes by the dreadful experiments in 'real' socialism, stated in earnest by Lenin and Stalin in the Soviet Union, Mussolini in Italy, Hitler in Germany, and Mao in China. With the end of the colonial era, real socialism morphed into planned socialism in India, Latin America, and Africa. But all the while, the soft collectivism personified by Shaw and his Fabian companions in Britain and paralleled by Social Democracy in Sweden and American liberalism in the United States, spread almost unnoticed in the advanced democracies and is making a comeback in the Great Recession years of the present century.

I am very partial to Anglo-Saxon biographies (as we call them in my part of the world). Given the decline and fall of the historical novel from the heights of Tolstoy's War and Peace or Graves's I, Claudius, I now much prefer the combination of empathy and fact in solid biographical portraits. Biographers face a more difficult task than do novelists: they must reconstruct the personality of their characters, make them live on the page rounded and full bodied, warts and all—but ground their tale on authentic documents so that historical truth is respected. The biographer must be governed by empathy rather than fantasy. He must also conscientiously recreate the times and places where his story unfolds. As an outstanding example let me recall Lord Robert Skidelsky's John Maynard Keynes,395 in which the complex personality of his hero and the quickly changing circumstances of the first half of the 20th century are portrayed in careful detail. The only trouble with present day biographies is that they usually run to three tomes; Skidelsky's Keynes is in three volumes. So was Holroyd's Shaw, plus a booklet on the ructions around the testaments of Shaw and his wife Charlotte. Still, I found Holroyd a great read, especially for the portrait of the mercurial, intelligent, gifted, unrealistic Shaw and for the analysis of the Fabian Society, both specimens of what it meant to be a socialist before WWI, in Victorian and Edwardian times.

My view of Shaw was out of focus. I had heard of his vegetarianism, of his cycling prowess, of his championing of Wagner, though I wrongly thought he knew no music. I had also heard of his mariage blanc and had laughed at tales of his many witty remarks. In sum, I saw him as a sarcastic rationalist lacking

in human emotion. My view was incomplete if not downright wrong. When I first came to England as a young student in 1952, he had just died and a battle was being waged over his will. I read him avidly to start understanding that strange country—a straitened but

395 Skidelsky, Robert (1983, 1992, 2000): John Maynard Keynes, 3 volumes, Penguin Books.

benevolent society, on a path towards generous social welfare that the Conservatives then back in power would not abandon. Shaw's plays I loved for their common-sense philosophy and sharp humour; the comments on society in his prefaces and essays I found enlightening. Of course capitalism was unjust and inefficient! Naturally socialism was inevitable and to be welcomed! But the road he wanted to follow was not holistic and revolutionary but municipal and piecemeal, what Hyndman, the leader of the (revolutionary) Social Democratic Federation, derisively called "gas and water socialism" in the stormy 1880s.

Socialism and the Arts

Very early in his native Ireland, Shaw came to reject market capitalism in disgust at the squalor of the Dublin slums. His family was always on the edge of poverty, despite its roots in the respectable Protestant middle-class. At home, there was lots of music, encouraged by the continuous presence of a Svengali figure called Vandeleur Lee, a voice teacher and musical impresario who engaged Shaw's mezzo-soprano mother and later his soprano sister in his musical ventures. Shaw did not learn music during his unhappy infancy but later heroically and virtually on his own taught himself to read it and play the piano. So, in his many years as a whimsical opera and concert critic, he built his apparently amateurish judgments on solid foundations. This side of his personality is clearly visible in his socialism: he detested the bad musical taste of the bourgeois society of his time and hoped that under socialism the working classes would acquire refined tastes and enjoy the higher pleasures of culture.

A lifelong friend of Shaw's, William Archer, first took notice of him in the library of the British Museum when on Shaw's desk he saw a French translation of Karl Marx's Kapital and the open score of Wagner's Tristan and Isolde. Shaw soon moved away from Marx, thanks to Philip Wicksteed's criticism of the Marxist labour theory of value. He realised that even from a socialist point of view it was wrong to maintain that the value of goods was determined by the quantity of labour expended in producing them; value depended on supply and demand and ultimately on the utility of the commodity for the consumer. From this Shaw concluded that socialists should not see society as divided into the working class producers of value on the one hand and their capitalist exploiters on the other. The division in society was between producers of all classes and the idle rich who unduly appropriated land rents and the interest of capital. If land and capital were appropriated by the state, their rent would be enough to lift the labouring poor from destitution and ignorance. "Socialism is and always had been an attack on idleness," he concluded.

Shaw at the Fabian Society

Thus freed from the influence of Marx, he felt able to join the recently created Fabian Society (1885). He there was lucky to befriend Sidney Webb (1859-1947), with whom he would work in tandem for many years. Webb, a number crunching civil servant, was the very opposite of Shaw in character and attainments. Where Shaw had a lightning brain, entrancing delivery, and masterly pen, Webb was a

memoriser of statistics, an inaudible speaker, and a leaden prose writer. Also, Shaw was an out-and-out individualist; Webb a collectivist. However, they formed a potent pair. How could an individualist like

Shaw swear by the collectivism of his friend and his equally potent wife, Beatrice Webb (1858-1943)? The three of them saw capitalism as a wasteful and anarchic system. A socialist country would be marked by efficiency and order. It is true that for Shaw the aim was wider than efficient collective administration: only in a Socialist society, free from the curse of the market, would people have the education and time to cultivate the arts; and only in a socialist society would working class men and all women be free from the straightjacket of Victorian conformity and able to fulfil their personal capacities. The order and efficiency dimension of his vision he got from Webb, with the latter's intimate knowledge of the social conditions of the people of England.

The Manifesto396 of the Fabian Society came from Shaw's pen. It is a two-page tract lamenting the social situation of England in 1885 and demanding profound change. "Under existing circumstances wealth cannot be enjoyed without dishonour, or foregone without misery," it started. Mal-cultivation "makes the Nationalisation of land in some form [...] a public duty." Capitalism falsely pretends to encourage invention and does not share its benefits fairly. Competition forces national industry to reduce quality, deal dishonestly, and organise inhumanely. The state should compete vigorously with private industry and renounce all public monopolies, such as the Royal Post. Aristocratic privilege would disappear, gender equality be established, education publicly financed, and state institutions would take unhappy children from their incompetent families (he had been one such). He concluded:

That the Established Government has no more right to call itself the State than the smoke of London calls itself the weather.

That we had rather face a Civil War than such another century of suffering than the present one has been.

The call for a Civil War became rather muted after the Local Government Act of 1888 allowed the Fabians to take part in the government of the London County Council, and in that of the different Town Halls. Shaw served as a municipal counsellor for his vestry for as much as six years.

Shaw was an active Fabian for a considerable time, writing Tracts for the Society, lecturing in and around London, trying to change the conduct of affairs of his townhall. He had also embarked on an unconventional but in the end successful career in the theatre, writing plays with which he tried to change the mores of Victorian society. He proposed the ideal of the New Woman, according to Henrik Ibsen, tried to demolish the marriage and divorce laws, traduced vivisection in consonance with his vegetarianism, and dismantled the heroics of war. On the personal side those years were also full of drama, not least in his many simultaneous flirtations and love affairs.

396 Available online in the London School of Economics Digital Library at "A Manifesto". Fabian Society, 1884.

Shaw's contributions stand out for their originality amid a great flurry of penny pamphlets demanding the municipalisation of milk supply, pawnshops, slaughter houses, fire insurance and whatnot. Thus, his Tract number 107 was titled Socialism for Millionaires (1901)397, where he commiserated with the very rich because they could not manage to spend their money on themselves as they had everything they could wish. Another one of Shaw's was Fabianism and the Empire (1900), written on the occasion of the Boer war, which split the Fabians. Surprisingly, Shaw became an imperialist. He detested that and all wars, but that disgraceful conflict could be redeemed if it led the British to administer the Empire for the good of the whole of humanity. Also, in a letter at the time of publication he wrote: "As for me, I delight in the war more and more. [...] It has put fourpence on the Income Tax which will never come off if the Fabians can help it; so that Old Age Pensions will be within reach at the end of the ten year repayment period, if not

sooner".398State pensions came indeed at the end of ten years, with Lloyd George's "People's Budget". Shaw's imperialism was a worrisome development, since in the 1920s and '30s the ideology of imperialism combined with the demand for social reform was the mark of Fascism and Nazism.399

Webb's organicism

Webb, as I say, was more of a bureaucrat than Shaw. Collective government was the object of his endeavours. He wanted to do away with the disorder of the market and its crises through an efficient public administration. 'National efficiency' was the by-word of the New Liberals who had moved away from William Gladstone and nearer to the German model. Webb's innumerable penny pamphlets dealt with 'Facts' and 'Figures' for London, with practical advice on the municipalisation of services, with proposals to change labour laws and institute the eight hour day. Especially revealing of his thought was his well-argued Tract number 69, The Difficulties of Individualism (1896).400

Webb argued that modern society was slowly and unwittingly moving in the direction of socialism. The laissez faire of the Manchester School was revealing itself as "an untried and nebulous utopia". Far from fostering individual liberty, the uncontrolled scale of production brought about by the Industrial Revolution had led to a new kind of feudalism accompanied by warlike "internecine competition". At the top of society one could see, "absolutely unproductive classes [...] exercising the ownership of land and capital" and lording over "industrial slaves". The cause of this unbalanced and unfair distribution was the effect of the (Ricardian) law of rent, where the means of production were in private property. This led to the remuneration of the toiling masses being "determined at the margin of the worst

397Available online in the London School of Economics Digital Library at "Socialism for Millionaires", by Bernard Shaw. Fabian Society, 1901. 398 Holroyd, Michael (1988): Bernard Shaw, 4 vols. Penguin Books. Volume I, page 243. 399 Dahrendorf, Ralf (1995): A History of the London School of Economics and Political Science. Oxford University Press, page 45. 400 Available online at the London School of Economics Digital Library at "The Difficulties of Individualism", by Sidney Webb. Fabian Society, 1896.

land" and the least productive capital. "The tribute of rent and interest" (he revealingly called it 'tribute') amounted to one third of the annual product. If land and capital were to be nationalised without compensation, there would be ample room to accommodate the needs of the great majority.

Another serious difficulty of individualism "is its inconsistency with democratic self-government". The employment of great numbers in industry led to collective action, be it by legislation or by trade-union action. Socialism is thus "the steady expansion of representative government into the industrial sphere". As a result of this process, the "captains of industry [...] be deposed from their individual command and turned into salaried servants of the people".

Those were Darwinian times, so Webb had to explain how society would modify the inhumane effects of the law of 'the survival of the fittest'. For Webb, a primary duty of government was to define the plane on which it will allow the struggle for existence to be fought out by its members. Since "a society was something more than the sum of its members [and ...] life and death distinguishable from those of its individual atoms," it had to deal with competition so as to turn it collaborative rather than hostile.

Industrial democracy must [...] necessarily be gradual in its development. The time may never arrive [...] when individual is entirely merged in collective ownership or control, but [...] every attempt to grapple with the 'difficulties' of our existing civilization brings us nearer to that goal.

As Holroyd says, the endeavour of Webb and of the whole group of Fabians was to promote socialism 'by permeation,' at least in England. Their Society was a forerunner of today's think tanks. Their group, which soon grew in membership to some 400, was guided by an ideal, that of a society where private property in land would have disappeared; where solidarity would have replaced money-grabbing; where everybody would have to work for their subsistence, where the social conventions of the middle and higher classes would be seen as sheer hypocrisy. Through the years they strove for high and progressive taxes on wealth, inheritance, and income, to pay for an all-encompassing welfare state; all this accompanied by growing paternalistic regulation. Over the long run they were improbably successful. Two World Wars changed circumstances so profoundly that their proposals became commonplace. The changes they had striven for were a reality by the middle of the 20th century. It is security before liberty everywhere and there seems to be no turning back.

The London School of Economics

In 1894 an unexpected legacy made it possible for the Webbs, helped by Shaw, to set up a school dedicated to disinterested research in the social sciences. Sidney, "knowing that research inevitably led to socialist conclusions" and despite his socialist leanings, wanted to create a scientific institution rather than a propaganda

set up. "Facts shall make you free" was one of Webb's mottoes.401 So was born the London School of Economics and Political Science. Shaw had wanted to use the money to set up a sort of Working Men's University, but Webb held firm. The first director he chose, W.A.S. Hewins, was not a Fabian but a conservative who later became an imperialist in the wake of Joseph Chamberlain.402 And the academic character of the new School opened the way for it being accepted as part of London University.

The tradition of the School that the faculty would not be of a single political conviction became ingrained. At the time of my studies at LSE in the 1960s and '70s, the School still was 'non-denominational' as Webb had intended. The student body was on the left but not the faculty. In the fields of Political Science, Sociology and Economics, one need only remember the names of Lionel Robbins, F.A. Hayek, Karl Popper, Elie Kedourie, Michael Oakeshott, Maurice Cranston, Morris Ginsberg; or later Harry Johnson, Allan Walters and David Laidler (and Chicago from afar): to understand how a classical liberal like me came out of the red furnace of the LSE.

Shaw and the Webbs go off the rails

After Alexander Kerensky was toppled by Lenin, Shaw embarked on a two decade defence of the Bolsheviks and Stalinist oppression. Then, in 1931-32 he undertook a long journey into Soviet Russia, accompanied by Nancy Astor (who turned out to be much more critical of what they saw). They had a long interview with Stalin. Shaw found a "frank, friendly and humorous character [... a] combination of the priest and the man of action" (relates Holroyd), sporting "a smile in which there is no malice but also no credulity".403 Bertrand Russell had not been so gullible when he had visited Russia in 1920-21: he regarded the Bolshevik regime with horror. Neither was Churchill taken in.

This contrasts with Shaw's short visit to the United States in 1933 immediately after Russia. Holroyd speaks of "a life-long quarrel with the United States very much in the manner of Charles Dickens." He heaped insults on Americans, calling them "windbags, swindlers and assassins". He proclaimed himself "more communist than Lenin". The Constitution was a "charter for anarchism." In Hollywood he continued to refuse having any of his plays filmed. He denounced New York as being ruled by "private racketeers, from the humble gunman to the great financial magnate". At the Metropolitan Opera House he gave a lecture broadcast to the nation and aimed his fire at the money-making obsession of his listeners. He contrasted America in the grip of the Depression with Soviet Russia where all "pulled through because the all pulled together". The point is not that the insults were undeserved but that the comparison with Communist Russia indicated a hatred of the open society.

401 Holroyd (1988), Volume I, page 410. 402 Dahrendorf, pages 11 and 69-71. 403 Holroyd (1988), Volume III, chapter IV, especially pages 244-5.

The Webbs did not perform any better. In 1932 and in 1934 Sidney and Beatrice Webb published Communism: A New Civilization? Dahrendorf points out that the query disappeared from the 2nd edition onward, after the Great Famine brought on by Stalin's land collectivisation and after the Moscow Trials.404 Socialism in my view is always in danger of becoming a dangerous creed, especially when combined with an organic theory of society.

In the 1920s Shaw fell for Mussolini. As Holroyd relates, he took a pure pragmatic view of Il Duce. "The only question for us is whether he [Mussolini] is doing his job well enough to induce the Italian nation to accept him faute de mieux." He even took in his stride the assassination of Giacomo Matteoti under Mussolini's orders and the fascist invasion of Abyssinia.

Shaw□s crotchets

A natural development of socialist ideology is to fall for the temptation of constructivist social engineering, to give it its ugly name. All his life Shaw detested the ingrained division of classes in British society and made it one of the objects of his socialism to get rid of distinctions by birth and education. The radical remedies he proposed were the ones pursued by the whole Fabian movement: the nationalization of land and capital, progressive taxation, old-age pensions, the generous supply of municipal services, protection of the arts, the loosening of family bonds, the emancipation of women, and all the nostrums we have seen proposed in great detail by his friends the Webbs. To this he added in a typical rationalist fashion the teaching and use by the working classes of correct English pronunciation and spelling.

Shaw's great gifts of intelligence and imagination, his knowledge of the ropes of the theatre, his sense of fun, and his Alice-in-Wonderland logic, allowed him to present his plan for language reform attractively and seductively in Pygmalion (1913), the most filmed of Shaw's plays. Those of my readers who have not read it will no doubt remember My Fair Lady and the rain in Spain falling mainly on the plain. The flowergirl jumps over the class barrier when taught to speak, move, and dress like a lady. He wanted to show how artificial class barriers were and how easily overcome by proper training. Towards the end of his life, Shaw even started a campaign to simplify the spelling of English by launching a strange new alphabet and so make correct pronunciation easy. He left a large sum for that reform of the alphabet in his last will and testament. I myself unwittingly followed Shaw's advice when learning, cultivating my clipped Queen's English as carefully as I could, because in those early years of Elizabeth II's reign broad vowels and regional accents (except Scottish) were not accepted in polite society. In fact, Shaw's recipe has failed: the erosion of

the class system in Britain has not come from everybody being taught good English but from society going down the proletarian path—including abundant expletives and profanities.

404 Dahrendorf, page 268.

He Is No Gentleman

April 3, 2017

Donald Trump is no gentleman; his vulgar remarks on women, his slanderous aspersions on Mexican immigrants, his intolerant condemnation of the critical media, and his aggressive pronouncements on foreign affairs during the Presidential campaign and his early tenure in office all leave an unpleasant aftertaste. There may have been some softening via the Vice President or the Secretary of State in their visits with American allies and even some correction from the President himself. But the tweets he shoots from the hip even now that he is in the White House are often over the top. The question we should ask ourselves is, if he is so awful, why was he elected? And the second question is, if Hilary Clinton is so civilised, why did she lose?

These are the questions Democratic Party voters (and some of the more classical Republicans) should be asking themselves, too. However, I will leave Americans to sort out their own worries. My topic today is why the European establishment got the American election so wrong and is now so unhappy with the result. In my view there are three main reasons for this. One is the number of Trump look-alikes sprouting on this side of the Atlantic. The second is the fear of being left alone facing Russia and the troubles in the Middle East. The third is more subtle, namely the sudden realisation that the social-democratic consensus that made so many Europeans happy with Barak Obama's and Hilary and Clinton's worldviews is dead and buried.

As I say, the first reason for the deep hostility shown President Trump in Europe is the menace posed by politicians here who have the same tone as the new American President and propose similar policies. In every European country now there are parties right and left bent on upsetting the apple cart. In Germany there is Uwe Junge, the leader of "Alternative für Deutschland", who wants to return to the Deutschmark, has declared himself against membership of the European Union, and rejects Angela Merkel's generous policy to refugees from the Middle East. In France, Marine Le Pen, who, as I write, leads opinion polls for the coming presidential election, wants to return to the French franc, leave the EU, and pull out of NATO. In Spain, there is no ultra right-wing party, but the radical left-wing "Podemos" party also wants to leave the euro and recover national sovereignty. Italy has Beppe Grillo, a comedian by profession, who leads the "Five-Star" populist movement, Holland has Geert Wilders and Austria Norbert Hofer, with their respective Freedom Parties. Similar movements can be found in Hungary, Denmark, Greece, Sweden, and Finland. In the United Kingdom, the 'Brexiteers' are nationalist and protectionist with a sprinkling of free-marketeers.

The second reason is that Trump's criticism of NATO, despite some later softening of tone, makes Europeans feel naked, especially those living on the edge of Russia. NATO itself has a very small budget. It is not there that President Trump wants allies to spend more on defence but on their own armed forces which could be called up for a NATO operation if need be. Europeans know how politically difficult

it will be for their Parliaments to raise their military spending to 2% of GDP. We grudgingly admit that Trump's criticism is fair and also fear American isolationism.

There remains a third reason for the widespread hostility toward President Trump felt by many Europeans: namely, the feeling that Hilary Clinton was a politician of their own kind. Obamacare they saw as a step towards the kind of universal health care which is such a part of European ideology. The fight against global warming (to give it its true name, not the Orwellian 'climate change') was one they eagerly wanted to join. Public education, state pensions, minimum wages, and pro-union legislation are all a fundamental part of Euro-faith. How could half of the American electorate not see that these were good for them?

Many of the measures taken or promised by Donald Trump are to be welcomed. The reduction of corporate taxes is overdue in America and much of the Western world. Let us hope they are accompanied by public expenditure cuts so that public debt does not go on growing. The condition that for a new regulation to be imposed, two old ones must be repealed is again an excellent idea; it would be even better if all new regulations included a sunset clause. President Trump is right in saying that a better way should be found for banking and finance to be made safer than the present day byzantine controls.

Some of the measures taken by President Trump as soon as he was in office are decried in Europe with more than passable hypocrisy. Germany and Sweden have been very generous with refugees from Syria, Iran, Iraq, and Afghanistan. But this is not so with the rest of Europe. Many Britons have signed a petition to stop Trump's state visit to London, but many more are itching to control immigration from the Continent so as to stop the proverbial Polish plumber from competing with the home-grown variety. Spain has a tall fence around the two Spanish enclaves in Morocco to try to stop unwanted immigrants. Hungarians are rejecting non-Christian arrivals from the Middle East. Italy, France, Poland, and Austria are complaining at the numbers arriving at their borders.

Even when complaining of Trump's commercial protectionism, Europeans are disingenuous. The negotiations for a Transatlantic Trade and Investment Partnership (TPP) between the United States and the EU were taking ages, a procrastination visible on both shores of the Atlantic. Trump may not understand the advantages of free trade, but neither do the Europeans. Of course, competition is uncomfortable for people who find it difficult to change. So is progress. But if one wants one's country to be great again, fencing trade off with hurdles border taxes is not the best way. An old libertarian friend of mine, who used to be a member of Margaret Thatcher's government, repined when I called for Britain fully to open its shores to trade unilaterally. I reminded him of Milton Friedman's call in Capitalism and Freedom for the United States to reduce their tariffs across the board by 10% every year, whatever other nations did. First, Friedman said, consumers would gain immensely from cheap imports. Second, foreign competition would force American producers to improve their goods in quality and price. In any case, in the modern world it has become almost impossible to know which part of imported goods had earlier been made in the US and which abroad. My friend was not convinced, when

I recalled British unilateral dismantling of trade protection from 1820 to 1840, principally to make bread and sugar cheaper for the working classes. So I used another example: in World War I and World War II the German Navy tried its best to stop the British importing goods from abroad; this no doubt gave a boost to home agriculture but it made life miserable to the beleaguered Brits. It is a grave failure of us economists not to be able to convince the public of the advantages of globalisation, especially for the deprived of the

world. Even more uphill it is to convince the locals to welcome immigrants for their contribution to economic prosperity. People say they care for equality, but all, Americans and Europeans alike, dislike foreign competition and resist the call of the Statue of Liberty's to "give me your tired, your poor, your huddled masses yearning to breathe free, the wretched refuse of your teeming shore".

The Fear of Robots

May 1, 2017

One morning a week I take part in a discussion programme on a Spanish radio station that specializes in economic and business matters. Just before we come on air we hear the day's expected events and statistics read by a new journalist in the firm: Sarah Bot, a very young robot with a strange voice. For the time being she has not displaced me and taken over my job.

I know I use robots continuously. I start with the iPhone that wakes me up in the morning, then read the mail I receive on my laptop, chase down on the internet the information I need to write my stuff (after all, Wikipedia is half run by machines!), send my 'copy' through the ether, so to speak, and read the newspaper where my article will be 'printed' also from far away. I well remember when I used to dictate my articles over the phone to patient tachygraphers at a cost perhaps higher than what I was paid for the piece. Still, like many others, I feel a vague disquiet at the as yet benign invasion of the robots.

Say□s Law

To allay my fears I remind myself, first, of Say's Law and second, of the fate of horses. Let me start with Jean Baptiste Say (1767-1832). He was the French economist who introduced Adam Smith to French public opinion and to the learned classes of the European continent, most of whom read French rather than English. Say was born in a Protestant family that had taken refuge in the Swiss city of Geneva, fleeing persecution in France. The family returned to the textile city of Lyon, where Jean Baptiste was born. As a young man, he was sent by his father to England to see for himself how England was industrialising. It was not his only visit to the land of economic progress. Later in life he met and befriended the great economists of the time—David Ricardo, Thomas Malthus, James Mill, and John Ramsay McCulloch—and corrected and bettered some of the classical theories of English political economy. He published his successful Treatise of Political Economy in 1803. Napoleon invited him to dinner to try to make him correct some anti-protectionist and anti-statist passages in the book. Say, a moderate republican and a defender of individual liberty, did not comply. At different moments in his life, Say tried his hand at business—banking, insurance, cotton spinning, and sugar— variously succeeding and failing as an entrepreneur. In 1828-29 he published an ambitious Course of Political Economy in no less than six volumes. Say made signal contributions to economics. In price theory, he introduced utility into the demand side of price formation. He corrected Adam Smith by including services in the definition of wealth. Notably, he introduced the figure of the entrepreneur in the explanation of economic progress. Finally and in parallel with James Mill, he codified what is known as 'Say's Law', to which I now turn in search of hope and consolation in a world beset with robots.405

405 See Thomas Sowell's doctoral thesis: Say's Law. An Historical Analysis. Princeton University Press, 1972.

One of the fears caused by robots is that total production in the economy will so increase that demand will not be sufficient to take it up, especially if people have become unemployed due to competition from non-humans. Could this bring about a general glut of the whole system? Would there then a crisis of overproduction, which might cause more unemployment? What Say's law sets down is that the very fact of bringing goods to the market amounts to demanding goods in exchange. In the case of overproduction, the economy will tend to return to equilibrium if supply prices are flexible and are allowed to fall. This may take time, since the alarm caused by falling prices may lead to a period of money hoarding. In the long run, however and as Ricardo said, "there is no limit to demand," surprising or even shocking though this may sound to people who hate our consumptionist civilisation. This whole idea was summed up by Say in the following phrase: "Supply creates its own demand". 406

Disproportionate production

Say and his classical companions of course accepted that there could temporarily be excess production in one industry and shortages in another whose products were more demanded. This would be the case with path-breaking technological advances, such as steam threshing machines or mechanical knitting frames in the early 19th century (or robots today). Though not leading to general underconsumption, those advances would for a time bring technological unemployment in their wake, as workers were displaced by the new, more productive methods or by free trade. What is called 'sunk capital' can also be affected, so there may also be resistance put up by the owners of capital or land endangered by shifts in supply through new productive methods or through trade.

The revolts of workers who saw their wages fall because of competition from new machines are now a part of the social history of capitalism. In the years around 1810, summers were very wet in England, badly affecting crops. Also, the general blockade of trade with Britain decreed by Napoleon in Berlin and Milan in 1806 and 1807 throttled the import of grain and made bread unwontedly expensive. The wages got by threshing wheat from November to February in England gave employment in the lean winter months. Hostility to the new-fangled steam threshing machines erupted in an epidemic of machine breaking by crowds allegedly led by a legendary 'Captain Ludd'—hence the name 'Luddites' applied to workers who wanted the competition of new machinery stopped. A repeat movement happened in the summer of 1830, dubbed the 'Swing Letters'. Again, times were harsh in the hungry thirties. It was a time of political turmoil, what with the campaign for Parliamentary reform in England and the Revolution in France. Landlords who were known to use threshing machines in the Southern English

406 One could not think of a view more contrary to the Keynesian idea that the main macroeconomic problem in a downturn is a failure of aggregate demand. Crises caused by the failure of misapplied investment suddenly revealed by a technical shift are characterised by a general thirst for cash or money hoarding. Capitalist growth is inevitably cyclical. It can be made less volatile by trying to keep the money supply stable, as Milton Friedman proposed. But this question is for another day.

counties received letters signed by a certain Captain Swing, threatening to break the threshers up and demanding higher wages.

This was not the only example of harsh technological competition suffered by manual workers. By 1830 the livelihood of some 400,000 handloom weavers was being threatened by the power-looms and knitting machines in the cotton mills. Those weavers were whole families who worked at home for merchants who

'put out' work at growingly extortionate rates, given the higher productivity of large factories. Petitions rained on Parliament. By 1840 the number of handloom weavers had fallen to 100,000, mainly specialised in silk fabrics and the more expensive cloths. The recourse to the 1834 Poor Law was felt to be a paltry remedy, since Poor Houses were organised on the principle that their standards should be less attractive than the least paid employment. A Royal Commission was formed to examine the plight of these workers, chaired by the economist Nassau William Senior. Famed for his understanding of the rapidly increasing productivity of the factory system when other classical economists saw England "within a hands breadth of the stationary state," Senior saw there was not much that could be done. Attrition had a human cost, but in the end an open door to radical technological change was the only answer. It is thus that the hungry 1830s and 40s turned into the more prosperous second half of the 19th century—helped by Robert Peel's decision in 1844 to repeal the Corn Laws. The social safety net of today is much more comfortable than Dickensian poor houses. The opportunities of gainful employment, much greater.

What happened to horse-power?

When I say that the plight of working horses brings me some consolation as I think of the possible effect of robots on employment, I do not mean to belittle their centuries' long contribution to the productive or destructive efforts of humanity. They were used in peaceful transport. Also, in all wars up to the middle of the 20th century, pack animals were used and sacrificed on the battlefields by their cruel and warring masters. I myself did my peacetime military service in a mounted regiment, where I learnt to ride the friendly beasts. In Hyde Park in the centre of London there stands a most affecting monument to the horses, mules, and donkeys misused by all armies in history. Anybody visiting London should take time to stop before it.

What I mean by linking the case of humans menaced by robots with that of horses displaced by the internal combustion engine is that there you have an example of job destruction by technological advance. The point I want to make is that horses could not and did not learn to drive motorcars and lorries. We men and women can learn new trades, albeit with some difficulty when we get older. Luddites are a danger to the very people they want to help because in the end progress will prevail.

The benefits of growth for the individual

Here is the crux of the matter. Technical advance makes for growth. The increasing use of robots is but a continuation of the story of triumphant capitalism. The countries of what we call the West have experienced a singular and unexpected two centuries of growth that is pulling the entire population out of poverty and into prosperity as never before in history. Now the rest of the world is joining in the ride, which we hope will last. There have been periods of growth in history that did not extend to the entire population of the world and ended in ruination. The examples that come to mind are those of Mesopotamia, Egypt, Rome, China, and the Aztec and Inca empires in America. In all of them the flame of growth died or was snuffed out by military disaster. Something quite different, however, happened in Britain around the beginning of the 19th century and then spread to continental Europe and North America. Productivity increased by leaps and bounds and was not even stopped by two world wars.

The size of these developments in the capacity to produce more with less are difficult to measure precisely. William Nordhaus, whose first claim to fame with the general public was his joint authorship with Paul Samuelson in the later editions of Economics, the textbook which has been the initiation rite of so many

into the queen of social sciences. More recently, he has become one of the high priests of the new religion of climate change. Whatever the disagreements one might have with that textbook and this alarm, he is an outstanding professional economist. I want to draw attention to the striking way in which he has presented the growth of real wages from 1800. To calculate real wages he has to take nominal wages and deflate them by a price index. He finds much to query about the price indices normally used to do this calculation. He shows that price increases over the years are much exaggerated by not properly accounting for improvements in the quality of goods due to technological progress. The case he uses is that of lighting. Prices per 'lumen' (the measure of light intensity) have fallen much more quickly than shown by ordinary price indices. If the same method he uses for the true price of light is applied to general consumption (so as to take account of the incredible improvement of goods and services over the last hundred years), then real economic growth will turn out to have been much greater in the United States and Western Europe than is generally thought. "In terms of living standards, the conventional growth of real wages has been a factor of 13 over the 1800-1992 period." If the downward bias is corrected as Nordhaus thinks it should be on the lines of the cost of lighting, "real wages have grown by a factor of 970." Some growth! 407

Let me show a graph I have used in a previous column, since it comes from so respected a pen as that of Angus Maddison. It shows the sudden increase in per capita production in the United States and the United Kingdom around 1840. The inflation adjustment is of the conventional kind: the productivity surge would be much larger if we used the Nordhaus method.

407 William D. Nordhaus: "Do Real Output and Real Wages Measures Capture Reality? The History of Lighting Suggests Not." NBER. PDF file.

Figure 1. GDP Per Capita

Source: M Tracy Hunter: Own work, CC BY-SA 4.0, https://commons.wikimedia.org/w/index.php?curid=34088252

Recently, Nobel laureate Robert J. Shiller has taken up the idea, characteristically hatched in the European Parliament, that a moderate tax should be laid on robots so as to put a brake on robot use. This tax would "slow the adoption of disruptive technologies". He seems to be worried about the effects of robots in increasing inequality and considers the tax would "accord with our natural sense of justice". The produce of the tax could then be used to finance an insurance fund to help the displaced workers who need time to change their calling. Professor Shiller seems to be another of those Nobel laureates who speaks outside his field of speciality, which in this case financial economics, not economic growth.408

What Shiller does not do is underline the trade-off between technical progress and anti-market regulation. In his future pronouncements in favour of a tax on robots he should pay some attention to worries generally expressed about the trend of economic growth in the United States and the rest of the Western world, especially Europe. I recently watched a TED talk by Professor Robert J. Gordon of Northwestern University.409 As he has been doing for a number of years, he worried about the fall in the long term growth rate of the American and the world economy due to the lack of great technical innovations. He showed us pictures of 19th and 20th century transformative innovations that, he says, are not happening any more—water closets, electrical appliances such as washing machines and refrigerators, the internal combustion engine, airplanes or telephones—but he

408 Robert J. Shiller: "Why robots should be taxed if they take people's jobs". The Guardian, March 27, 2017. 409 Robert J. Gordon, "The death of innovation, the end of growth,". TED 2013.

pictured no robots. Professor Gordon may turn out to be right in discounting robots and artificial intelligence as engines of growth, if the likes of Professor Shiller have their way. Luddites all!

Thoughts for Tigers

June 5, 2017

At the 2017 Regional meeting of the Mont Pelerin Society in Seoul I gave a short paper where I turned a critical eye on some of the policies applied by Asian, African, and Latin-American "Tigers." It was invidious of me to disagree with measures that in the opinion of many have led to fast growth in some parts of those regions, especially so in Korea, where years of extraordinary growth had been attained up to four years ago. In rewriting this paper I insist on the advice I gave the very attentive and polite audience: for the Korean economy and other developing nations to sail out of the economic doldrums in which they are caught, they could do worse than attend to the following three objectives:

- Creating reliable monetary arrangements - Moving away from export led development - Resisting the temptations of the welfare state and turning a kinder eye on private education

Currencies

In the 19th century, large and prosperous nations adopted the gold standard, which by definition is a fixed exchange rate regime, while poorer and smaller countries tended not to fix their exchange rates, whether by design or by force of circumstance.410 The movable exchanges of developing countries took two forms: one was a proper float against gold, because the national currency was fixed to silver when all their big trading partners were fixed to gold, as was the case with Spain; the other was repeated exchange failure, when imprudently issued gold denominated bonds turned out to be impossible to service, as was the case with Argentina. At the present time the regime is the reverse: large advanced countries or blocs, like the United States, Japan, the United Kingdom, and the European Union, float and manage their exchanges, while small open countries either set up a currency board or directly make the U.S. dollar, the French franc, or the euro their legal tender. The reason for this inversion of policies is that large advanced countries now feel confident they can use the exchange rate as a monetary and commercial tool; while small countries with a large foreign sector fear forex

410 The choice faced by the advanced countries was well analysed by John Maynard Keynes' 1924 Tract on Monetary Reform. Keynes there showed that if the United Kingdom fixed the exchange rate to the dollar (and thus indirectly to gold) the price level in Britain would in fact be governed by the Fed in Washington; and that only if the Bank of England allowed the pound to float would she be able to steady the domestic price level. This was before the United Kingdom rejoined the gold standard for a brief period, from 1925 to 1931, only to give it up gave it up finally in 1931. Now that the gold standard has been abandoned by all and sundry, countries with a large economy that can be to some extent be isolated from the rest of the world prefer Keynes's second policy and manage their exchange rate so as to conduct a national monetary policy—God bless them! In 1931, by giving up gold, devaluing, and floating, the United Kingdom made an early recovery from the Great Depression. But over the years this policy of managing the currency politically has led to a huge loss of value of the pound—some 93% from 1931 to 2017.

volatility and the financial crises it could bring in its train. However, the 1997 Asian crisis showed that not even pegging their money to a world currency was a foolproof protection from sudden monetary typhoons. So then, what is the choice for small emerging countries?

There are three possible exchange regimes for them: (a) running two different currencies, both freely accepted in payment of debts; (b) setting up a currency board, with a fixed exchange rate between the national and a world currency; or (c) dollarizing (or eurolizing) the country.

Two currencies

The most revealing case for me is that of Peru after the drastic reforms undertaken by Alberto Fujimori when first elected President in 1990. Among Fujimori's reforms was the issuing of a new currency (nuevo sol), abolishing exchange controls, and lifting controls on foreign investment and dividend remittances. Though dollars are not legal tender, individuals and corporations, whether national or foreign, can freely open accounts, write contracts, and make and receive payments in dollars or soles, as they wish. The use of dollars is convenient for international companies in the large mining and oil sectors. The Reserve Bank of Peru keeps a large balance in dollars to maintain confidence in the payments system. It is, however, slowly trying to reduce the weight of the dollar in the monetary system, by deftly managing the exchanges and by setting lower interest rates in its loans of soles to commercial banks, compared with dollars. It does this with two aims: insulating the country from the vagaries of the U.S. Federal Reserve and increasing seignorage income. However, the exchange rate acts as a brake on possible imprudent issues of soles. Indeed, the officials of the Bank told me that they appreciated the advantages of having to deal with an important dollar sector, as this reinforced the independence and prudent monetary policy of their central bank.

Legalising the use of two currencies in developing countries is not such an outlandish idea as central bankers steeped in the lore of monetary sovereignty tend to think. Parallel currencies can help ease monetary reform or alleviate the harshness of orthodox monetary policies. John Major, the British Prime Minister, proposed that the euro (then called ecu) be issued in parallel with the national currencies of the European Union members, with a floating exchange rate between the two and for the use of tourists and foreign investors. Jacques Delors, then President of the European Commission, rejected this idea because he wanted a single currency that would act as a flag for the future European Federation. Double circulation would have made the European currency much more acceptable generally, while keeping the national currency as a cushion in times of emergency.

The unending plight of Greece seems to call for the double circulation of euros and drachmas. The necessary condition is a fully flexible exchange rate between the two. Using new drachmas for internal transactions could have alleviated three problems: (1) the sudden lack of euros as means of payment when the crisis struck; (2) the wide protests when state services and pensions had to be cut to reduce the

budget deficit; and (3) the pain of internal devaluation to correct the balance of payments deficit. Drachmas would be used as ready money while euros were being hoarded. Pensions and welfare could be discharged in drachmas. And by reducing the euro costs of exports it would help rebalance foreign payments. The consequent fall in the value of new drachmas in terms of euros would in time act as a brake on excessive issue of the national currency, for fear of a steep devaluation that would lead to the disappearance of the drachma from circulation. This idea could be applied in Zimbabwe or other African economies where parallel currencies exist de facto.

Currency Boards

Leaving aside the temporary arrangements for European countries aspiring to join the euro and the currency board in the two economic unions in French Africa, the outstanding example of success of a currency board is Hong Kong, and of failure, Argentina.

The main advantage of a currency board is that it aligns the domestic inflation rate to that of the anchor currency. However, it imposes a harsh discipline. The nation's monetary authority has to focus only on keeping the exchange rate at the announced price (in the case of Hong Kong, 7.80 ? 0.05 HK$ = 1 US$). A currency board is always open to speculative attacks to try to force the local currency off its peg. This means that the monetary authority and the issuing banks must keep a reserve of dollars equal to or greater than the total high-powered money of the country.411

The monetary authority cannot act as a traditional central bank trying to manage credit or act as a lender of last resort. The government must avoid running a budget deficit, or at least must keep a reserve that will answer any unexpected fall in tax revenue. Ministers should be very prudent in their plans for long term investments financed by debt.412 The reason is that, as is well known, a continued budget shortfall will lead to a balance of payments deficit of similar size. A country with a currency board will be forced to abandon it if the government falls into continuous debt. This was the trouble in Argentina during its period of fixed exchanges, when it set the rate at $1 to 1 peso; the central government could not bring the provincial governments back to a zero budget deficit.

Also, the country and the government must be ready to ride over recessions caused by regional financial crises or large and sudden appreciations of the anchor currency, and credibly so, because its wages and other prices are known to be fully flexible. Thus, during the 1997 Asian crisis, Hong Kong saw its GDP fall by more

411 In very difficult times there may be need for the monetary authority to fight the hedge funds that shorten the currency or the stock exchange as a whole, by purchasing futures and securities on the local stock exchange, but this has to be a very short term intervention (as happened in Hong Kong in 1998). See the very revealing letter of Joseph Yam to Alan Greenspan, of September 17, 1998. 412 This the Hong Kong government has tried to avoid doing by creating a "Future Fund" in the 2016-17 budget under the previous Financial Secretary, John Chang Chun-wah). See the 2016- 2017 Budget Speech, at budget.gov.hk.

than 20 percent, a situation that was eased by the fact that in Hong Kong trade unions are forbidden by law.

Dollarisation

Three counties in Latin America (apart from some island states) have dollarised their economies: Ecuador, El Salvador, and Panama. Ecuador dollarised to try to stabilise an ailing economy in the midst of the financial and banking crisis of the year of 2000, when the sucre was showing a CPI inflation rate of 96.2%. Now it lies at around 1%, with a tendency to rise a little with U.S. inflation. El Salvador did so in 2001 for the inverse reason, to reinforce the stabilisation already carried out after the end of their civil war.

Giving up the national currency is in principle a more credible regime than pegging the exchange rate. It more directly imports the inflation rate of the anchor currency.413

Other advantages are that the savings of residents are less liable to melt, that remittances become more secure, and foreign investors have a greater degree of confidence in the country. Also, there is no central bank to act as lender of last resort, which makes depositors look much more closely at their bankers. But the main advantage is that there is no monetary policy to please (leftist) Governments. Alleged disadvantages are that any sustained rise in the value of the dollar makes exports more expensive in the short run, and that in times of high oil or coffee prices there could be bouts of over-spending. I say 'alleged' because in the long run it is not the market exchange rate that governs export prices but the real rate of both exports and imports, and this rate lies beyond the grasp of governments. Also, bonanzas could be corrected with the creation of a sovereign fund to invest surplus foreign money abroad, along Norwegian lines.

The case of Panama adds an interesting note to this analysis. Panama dollarised in 1904 and has stuck to dollarisation through thick and thin, even when the Canal was nationalised. This means markets fully expect dollarisation to be maintained for a long time to come, a credibility that has allowed Panama to borrow itself out of crises caused by the vagaries of the U.S. dollar, be they sudden revaluations and interest rate hikes.

The lesson of all these attempts by developing countries to create a stable monetary environment is a demanding one. A good name is not acquired overnight. A responsible public opinion must be shown to exist in election after election. Governments need to be trusted to apply predictable macroeconomic policies, year in, year out. It is only slowly that a country can achieve monetary stability.

Export-led growth

413 The risk premium will tend to set domestic rates of interest higher in the small country. Also, there may be temporary differences in price levels depending on expectations and the tariff regime and on how oligopolistic the small economy is.

The world is a different place after the 2007 crash. Though the emerging markets of Latin America, East and South Asia, and Africa have not suffered as much as those of the developed world, the ground on which to build a prosperous future has shifted markedly even for them. This means that the economic policy of the 80s and 90s of artificially engaging in export-led growth should be re-examined and perhaps given up, just as import substitution policies of the 1950s were.

An export-led growth policy, as applied by the East Asian Tigers, has been was based on the following four elements:

- An abundant and well-trained labour force - The institutional environment needed to attract foreign direct investment, to incorporate quality foreign technology, and to apply well-tried management techniques - Company strategies for succeeding in foreign markets - Government protection through tariffs, abundant finance, and acceptance of private oligopolies

Government intervention is what has attracted special attention because it seems to go counter the classical theory of international trade. There certainly is an element of protectionism in export-led growth, in that governments tend to reserve the domestic market to companies which later take the jump to sell abroad. Also so is the insistence that foreign corporations wanting to access the domestic market should form partnerships and share technology with local firms are clearly forms of protection. But this is not all.

There was more resentment in the developed world at what were seen as unfair practises of Third World exporting countries. One was state aid received by exporters. Second was the large proportion of nationalised companies among exporters that made people suspect a continued tolerance of hidden losses.

Third was crony capitalism, in Korea, tolerating chaebols. Finally, there was the general category of practices condemned as 'dumping'. All four practices are not in any case very efficient for the exporting countries since at bottom they are gifts to foreign clients or harms to local residents.

But the main accusation of unfair practices has centred on artificially low exchange rates. I am highly sceptical of the effectiveness of under-pricing the national currency to foster exports and make imports more expensive. Politicians, journalists, and pressure groups tend to focus on nominal rather than real exchange rates. Sustained depreciation of the national currency, either by excessive printing of money or by artificial devaluation, is soon reflected in the prices of the exporting country, be they at factory gates or in consumer baskets. Such policies are only sustainable if there is a large supply of labourers ready to enter export sectors and so keep real costs down. So, it is the number and quality of wage-earners and their productivity that explains low export prices, not the nominal exchange.

More generally, I think that attributing Asian progress from 1980 simply to state sponsorship of exports is an over-simplification. Professor Razeen Sally wrote some four years ago a Policy Analysis pamphlet of the Cato Institute titled Asia's Story of Growing Economic Freedom414 that should be read by all who are mystified by the up to date success story of South and East Asian. Dr. Sally accepts that, for a time, developing nations can grow fast by throwing everything at exports, including government aid and indulgent finance. This is what he calls "catch-up growth", based on a high rate of investment, on imitation of advanced nations' technology, and on the low wages of the hidden unemployed. Even so, he questions the belief that catch-up growth could be helped by the Government picking winners. He says,

"Vertical" policies of selective intervention promoted targeted industrial sectors, restricted imports and foreign direct investment, and directed the financial system to channel cheap credit to favoured sectors... However, there is scant hard evidence—only assertion—that industrial policies worked. At best, they altered the sectoral composition of output and exports and did not seriously impair growth.

For Professor Sally, government programmes to foster export-led growth are simply old-fashioned industrial policy writ large. He rather maintains that catch-up growth comes when the developing country starts freeing markets and moves towards a capitalist economy. Says Sally,

The lesson from the [East Asian] "miracle" economies is for governments to provide for economic stability, to expand economic freedom, and to open up to the world economy—not to "guide the market" with dirigiste policies.

Old and new tigers need to get on the globalisation bandwagon with no afterthoughts or holdbacks. Simply continuing with the same blanket development policies will lead to a waste of resources. When capital, specialist labour, and finance become scarcer, growth demands that opportunity costs be taken into account. The misspecification of the reasons for the success of export-led policies tends to stop further progress.

If we follow the theory that enhanced economic freedom is what promotes growth, the first steps to be taken by the expanding nations of Asia are what Dr. Sally calls "first generation reform:" macroeconomic stabilisation and market liberalisation. As for the already advanced tigers, much more difficult "second generation reforms" are needed, to wit, structural reforms to boost innovation and competition. He classifies these structural reforms under three headings:

- Freeing financial market from the grip of politics - Opening trade not only to partners of regional accords but unilaterally to the whole world, after the fashion of Chile in the 1970s.

414 Available online at "Asia's Story of Growing Economic Freedom", by Razeen Sally. Cato Institute, June 5, 2013.

- Avoiding the trap set by enemies of free energy markets in the name of climate change.

This goes counter the typical Keynesian reaction of governments when fostered export policies come to a dead-end and the rate of growth starts falling. Thus, orthodox opinion holds it that the way forward for China is politically imposed redirection of the national economy towards consumption and public welfare. The socialists of all parties expect China to develop generous social services, control working hours and labour conditions, and in general drastically regulate industry and markets. Also, they recommend increasing home consumption and reducing the rate of investment. Consumption and investment can look after themselves if the credit market is not interfered with. What is needed is further privatisation of national corporations and doing away with obstacles to free competition and free trade: in sum, more economic and personal freedom, not liberal-socialism.

The lure of the Welfare State

This brings me to the danger that developing countries goi down the primrose path of a full-blown welfare state: labour regulation, minimum wages, unfunded health systems, pay-as-you-go pensions, state education, and so on. This message is timely in many countries, but especially in Korea. Mr. Moon Jae-in, the new President, calls himself a progressive but really is a socialist; he wants to "democratise the economy", which means that he sees inequality as the main problem. He wants to make entitlements more generous for the poor; to make housing more affordable, and so on. We in Europe know the lyrics of this song, especially now that Theresa May, the British Prime Minister, is singing it with gusto.

The protectionists in the advanced countries are much to blame. They demand an 'even playing field'. They complain of the unfairness of competition from countries where the cost of labour is not increased by welfare contributions. They think that wages are determined by bargaining between business and trade unions or by political fiat, not by the value of the marginal product of labour. They also see social security contributions as an inevitable tax on labour because families cannot be trusted to save for a rainy day or educate their children or treat their employees properly and competitively. Neither do they think that private charity and trade union cooperation can look after the needy when in trouble, as was the case in the Britain before the 1942 Beveridge Report.

An easily avoidable mistake in countries with a very young population is that of going for pay-as-you-go pension systems. José Piñera well explains the advantages of capitalised pensions. Individuals have property rights over what they have saved for their pension. Those funds are invested in and outside the country for the benefit of future pensioners rather than applied to defray current pensions. This creates the right kind of incentives, so that frictions between generations disappear. The aging of the population ceases to be a problem. Investment of the pension funds markedly contributes to economic growth. However, the main question is how to deal with current pensions when individuals at work start saving for their own benefit rather than financing current pensions. A youthful population alleviates but does not do away with this conflict. The reality is that the obligation

to retirees was there before but hidden from sight, so that recognising it with a special issue of public debt would be a move for democratic transparency. Many countries round the world now have capitalised

pensions of different kinds. A discussion of what the best scheme could be for each would be a useful way of moving forward towards a sustainable pension system.

There are many dangers for developing countries when they try to imitate the welfare and social policies of the advanced world. But before I end this column I must allude to one singularly mistaken policy, that of overlooking the shortcomings of state education, both foreign funded or paid out of taxes. In fact, in East and Southeast Asia, school education is customarily supplemented by high cost private tutoring within the family. The combination has made for education of high quality. A great part of the four Tigers' economic miracle is due to the human capital accumulated over the years by the young in Asia. This is so even in China, where literacy has made huge advances. As a parting shot, may I ask my readers to see what James Tooley has to say in The Beautiful Tree (2009). One of the great slurs on the very poor is to say that they do not really care for the education of their children. John Stuart Mill was one of the first to allege that one could not expect the uncultured to understand the use of schooling and he therefore demanded that elementary education be made compulsory. When Tooley recounts droves of poor parents in Zimbabwe, Ghana, India or even rural China, paying what little they can afford to send their offspring to private schools, while rejecting the free education offered by the State, one's confidence in liberty is reaffirmed and multiplied.

Brexit Poison

July 3, 2017

This is truly a letter from Europe, for I will try to explain why our Continent is in a right awful mess. A year ago, on June 23rd 2016, a majority of United Kingdom voters signified their wish to leave the European Union. These last three summers I have been teaching in England and in any case I know the place well: I can aver that there is no chance that such a decision will be reversed. Another electoral upset has added to the confusion. On June 8th the UK Prime Minister, Theresa May, held a snap general election and failed to increase her majority in the House of Commons as she hoped; now that the Conservatives are in a minority, she has a much weaker hand for her negotiations with the European Union.

On the other side of the Channel, the economy is still suffering from the 2008 financial crisis, with Greece still in deep trouble and growth generally lacklustre. Populist rumblings are heard on the Leninist left in Spain and on the extreme right in Italy, and what a disappointment it is to see the Magna Charta democracy sailing away from a Continent that has a great deal of dark history to bury.

Mrs. May's troubles

Let me start with down-to-earth politics. As I say, Prime Minister May is in a minority and needs the votes of the ten members of the Democratic Unionist Party of Northern Ireland to be able to effectively govern. Though the DUP is staunchly 'Leave' on the question of Brexit, the Northern Irish are greatly worried about an international border separating them again from the Republic in the South. Can the present seamless communication between the two parts of the Isle that does so much for peace and prosperity be preserved? A further complication is that the DUP is staunchly conservative in matters of abortion and same-sex marriage, which crosses the open-mindedness of British Conservatives, whose leader in Scotland, Ruth Davidson, is soon to marry her female partner.

Theresa May's minority government now has to consider contending views in Parliament and in the country. It is not only in Ireland that large numbers worry about leaving the European Union. In Scotland, too, there were more votes in favour of staying in the European Union than of leaving. The main reason is that EU agricultural and public work subsidies greatly benefitted the poorer regions of Europe. Socialists in the Labour Party would not hear of doing away with 'workers rights' embedded in European legislation. One must not forget the 48.1% who voted to stay in Europe.

One must also take into account the personality of the Prime Minister. She is not a second Margaret Thatcher: not a pro-market, free trade liberal, but a paternalist Tory who wants to re-industrialise the country and listen to the voice of the 'ordinary people' ignored by the pro-European elite. She instinctively sympathises with the people who want a better National Health Service, better funded state schools, a more equalising taxation, and more regulation.

These cross-currents will muddy the negotiations, themselves very complicated because of the depths to which European legislation has penetrated the United Kingdom in all its aspects. The time left for negotiation is until March, 2019 and then all the Parliaments of the EU nations will have to approve the terms unanimously. Along the way, the UK Parliament will have to pass eight monster bills to expunge European legislation from the Law books.

Complaints

The four reasons why a majority of the British people voted to leave were: to regain control of their laws, their borders, their moneys, and their independence. Even among the 'remainers,' many resent the fact that within Europe the UK Parliament is not sovereign; and they do not accept that the European Court of Justice can reverse the decisions of British Courts. They are proud of their 'Mother of Parliaments' and of the quality of their judges.

A second point of difference with the European Union is the free movement of people in and out of the country. The United Kingdom is a multi-racial community, but many are scared of a Muslim invasion, especially after repeated terrorist crimes. There are also complaints of abuses of the welfare state by immigrants, as there are of the competition of workers coming from Eastern Europe.

The third source of discomfort is the large UK contribution to the EU budget. There was much exaggeration during the referendum campaign, with some leavers saying it was equivalent to the cost of a week's hospital stay. The net amount must be calculated as follows: In 216 the UK government paid £13.1 billion toward the EU budget, and EU spending on the United Kingdom was forecast to be £4.5 billion. So

the United Kingdom's net contribution was estimated at about £8.6 billion. Without the rebate Mrs. Thatcher forced through at the Lisbon Summit, the sum would have £17 billion. Still, £11 billion a year is a tidy sum.

And the fourth point of contention is the old resistance to the programmatic assertion in the European Treaties since 1983, that "on the basis of an awareness of a common destiny [the signatories wish...] to affirm the European identity, [and] confirm their commitment to progress towards an ever closer union among the peoples and Member States of the European Community." This has proved to be unacceptable even to pro-European Brits.

Brexit is Brexit

When Mrs. May spoke for the first time on the steps of Ten Downing Street after becoming Prime Minister she uttered the self-satisfying phrase that "Brexit is Brexit". There is nothing more fulfilling than tautologies: they are always true. One can only try to fill them with meaning by surmising intentions. In this case she was not saying much. There are at least three possible meanings: hard Brexit, soft Brexit, and negotiated Brexit.

Hard Brexit means the United Kingdom walking away, managing their affairs according to their will, being content with World Trade Organisation rules, and making the London City fare on its own, no favours asked. This would pose some hard questions, such as the rights of EU residents in Europe and vice versa. There are no less than three million EU residents in the United Kingdom today and 1.2 million British living in Europe. Spain has the largest contingent: 308 thousand, one third of which are pensioners who for the time being can unrestrictedly use our health service and receive their pensions paying Spanish taxes. On the other hand, the United Kingdom needs those immigrants, especially doctors and nurses. In any case the human cost of expulsion by either side would be unbearable. As for trade, the cost of leaving the Single European Market would not be as grave as Brussels says and the tamer part of British business claims. After all, the average external tariff of the European Union is low, estimated by the World Bank to be 1.6%. True, there would be more red tape. And as to services, I do not see Frankfurt or Paris displacing London as a financial or insurance centre. If Europe can sign a trade treaty with Canada, why should it not be able to do so with the United Kingdom? If the British government were composed of libertarians it could throw away the principle of reciprocity in trade and just open up the economy to foreign imports of goods and services—to the benefit of British consumers and as a wake-up call for British producers—along the lines of Hong Kong or Singapore. A further advantage of just walking away would be not having to pay the 60 billion euro ($64.73 billion) that Brussels is asking as a leaving fee. However, I do not see Mrs. May taking the libertarian road.

A Soft Brexit solution would be joining the small European Free Trade Area (EFTA) made up of Norway, Switzerland, Iceland, and Lichtenstein. These countries have access to the Single Market but must allow free movement of people and submit to the rulings of the EFTA Court. Also, they would have to obey EU laws in whose drafting it had no say, just as is the case of Norway regarding the EU. This is, in sum, no 'soft' Brexit.

All that is left then is Negotiated Brexit. We do not know nor can we know the final content of the deal. Mrs. May has just made a generous offer for EU nationals settled in the UK. Those that have been legally there for five years can stay indefinitely with all the advantages of British nationals. Those who arrived

before the break away date or have less than five years to their credit will be able to build up 'settled status' so that they can reach the five years. After that, all will depend on the Immigration Bill and the European reciprocal concessions. But one thing she made clear: it will be for the British Courts to adjudicate.

Will the opportunity be missed?

From my point of view, the great opportunity to build a free trading and fully capitalist United Kingdom should not be missed. Here is the chance to show what the British can do. However, I read that opinion polls reveal a veering of public opinion to the left: 36% versus 32% now believe socialism is superior to capitalism. All the talk in the papers and on the radio is that more money should be spent on the failing National Health Service and the less than satisfactory state schools; and

workers' rights guaranteed under European Union rules should be expanded when the United Kingdom breaks away, including the minimum wage, which some clever double-think minister has dubbed 'the living wage'. As you can see, I am not optimistic. The only silver lining in the grey clouds is that I will still be able to teach at Buckingham, for the grace period at least.

Having Tea with the Queen

August 7, 2017

A State Visit to Britain by a foreign dignitary is a very special occasion. King Philip VI of Spain and his Queen Letizia have just been hosted in London by Queen Elizabeth II and Parliament for three days. I know, all those ceremonies look quaint when seen on television, but ceremony is an important part of life, especially in our proletarian times when no ties and crumpled jeans are becoming de rigueur. Further, and this is the point of my column, the pageant in democratic monarchies shows how deeply the role of kings and queens has changed with the spread of democracy in Europe and how important this new role is for a healthy social life. Perhaps, as the historian that I am, I am more sensitive than most to solemn celebrations of links with the past, but I think there is more to such ceremony than a mere recalling of ancient times. Monarchy is one of the ways of reminding us of the unimportance of politics in everyday life.

King Felipe, as we call him in Spanish, is the sixth of his name. His predecessor, Philip the Fifth, started his reign as far back as 1700 and was a fond enemy of then Queen Anne of England. Our two countries faced each other in the "War of Spanish Succession;" the English did not want a French king on the Spanish throne. Today the Queen of England and the King of Spain treat each other as cousins. How the situation has changed... except for one small spot? In 1706 during that same War, the English occupied Gibraltar, a fortress at the southern tip of the Spanish Peninsula, across from Morocco. The British have kept Gibraltar ever since and the Spanish haver never ceased claiming it back through fair means and foul. Would Philip VI mention the Spanish claim on Gibraltar in his speech to Parliament, was the question posed by the British media? More of this anon, but thus do small stones in the shoes of statesmen disturb the even pace of solemn processions.

The last state visit by a Spanish king to the United Kingdom took place in 1986, when Juan Carlos, the father of the present king, was given a royal welcome. That state visit was especially important at the time because democracy in Spain still looked fragile. The Mother of Parliaments gave Juan Carlos a precious

accolade. Juan Carlos had done good service on the throne. I well remember how relieved I was the night of the 11th of February 1981 when I saw Juan Carlos on the TV screen in his full uniform as Head of the Armed Forces, telling the rebellious officers of the army and police in no uncertain terms to lay down their arms and return to their barracks: the coup failed, and he thus saved the Constitution and democracy. The end of his reign was perhaps less glorious. He resigned in favour of his son on account of an elephant and a blonde. The elephant he shot in Botswana, bang in the middle of the grave economic crisis his people were suffering; the lady was an Austrian beauty who acted as a business go-between for Middle Eastern sheikdoms.

Those of my readers who know London will remember the wide avenue that goes straight from Trafalgar Square and Admiralty Arch to Buckingham Palace. On state visits, the Household Cavalry in their gleaming cuirasses take the carriages with

guests and hosts to Buckingham Palace. As always, it was a sight to be seen, with the Spanish flags and the Union Jacks fluttering in the wind along the red carriageway. The drive ended with tea at the Palace offered to her guests by the Queen. The English newspapers noticed that Felipe, after kissing Queen Elizabeth's hand gave her a peck on the cheek, as the third cousins once removed that they are. The Queen also made Felipe a foreign Knight of the Order of the Garter founded by King Henry III in 1348. You may remember the fetching details of the origin of that Order. A garter of Joan "the fair Maid of Kent" fell to her ankle while dancing with her first cousin Henry III. The king picked it up and gallantly put it round his thigh. A titter went round the Court. And the King pronounced the words that to this day are the motto of the Order: "Honi soit qui mal y pense", 'Shame be who evil thinks'.

Brexit again

King Felipe's speech the next day before the assembled Lords and Commons in Parliament also went rather well. At this point we must begin to go beyond ceremony and get down to brass tacks. The soon-to-come separation of the United Kingdom and the European Union is complicating the relations between Spain and Britain in more than one way. The first is the reappearance of a border between Gibraltar and Spain. The other is the uncertainty around the very large trade, investment, and personal relations between Spain and Britain.

Gibraltar is a small enclave of 2.6 square miles and some 30,000 inhabitants at the door, so to speak, of the Mediterranean Sea. It has a land border with Spain and is separated from Morocco by a mere ten miles of sea. While the United Kingdom was a full member of the European Union, the border between the Rock and the Spanish hinterland was quite porous. There were searches at the gate for contraband tobacco and marijuana but every working day about 7,000 Spaniards and another 5,000 Moroccan residents crossed the Gate to their employment on the Rock. The fact that the governments of Spain and Gibraltar are not on speaking terms allowed many of those workers to claim unemployment benefits in Spain and then draw a wage for the work they do on the Rock. Gibraltar also prospers as a tax haven and financial centre. Many of the executives of the companies domiciled on the Rock return to their homes on the Spanish mainland every evening, as space is at less of a premium on the British side of the border. What will happen after Brexit is anybody's guess. The Treaty of 1713, whereby Gibraltar was ceded to the British, gives Spain the veto on any arrangement that does not include her. So the Spanish want to establish twin sovereignty over the Rock, British and Spanish. The British cannot forget the crucial role played by Gibraltar in World War II. Together with Malta, the island lying between Italy and Tunis that the Italians and the Germans could

never conquer, Gibraltar kept the Mediterranean open for the convoys supplying British Egypt when North Africa was in the hands of Fascists and Nazis. Franco never gave in to the temptation of conquering the Rock for Hitler, in fear of British and American reprisals. So Gibraltar is part of the folklore memory of the British. An overwhelming majority of the 'Llanitos", as the Gibraltarians call themselves, refuse to be considered as anything but British. But in the Brexit

Referendum 96% of them voted to stay in Europe; the vote in Britain went against their wishes. They now are in a pickle.[415]

Before his speech in the hallowed halls of the UK Parliament, King Felipe was warned there was a danger that some MPs and Lords would walk out if he claimed Spanish sovereignty over Gibraltar or denounced its anachronistic status as a colony, as he had done in the UN General Assembly. He contented himself with saying that the problem should be talked over, so that The Times was able to headline on its first page: "Spanish couple offer warm words on Gibraltar".

Indeed, there were more things to be celebrated about this meeting of royal houses. It increased the chances that the economic and social ties between the United Kingdom and Spain would not be harmed by the British leaving the European Union. In 2015 Spanish exports to Britain were worth £25 billion and British exports to Spain worth £14.8 billion. The heads of a hundred Spanish companies were in the king's party and could be seen round the table at the Mansion House dinner in the City. The royal couple's plane touched down at Luton Airport, which is managed by a Spanish organisation, as is (in part) Heathrow. Scottish Power is owned by a Spanish corporation; and so is O2, one of the British telephone providers; Banco Santander is now a high-street name in Britain, and so is Zara in one or another of its different trade-marks. The reason why the United Kingdom is the first venue for Spanish investment is that, up to now, the UK government was free of any nationalistic prejudice stopping the sale of British assets to foreigners, which is certainly not the general attitude on the European continent.

Even more surprising is the human dimension of the friendship between Spain and the United Kingdom. British visitors to Spain (a country of 42 million people) last year numbered 17.8 million, 6 million more than those from the next nationality, the French. British expats in Spain are reckoned to be 296,600. Spaniards residing in Britain may be double that figure, and one should not think that most of those who are at work are to be found in hotels, restaurants, and cafes: a large proportion are teachers or health workers.

King Felipe did have words of warning about the future of residents of both nationalities in either country: he asked that both governments should find a way to guarantee "assurance and certainty" for their life and that of their families in the other country.

The changed role of the Monarchy

Of course I am glad to be able to celebrate these economic and human ties between our two countries, but my readers may wonder if I have not grown soft in the head when celebrating the encounter between the Queen of England and the King of

415 Another border poses a problem after Brexit, though a much graver one: that which will split Ireland again into two, Northern Ireland as a part of the United Kingdom, and the Republic as a part of the European Union. The ghosts of civil war may haunt the Green Isle again.

Spain amid glorious pomp and circumstance. I argue in atonement another, weightier, reason for my giving attention to this royal occasion.

Since at least the 16th century and through 1914, the monarchy was the symbol and instrument of statehood and centralisation. As Max Weber put it at the beginning of the 20th century when the process was coming to full and venomous fruition, "the state is [...] a monopoly of the legitimate use of physical force within a territory". Another way of expressing this political theory was to say that sovereign power resided in the state and that from there flowed the monopoly of legislation, taxation, and conscription, a monopoly barely contained by constitutional democracy. Ever since Machiavelli, political philosophers have lent a willing hand to the reinforcement of state sovereignty; nothing changes much if we say that sovereignty belongs to the people so as to give it a democratic varnish. The warnings of Alexius de Tocqueville, John Stuart Mill, Bertrand de Jouvenel, Karl Popper, F.A. Hayek, and others have been to no avail, for the idea that sovereignty is indivisible has become a part of constitutional philosophy in the West, with the exception perhaps of Switzerland and the United States.

The role of kings and queens in this process of concentration of state power was crucial. Henry VIII in England, Philip II in Spain, Louis XIV and Napoleon in France, Maria Theresa in Austria, Frederic the Great in Prussia, and Bismarck in Germany, all put the figure of the monarch at the service of Leviathan. So what is it I celebrate in this saga of monarchs slowly transforming powers dispersed in society into political sovereignty?

My thesis is that with the growing predominance of democracy, parliamentarian monarchies have morphed into quite a different institution from what they were when monarchs actually governed. Kings and queens have ceased to be sovereigns. They are bereft of power but now are symbols of Individuality in their nation and their society. As Walter Bagehot wrote in The English Constitution (1873), "A family on the throne is an interesting idea [...] It brings down the pride of sovereignty to the level of petty life." Politics and government are boring and often dangerous. As an antidote we need to feel that the lives of the great are on the same plane as ours. Is it important for us to know that Queen Letizia of Spain for her tea at Buckingham Palace "wore a yellow on lemon dress with a guipure lace hem and a complementary tweed coat", duly form-fitting to stress her attractive figure? Maybe not, but still importantly for those of us who at bottom are wary of politics. As I have said in other columns, it is crucial that we should understand that the greatest part of our lives, personal and social, is non-political. When religion, sport, education, art, and cuisine are turned into political weapons, personal freedom is in danger. Monarchies take our minds away from power games.

Unilateral Commercial Disarmament

October 2, 2017

Few are those who fully understand the workings and benefits of international commerce—especially so, it seems, President Donald Trump. That is surprising, as the economics of international trade are not difficult. After all, we economists have striven to explain them with simple reasoning and homely cases for more than a century now. It was in 1817 that David Ricardo took up Adam Smith's example of the benefits of importing claret or burgundy wine rather than producing it in Scotland, and presented his improved model of cloth and wine trade between England and Portugal. The Ricardo model is known as the model of "comparative costs". With it, he showed how a poor country with low productivity could prosper in the world of trade with no need to take protective measures—and vice versa for a rich country. My teacher Lord Lionel Robbins used to say that the theory of comparative costs was the pons asinorum of economic reasoning, alluding to the Euclidian theorem of the angles of an isosceles triangle that dim students had so much difficulty in getting over. The reason for this lack of understanding by intellectual donkeys is perhaps that the conclusions of the theory of international trade go against common sense. So say many: 'You cannot truly believe that foreign competition is good for us? Do you actually hold that commerce will reduce the number of the poor? Doesn't fair trade need a level playing field? Come on...!'

Freer trade from 1815 to 1870

This would not matter much if the lack of understanding of the economics of international trade did not result in grievous loss of well-being for the whole of humanity. Care for the poor is at the heart of the politics of free trade. This was the aim of the great movement in 19th century Britain, culminating in the repeal of the Corn Laws in 1846. Rather than Britain, I should say the United Kingdom, because it was the acute suffering of the Irish subjects of Queen Victoria during the potato famine of the 1840s that was the clinching argument of the free traders.

The Corn Laws restricted the importation of corn (not maize but cereals in general) into the United Kingdom; British agriculture had received some form of protection since at least the 17th century. The first modern Corn Law was passed in 1794, but the question became urgent on the return of peace after Waterloo, when British ports reopened to trade with Europe and America and cheap foreign corn was on offer again. In 1815, a law was passed limiting the import of wheat until its price on the home market was more than 80 shillings per quarter. This restriction was felt to amount to a prohibition of imports, and in 1828, Lord Wellington's government legislated a sliding scale whereby foreign wheat could in fact be introduced only when its price in the home market was 73 shillings per quarter or above. This Corn Laws were denounced as the most visible part of the traditional limitations of trade that Adam Smith had criticised as forming the 'mercantilist system'.

A motley alliance of economists, politicians, industrialists, agitators, and later trade unionists laid siege to the citadels of mercantilism. Adam Smith, Ricardo, his friend

and mentor James Mill, John Stuart Mill, the son of James, and the whole group of 'philosophical radicals' around Jeremy Bentham, argued intellectually in favour of free trade in Parliament, in the literary reviews, and in the daily press. They were the learned arm of a much larger popular movement culminating in the

founding of the 'Anti-Corn Law League' in 1839, under the leadership of Richard Cobden and John Bright. The League agitated for the dismantling of agricultural protection, in fact of all commercial protection. Finally, in 1846, Sir Robert Peel, the Prime Minister at the time, was swayed fully to free the import of corn.

Many historians have tried to besmirch the story of the movement that led to the unilateral dismantling of tariffs by the British in the years from 1815 to 1846. The story told by cynically inclined historians is that the advocacy of free trade, given the industrial supremacy of England, made foreign competition no danger; and that the anti-Corn Law coalition was motivated by special interests. First, there was no supremacy of British agriculture over world food producers within reach, given the progress of railways and steam sea transport. Then, even if class interest was one of the factors that explain the widespread backing of the repeal movement, there is nothing wrong with self-interest when it promotes the general good. Thus, the middle and popular classes were incensed by the rent the landholders extracted thanks to protection. Factory owners complained that interference with foreign trade not only reduced their profits but also lowered the standard of living of their workers. The high prices and low quality of food angered the popular classes. The electoral reform 1832 was wind in the sails of the free traders as it gave voice to middle class voters who resented the power of the Lords over the House of Commons. Nevertheless, a freer economy was advocated even when it went against industrial interests: for example, the prohibition of the emigration of expert artisans and workers to rival countries was derogated in 1824, and trade unions were legalised in that same year. The final repeal, however, needed the personal conversion of the great and the good, a conversion, as we shall see, based both on scientific analysis and on humane feelings.

Such was the situation when the Tory Sir Robert Peel again became Prime Minister in 1841. At the start of his premiership, he still believed in agricultural protection, though he was in general favourable to free trade. He began to change his views on the importation of food by a point of theory. Some protectionists rested their case on an argument of Ricardo's (taken out of context) that cheap sustenance made for low wages: Peel says in his Memoirs,416 that he was swayed "by the many concurring proofs that the wages of labour do not vary with the price of corn".

The other element of his change of views was the coming potato famine in Ireland and the loss of the wheat crop in England. In October 1845, a number of botanists told him that continual rain during the summer would result in the spreading of a blight and result in the general failure of the potato crop—the only food, he writes, of four million Irish peasants. Moreover, due to the failing crop, potatoes otherwise kept for seed would be eaten by the spring, further reducing the supply of food next year. Observers on the ground informed Peel that the weather had also made it

416 Memoirs of the Right honourable Sir Robert Peel, edited by Earl Stanhope and Edward Cardwell M.P. London, 1857, page 182. Archive.org.

impossible to reap the normal crop of wheat in England during the late summer. When he proposed a suspension of the tariff on the imports of food to his Cabinet, only three minsters backed him, and he resigned. The uproar in the country must have been so great and the plight of the Irish so miserable that even aristocratic landholders fundamentally opposed to the repeal, such as the Duke of Wellington, changed their position. Asked again by the Queen to lead the government, Peel got the full backing of the ministers and of a majority of the House of Commons for the repeal. As for him, he had taken "a course manifestly opposed to his own private and political interests;" he himself was a landowner, and the repeal split the Tory party asunder.

Most favored nation

The repeal of the Corn Laws began a period of thirty years during which free trade agreements proliferated in Europe. The agreements of the 1860s were a consequence of the 'most favoured nation clause' (MFN) inserted in the 1860 Cobden-Chevalier Treaty between France and the United Kingdom. This kind of clause (present also today in the constitution of the World Trade Organization) automatically extends the 'favourable' clauses of the most recent commercial treaty of a country to all the parties of previous ones. Note that 'favourable' means the opening up of one's market to the other party in a treaty. This reflects the mercantilist idea that exports are good and imports are bad. Rather, it is the total amount of trade that matters for people's individual benefit. Nevertheless, over a period of fifteen years from the signing of the Cobden-Chevalier Treaty fifty-six other preferential trade agreements were signed in Europe. Markus Lampe explains the spread by a number of factors, mainly the attraction of trading in a larger market and the fear that not adhering to the movement would lead to trade diversion away from the outsider. However, the attraction of joining an existing free-trade area would diminish further the distance, as lower transportation costs would neutralise the gains from the MFN clause. This explains why the adoption of the clause was effectively limited to Europe.417

So, the spread of free trade agreements came to a halt in the 1880s, and tariffs came back to continental Europe, starting with Bismarck's 'rye and iron tariff' of 1879.418 This to my view shows that bilateralism has limited value for the free trade programme. Bilateral free trade agreements are immensely complicated, given the network of special interests they have to respect. In addition, their advantages for consumers and their effects on producers' competitiveness are difficult to perceive. The gains are much clearer when countries free imports of goods and services unilaterally—which is what the United Kingdom did after 1846 and should do now after Brexit.

Unilateral free trade may look to most of my readers as an unreachable ideal for democratic countries. The only recent example is to most people not very

417 Lampe, Markus. (2010), 'Explaining nineteenth-century bilateralism: economic and political determinants of the Cobden-Chevalier network', Economic History Review. 418 Asaf Zussman, "The Rise of German Protectionism in the 1870s: a Macroeconomic Perspective," Stanford University, July 2002.

attractive—it is the free trade policy in Pinochet's Chile. The trade slogan of the 'Chicago boys' who advised the General's government was "aranceles bajos y parejos", "low and even tariffs". This has been the basis of the diversification of Chile's exports, and a clear contribution to its people's well-being (in economic parlance, growth). Can it be done in a democracy?

Adam Smith and David Ricardo on international trade

One of the causes of the political resistance to unilateral free trade is the general presentation of international trade theory in terms of advantage and disadvantage and then insensibly formulated in terms of national power. The 'Wealth of Nations' became 'The Wealth of States'.419 Bismarck's move and those of his rivals and imitators was a symptom of the illness that affected Western politics in the years leading to World War I: to wit, putting the productive capacity of capitalism at the service of nationalism, imperialism, and welfarism. Then came the Great War, where the productive powers of national economies at war brought about the Urkatastrophe, and the original catastrophe of the liberal West.

Adam Smith started his reflections on international trade at the correct point: with the trades of individuals and families. "It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy." This he extended then to the whole country or, as he put it, "the produce of the land and labour [...] taken complexly": "What is prudent in the conduct of every private family, can scarce be folly in that of a great kingdom."420 This limited his argument to situations where the cost of producing a commodity was absolutely, though not relatively, above that that of another family or country, as when in another famous example he noted the folly of substituting wine produced in Scottish hothouses for claret and burgundy imported from France.

David Ricardo, in his Principles of Political Economy (1817), extended Smith's analysis to explain why trade was for the advantage of all parties even when the products of one country were more expensive than those of another in all lines of merchandise. If Portugal proved to use less labour to produce both wine and cloth, that did not mean that England was reduced to import both and produce neither. The outcome of trade depended on how much more productive Portugal was in wine than in cloth, even though superior in both to England. In that case, it would be more profitable for Portugal to apply its labour to the production of wine and import the cloth.

Paul Samuelson explained this with a more personal example. Although he was better at economics and at typing than his secretary, it was more advantageous for both that he should specialise in economics and have his letter typed by his

419 Such is the suggestive title of John M. Hobson 1997 book: The Wealth of States: A Comparative Sociology of International Economic and Political Change , Cambridge: Cambridge University Press, 1997.
420 Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations. Paragraphs II.ii.2 and IV.ii.11-12. Library of Economics and Liberty.

assistant. The sacrifice of economics time spent by Samuelson to write his letters would be greater than the sacrifice of his assistant in giving up typing for economics, so they both specialised.

The belief that countries trade

Ricardo's model had one drawback. It has led many people to think of trade as a question of countries specialising, not of individuals and firms exchanging goods and services for their mutual profit. Planners of different hues became obsessed with how to make countries specialise in their comparative advantage, as if 'countries' were the subjects of international trade (in fact the active subjects of anything in economics) and could choose what they produce as if they were individuals. Modern economic production is scarcely reducible to a Ricardian model of exclusive specialisation: innovation mushrooms in unexpected locations, supply chains cross borders, and individual effort changes relative advantages. Geographic specialisation induced by government has had its day.

This outdated caricature of the Ricardian model was applied in the Soviet Empire, where the planners would concentrate all of a single industry in one region of their dominion, multiplied by the notion of increasing returns to scale. Such was the policy of the Gosplan in the USSR, not least under Nikita Khrushchev, as when they decided to concentrate car and lorry making around Moscow or in Nizhniy-Novgorod, textile towns between the Oka and Volga rivers, or scientific research in remote cities of science such as Akademgorodok in Siberia.

Unilateral free trade after Brexit

However, these thoughts are also applicable to British international trade policy after Brexit. Politicians of all shades speak as if international trade were a twoperson power game, and more often than not zero sum, where 'concessions' have to be mutual. If trade were understood as a multi-person dynamic and positive sum game, protectionists would be seen for what they are, defenders of their own personal interest at the expense of the rest of the people.

First, there is no doubt that consumers, especially the poor, gain by the variety of supply and by the lower prices of what is on offer under free trade. Secondly, though it is true that the sudden opening to foreign trade will hurt some producers, general productivity will increase more than proportionately—just as technical advance embodied in robots will in the beginning displace some workers and cut into the value of obsolete capital. In any case, the cost to some producers' untamed foreign competition will be much smaller than protectionists say: supply from abroad will be less expensive and competition will force other British producers to be more efficient. When I watch show jumping championships, I rue how few are the horses left in this world now that they are no longer needed for transport. The internal combustion engine has displaced those not used for sport; but then horses cannot learn to drive, in contrast to humans. Naturally, coal miners in the United States will be displaced by imports of foreign coal, and more so by the competition

from the fracking industry. This is the short-term price of progress and in any case would be alleviated if trade were totally freed.

If the European Union members try to exact a heavy price from the United Kingdom for Brexit, the free-trade reply should be the answer. As in the 19th century, Britain could pull down all tariff and non-tariff barriers. Then, in obedience to WTO rules, the same should be offered to all WTO partners. No thought should be spent on possible balance of payments deficits. Ever since David Hume, we know that the balance of payments of a country can be left to itself. The floating exchange rate will do the job, falling or rising to equilibrate the foreign sector—on the condition that the Bank of England behaves and does not unduly pump money into the system.

I was interested in the analysis of a free trade Brexit by Edgar Miller in The Conservative magazine last June. The standard growth model he has used allowed him to forecast that

... removing tariffs creates a long-term GDP gain of four per cent [for the UK], a fall of eight per cent in consumer prices, and an increase in Treasury revenue of more than seven per cent.421

The reasons for these gains are the removal of the Common Agricultural Policy and other barriers and the freeing of imports from the rest of the world. We know that models are not exact predictors, but these and other studies of the future of the British economy outside the European Union under free trade and with flexible exchange rates allay many of the worries peddled by the interventionists. Unilateral free trade is the answer.

421 Edgar Miller: "Never mind what others do: cut your own tariffs". The Conservative, Issue 4 (June 2017), pages 87-8.

King Midas in the Indies

November 6, 2017

The world of money and finance was transformed by the discovery of America, as that Continent unjustly came to be called, or the Indies, as the Castilians named it. A flood of gold and silver washed over Europe raising the level of prices, transmuting trade and banks, changing the finance of governments, and giving rise to a new constellation of power, by pitting kings and queens, bankers and merchants, pirates and privateers, against each other.

The name of "Las Indias" reveals what the initial incentive was for the intrepid sailors that first undertook the crossing of the Atlantic in three minimal boats of some 51 gross tons each. Columbus wanted to reach the Portuguese Indies in the Far East through the back door, so to speak, sailing west. His flagship was a carrack, the Santa María; the other two, the Pinta and the Niña, caravels. It was later that galleons were used for the traffic of the Indies with Europe. One gets an idea of what it meant to sail across the Atlantic in those times if one remembers that the Santa María was lost in a storm in the Caribbean, and the Niña attacked by Berber privateers on her return. The hope was to obtain the spices of tropical India for which there was such a craving in Europe. But this was certainly not all. Gold appeared obsessively in Columbus's diary. We only know this journal because it was amply quoted by friar Bartolomé de las Casas, the great critic of the Spanish conquest. The friar made great play of the auri sacra fames of the Castilians to question their alleged care for saving the souls of the natives.

Some gold was found in the island of Hispaniola and the other Caribbean islands, and sent to Spain. Then came the gold taken by force from the Aztecs in Mexico and of Incas in Peru. An abundance of votive and religious figures in gold were melted and sent back to Spain (and to smugglers). Last century, the great historian of the traffic of precious metals in the Spanish kingdoms and captaincies, Earl J. Hamilton (1899-1989), gathered data on the proportions of weight of gold and silver officially sent to, and registered by, the authorities in Seville: from 1503 to 1530, more than 95 per cent was gold. But the treasure of gold objects accumulated by the natives was exhausted after thirty years and the Spaniards had to turn to silver and become mining entrepreneurs.

The gold and silver industry

I have mentioned Seville, where the overseeing body "La Casa de la Contratación" was established 1503. All the traffic with the Indies was monopolised by this beautiful city. In 1717 the monopoly passed to Cadiz. When visiting this gleaming white city, at the mouth of its magnificent bay, one can still see the slender towers on top of houses from where signals were exchanged by eager speculators with the arriving "Flota". Foreign merchants could not travel to the Indies but dwelt in the monopolising city. The subjects of the King of Spain outside Castile, Andalusia, and Navarre were forbidden to travel to the Americas. Even the Castilians wishing to cross the pond were carefully vetted: for one, Cervantes applied to go to America

and was rejected, perhaps because he had spent some time in prison as a tax official under suspicion. It was not until King Charles III freed trade within his possessions in 1778 that the dwellers in the Kingdom of Aragon could trade with the Indies.

The Crown did not own the mines in America, be they of gold or silver. They were claimed by their discoverers and were private property. The metal obtained, however, had to be taken to the office of a public assayer to have its fineness tested and a fifth retained by the Crown. The metal bars or cakes were engraved or punched to show all this. They could then be sent to Spain. If they were taken to the colonial mints, the amounts had to be duly registered.

Strokes of luck

A number of fortunate coincidences made the Spanish Crown rich and powerful, as the distinguished and ingenuous Italian historian, the late Carlo Cipolla, noted. The first was the circle of winds that made it possible to navigate the Atlantic taking the southern route by the Canaries to the Caribbean, and the Northern route by the Azores back to Seville. A similar wind system made it possible to send a yearly ship to the Philippines from Acapulco across the Pacific along the southern route laden with silver pieces of eight, and bring it back by the northern route with silk cloth and other Chinese specialities and ornaments.

The second piece of luck was the discovery by chance of hugely rich silver mines in Potosí in the middle of a desolate plateau high up in the Andes, crowned by the "Cerro de la Plata", the Silver Mountain. If this was not enough, systematic prospecting was crowned by the discovery of the rich mines of Zacatecas and Guanajuato near Tenochtitlán or Mexico City.

The third piece of luck came in the 1560s: the discovery and application of a new method of separating the silver from its mineral. Cinabrium is an amalgam (not a compound) of silver and metallic sulphur. The traditional process to recover the silver was to toast the mineral in furnaces, with a great expense of scarce charcoal. An enterprising merchant of Seville called Bartolomé de Medina proposed the new method of the "Patio" to separate the silver. It consisted in crushing the red cinabrium rocks on a wide surface, adding salt water and mercury to the gravel: the mercury displaced the silver in the amalgam, was then evaporated and the silver could be easily recovered. At first the needed mercury came from Almadén in the centre of Spain. The metal had to be transported in leather pouches across the ocean and then by mule to Zacatecas or llama to Potosí. Then a fourth piece of luck! An inexhaustible reserve of mercury was discovered in Huancavélica in the Andes.

What all this meant for the Indian workers can easily be imagined. In Mexico the system used to engross them into the mines was based on the Castilians acting as trustees or 'encomenderos' of the natives. In Peru they simply took over the Inca arrangement of the 'Mita' or rotation of indentured labour. The Spanish Crown tried to control excessive exploitation with ponderous laws but, in the Spanish expression, "las leyes se acatan pero no se cumplen", laws are respected but not

complied with. The poisonous effluvia of mercury were neither respecters of race and must have shortened the lives of miners and sailors in Spain and America.

Good traded between Seville (later Cadiz) and the Indies

Until the beginning of the 17th century only a minimal part of the goods needed in the Americas was produced locally. Cipolla quotes a suggestive list of the varied merchandises ventured on those frail ships apart from mercury. In 1594, the merchant Gaspar Gonzalez had his ships laden, with "spoons, candelabra, stills to produce rum, razors, leather goods, rosaries, crystal bead collars, cloth, shirts, cambric, velvet, taffeta, handkerchiefs, copper lanterns, and many other things". The return goods, apart from silver, could be scarlet cochineal, blue indigo, medicinal plants, precious woods, sugar, tobacco, and silk from the Philippines. This trade however was only the surface of what has been called "the great Columbian exchange." Some of it was conscious: Columbus took sugar plants, cattle, sheep and pigs to Hispaniola. Cortés invaded New Spain (Mexico today) with the help of horses. Coffee, wheat, and other cereals (except maize) were transplanted to the Indies. Some of the transfers were technical, especially the wheel. Going the other way were potatoes, tomatoes, chocolate, chillies, peanuts, manioc (to Africa), and tobacco. One deadly and involuntary export from Spain was the diseases against which the natives were not immunised: Thomas Grennes reminds us of the tragedy of 90 percent of the population in today's Mexico dying of new illnesses in the century after conquest.422 In sum, as Grennes adds, there would be no hamburgers in the United States, nor tomato sauce for the spaghetti in Italy but for the great movement of species of plants and animals started by Christopher Columbus. The beheaders of his statues in Los Angeles should totally renounce Big Macs and pizzas if they were consistent!

To fight off pirates and privateers it became obligatory to travel in well-armed convoys. The earliest is known to have been organised in 1535. In July 1561 a decree laid down that there were to be two convoys per year on the "Carrera de Indias", the Road to the Indies. One would leave Seville in March or April destined for New Spain to collect the Mexican silver and other goods in Vera Cruz; the other in August before the hurricane season, to ship back the Peruvian silver, brought to Cartagena de Indias across the Isthmus and by ship from the port of Callao. It must have been a magnificent (and tempting) spectacle to see the long train of merchants vessels in full sail, headed by the Captain's armed Galleon, the rear brought up by the Admiral's Galleon, and two or three men-of-war to windward of the convoy. The successes of pirates have been exaggerated. In total only three convoys were captured in two and a half centuries, one completely in 1628 by the Dutch privateer Piet Hain and two others partially by the English. Not one was captured on the Pacific route from Callao to Panama. The true headache of the Spanish authorities was smuggling. Ramón Carande, the author of the classic Charles V and his Bankers gives the example of a galleon that sank between Cadiz and Gibraltar in 1555. The declared treasure on board was 150 thousand pesos or pieces of eight. The cargo was retrieved and it was discovered that the ship was

422 Thomas Grennes, "The Columbian Exchange and the Reversal of Fortune." PDF file.

carrying another 150 thousand undeclared pesos. The measures taken to stop smuggling were not very successful! How much gold and silver

The statistic everyone uses is that of E. J. Hamilton for declared gold and silver imported into Castile. Smuggling under its different forms must have increased that amount sizeably. But let me give the figures collected by the heroically patient Hamilton in Table 1.

Table 1.

Of course, if we compare these totals with the present day's gold and silver production they seem puny: some 2,500 tonnes are the yearly average gold production today; and 26,800 tonnes that of silver. But there

had been a dearth of the precious metals in Europe before 1492, so that these small quantities were nothing short of revolutionary for trade and for prices.

The story of the rivalry between gold and silver has been one of slow retreat of silver due to its progressively greater abundance. From 1497 to 1536 the official rate of exchange in Castile was 10.11 to 1. Then it fell to 10.61 in 1567. The 19th century bi-metallic systems rated silver at 15.1. The market today has it at around 74 to 1.

Much of this silver was coined, in pieces worth eight reals, "reales de a ocho" as they came to be known. These pieces came to be so well accepted that they were found in Japan, China, and India. Cipolla carefully explains that in the Far East they were valued by weight and not by size, so that one often finds them cut in half or quarters to fit the exchange. However, in Europe they became so popular that they were accepted at face value, which led to some authorities in Italy, for example, forbidding the circulation of coins proceeding from some mints in the Americas, for being underweight or lacking in fineness.

To give an idea of what these precious metals could buy, let me calculate what building the Monastery and Palace of El Escorial must have cost. Some of my readers may have visited that imposing pile. The sharp air of the mountains behind Madrid has kept the stone in its primitive neatness. Rarely is a royal palace started and finished within the life of its kingly builder. It is in a way the portrait of Philip II—severe, majestic, and almost forbidding. According to Father José Sigüenza, present in or around the Monastery for the duration of the works, from their inception in 1562 to its completion 1598, the year of the king's death, its total cost was 5,260,568 ducats, to which he added the expense of other "embellishments", resulting in a final figure of 6,200,000 ducats423 spent over 36 years, the equivalent of nearly one billion dollars at today's gold prices.424

The sorrows of inflation

Of course, the flow of gold and silver pushed up prices in Spain and to a lesser extent in the rest of Europe. Hamilton was a 'quantitativist', by which I mean that he applied the 'quantity theory of money.' The very title of his book shows it: American Treasure and the Price Revolution in Spain, 1501-1650. To show this he made a brave effort to calculate inflation for those years in Castile. The comparatively small quantities of gold and silver did have a clear effect on prices.

At the time, inflation was noticed but wrongly attributed to the demand for goods coming from the Indies, or even more superficially to speculation. Today, critics have argued that the rate of increase in prices did not faithfully follow the increase of the money supply. In a closed economy prices in terms of gold and silver would tend to reflect proportionately the influx of the two metals. But much of the smuggled amounts passed to the rest of Europe. A large part of the sums received by the Treasury were spent abroad in the different wars and foreign exertions of the Crown. Still, inflation there was, causing a veritable revolution in the economies of Europe.

According to Hamilton's careful calculations, based on the accounts of hospitals and colleges, from 1501 to 1550 prices in Andalusia, the New and the Old Castile,

423 The Venetian gold ducat was a money of account, equivalent to the value of 0.11223 troy ounces in 1570, an ounce being worth some $1,350 on the market today. The 6.2 million ducats are equivalent to 21.6 metric tonnes in weight. 424 The minimum yearly cost of 20 infantry regiments and 10,000 cavalry is reckoned at

5,528,640 ducats by historian Modesto Ulloa (1977), pg. 110. And the yearly cost of a large war galley with its full complement and armament is given by the historian Modesto Ulloa at 10 to 11,000 ducats.

and Valencia increased by 127.74 percent. The rise continued, so that by 1600 the increase from 1501 had been 252 percent. Now 252 percent over 99 years is, according to my calculations, a 5 percent annual rate of inflation. This must have looked enormous to the ordinary consumer in a half monetised country, though to us poor subjects of authorities intent on maximising the inflation tax under the pretext of fostering growth, it may not appear so great.

A paradoxical consequence of the unwonted abundance of precious metals was that money became scarce. The Crown, the Church, and the great noble houses lived beyond their means. Honour and Reputation led to continuous was and expensive show. The higher reaches of society were in thrall to German, Italian, and converted Jewish bankers. But this was not all. It is a well-known phenomenon that there comes a point during a sustained inflation when money disappears. Silver left for other parts where its purchasing power was greater. Small change disappeared, as its metallic content became greater than its face value. The Cortes complained bitterly because there was no wherewithal to conduct trade. The King, in this case Philip III, relented and graciously debased the currency and struck more copper coins. Of course, the real aim was to obtain more seignorage for the Crown— seignorage meaning the difference between the metal content and the higher face value. The first large issue of pure copper coins took place under Phillip III, as I say, in 1606. Then came the second large issue of copper money or vellón (old Spanish for 'ingot' or 'bullion') by Phillip IV in 1624-28 in great need of funds at the beginning of the Thirty Years War: the premium on silver then reached 55 percent. The third copper inflation took place in 1640 to 44, forced by the need to put down the rebellion of Portugal and Catalonia in the 40s and the silver premium reached 200 per cent in the Old Castile in 1642. One must not forget that the price level in silver terms was itself inflationary—a double whammy.

The most important consequence for Castile of the discovery and exploitation of precious metals in the Indies is another one: Spain in the 16th and 17th centuries suffered the so-called 'oil curse', a combination of monopolistic mercantilism and distorted politics, as happens to traditional societies that suddenly discover oil or gas. A plethora of rich mines together with a great technical advance in the extraction of silver made the precious metals the main, almost single, exportable product of the Spanish economy. This meant three things: that silver displaced other possible exports; that silver lost value in international markets; and that price inflation hit the domestic economy hard. The illusion of riches made the European rulers of the kingdoms and captaincies of the Indies pursue unreachable political and religious goals of domination—to the cost of Castile, Sicily, Naples, and Southern Flanders. For two centuries everything Spain touched seemed to turn to gold and silver. This has left us with a magnificent heritage in art, architecture, music, literature, and a language shared by twenty-three republics and a kingdom. However, it is one of the great lessons of classical economics that financial services do increase production, but money itself is not wealth. One cannot eat gold and silver, as Midas to his sorrow found out at the dawn of civilisation.

Let Me Make My Peace with Mill

January 1, 2018

John Stuart Mill was my companion for more than three years, while I was writing my dissertation on what I called his New Political Economy (1965, 1972). Every generation, every school of economists, has the ambition to rewrite economics. The case of Mill was a special one. Analytically speaking he was the last of the great English classics, but as a political economist he was the first of the moderate socialists. His Principles of Political Economy (1848) made reformist socialism respectable in his country. In American terms, he was a 'liberal' economist of the best kind, theoretically precise and politically radical.

However, Mill cannot be understood merely as an economist. It is enough to pick some of his principal writings in the different fields of philosophy to see that an evaluation of his legacy must take a wider perspective. Thus, his System of Logic, Ratiocinative and Inductive (1843) was a polemic against the kind of metaphysical and intuitive philosophy that was being imported from Germany. His three great essays, On Liberty (1859), Utilitarianism (1861) and Representative Government (1865), dealt with individualism, ethics, and political theory. And The Subjection of Women (1869) dramatically linked the inequality of women in Victorian society with the great question of the emancipation of slaves, in which Mill was prominently engaged.

What I want to do in this limited space is to review Mill, the social-liberal thinker, from the point of view of a classical liberal, which is what I am today. I will do so without regard to chronology, as if I were discussing Millian philosophy with a young person who was asking advice on how to approach that great thinker.

Individual liberty

John Stuart Mill's greatest contribution to political philosophy is without doubt what he had to say about the freedom of the individual in his 1859 essay On Liberty. This essay starts from two principles: the first one is that the free discussion of all doctrines and ideas is essential for the discovery of error or the reassertion of truth; the second is that adults should be able to act according to their wishes and convictions in all that concerns only themselves. These two principles are in a way equivalent: freedom of opinion and discussion is essential in the search for truth; and freedom to act in all self-regarding matters and bearing the consequences is essential for character building and the flourishing of personality.

As regards the liberty of thought and expression, Mill's doctrine is the canonical liberal position. He defends it with three reasons: (1) an opinion forcibly silenced may be the truth, even if we cannot eo ipso know it; (2) even if a silenced opinion may be wrong, it may contain a parcel of truth and normally does; (3) even if a received opinion is wholly true, it may, unless seriously challenged, become mere prejudice and those who hold it may not be aware of the reasons that back it. What

could be missing here is the argument from corruption: the spreading of false or wicked opinions may smother the truth, unless we think that truth will in the end always prevail. Mill himself accepted the fact that prison and the stake could repeatedly smother new truths but he used this argument a contrario by stressing the importance of allowing free discussion and rejecting the use of force to defend any doctrine. These three reasons are for me incontestable. In any case I think Mill's arguments for freedom of opinion and expression in the end have the day.

Mill then widened the argument as he proceeded to defend more than freedom of opinion: full personal autonomy in "Individuality" and in "On the Limits of the Authority of Society over the Individual." The tradition going back to the common law, Magna Carta, the Bill of Rights, and the First Amendment of the American Constitution was the defence of individual freedom against unlawful interference. But Mill went further, by defending the freedom of "experiments in living." He argued not only against legal and political interference with individual autonomy but against "the tyranny of public opinion".

We classical liberals are usually more restrained in our defence of individual freedom. We dare not go further than defending "negative freedom", as Isaiah Berlin called it and do not back our claims by alluding to the wondrous things individuals would do with their self-government. Mill and his beloved friend Harriet Taylor showed more ambition. Personal liberty was for them (and I say 'them' intentionally) a crucial factor in the formation of character and the flourishing of the individual. Personal flourishing was something he deeply prized after rebelling against his utilitarian education and cultivating his friendship with Harriet Taylor.

Frederic Rosen (2013) rightly stresses the odd expression used by Mill in the introduction of the essay: he says that the subject of On Liberty is "civil, or social Liberty". This expression indicated his wish to criticise "the idea of society exercising power, presumably through social or public opinion." All this indicates that Mill was not exaggerating when he presented the essay as a joint effort; and social oppression was heavily felt by both during their fifteen year friendship and three year marriage. Harriet Taylor died before the work was finished.425

Of course today we think mainly of the unacceptable rejection of different forms of sexuality in Victorian times. Here it is enough to apply the rule that selfregarding actions are to be fully permissible, while focussing on the character and

425 This was the dedication. "To the beloved and deplored memory of her who was the inspirer, and in part the author, of all that is best in my writings—the friend and wife whose exalted sense of truth and right was my strongest incitement, and whose approbation was my chief reward—I dedicate this volume. Like all that I have written for many years, it belongs as much to her as to me; but the work as it stands has had, in a very insufficient degree, the inestimable advantage of her revision; some of the most important portions having been reserved for a more careful reexamination, which they are now never destined to receive. Were I but capable of interpreting to the world one half of the great thoughts and noble feelings which are buried in her grave, I should be the medium of a greater benefit to it, than is ever likely to arise from anything that I can write, unprompted and unassisted by her all but unrivalled wisdom."

feelings of the people involved in marriage or personal relationships to value forms of life in each case. Positivism

One of Mill's lifelong battles was the one he waged against metaphysics in the theory of knowledge and against intuitionism in ethics. In this battle he clearly followed in the tradition of Jeremy Bentham's positivism and James Mill's associationism and added a historicist bent taken from Auguste Comte. Bentham always insisted on reducing abstractions to their observable material parts— witness his rejection of natural rights as "nonsense on stilts". James Mill was the author of a detailed book on association theory, the basis of his rejection of the influence of innate qualities compared with environment and education—the best instance of which was the relentless upbringing of his son John. Comte for his part thought he had discovered the sociological laws of evolution of society, so that he tried to convince his

friend Mill of the uselessness of a merely static analysis of logic, psychology, and economics in favour of dynamic historicism.

The 1842 book published under the title A System of Logic, Ratiocinative and Inductive makes one marvel at the intellectual power of its author. It is on the same plane of achievement as his Principles of Political Economy, which appeared in 1848 and then many times was republished. Mill's other productions are shorter or more specialised and given to the application of one central idea to a particular question. They are no small achievements. However, the sheer width of treatment and the integral connection of the Logic and the Principles makes one wonder at the power of his fine mind. It is no surprise that he suffered from repeated depressions along the years. I say this to put my critical reflections in context. It is very rare to see one person produce such major works and in such a limited span of years, and all this while he was occupied at India House. Mill continued to be a prodigy long after he had long left infancy.

I see from the marks in my copy of the Logic that I read and tried to digest the book in my younger years, though it would take me now long hours of study and much reference to other writers to make intelligent comments on so abstruse a topic. The first thing to be said is that it is a positivistic treatise, where abstract concepts are rooted in sense data, observable fact, and material verification. Even numbers were sublimations of material things, got from counting and operating with actual phenomena.426 It seems clear that this view of logic and scientific discovery was inductive to the core, starting from, and validated by, sense data. It was meant to present an empiricist view of knowledge, in the tradition of Thomas Hobbes and John Locke and in direct opposition to the intuitionist and metaphysical philosophy coming from Germany. During the composition of the Logic Mill was in constant correspondence with Auguste Comte. They both approved of the destruction of the mediaeval metaphysics wrought by the likes of Jeremy Bentham and James Mill in the 19th century. But they wanted to proceed to a positivistic philosophy to

426 Thus, the difference between one gallon of water and ten gallons of water "is known to us by a set of sensations it excites"; the number does not exist on its own but is an abstraction of sense data. (Logic, Book I, chapter iii.12, "Quantity").

counteract the new Tory intuitionism of those who rejected analytic criticism of traditional institutions.427

His epistolary friendship with Auguste Comte is a strange episode in Mill's life. They never met but exchanged no less than 89 letters from November 1841 to May 1847, while Mill was fully occupied with writing and publishing his Logic and well advanced with the Principles. Comte, who was really deranged, submitted to himself systematically to "cerebral hygiene", consisting in not reading any but his own works. He ended by foreseeing the necessary arrival of a 'positive' dictatorship imposing 'Ordem e Progresso", the Comptian motto on the Brazilian flag. Mill joined him in the battle for positivism against reactionary metaphysics. As can be seen in Book VI of the Logic, "The Logic of the Moral Sciences", Mill was attracted by Comte's highly questionable idea that societies necessarily evolve in three states: theological, metaphysical, and scientific or positive. One can also see the influence of Comte on the Principles in a number of points, such as the distinction between the unchanging laws of production and the modifiable laws of distribution, parallel to Comte's concepts of 'statics' and 'dynamics'. Yet he still wanted to write a treatise of economics, despite Comte's rejection of this science. In the end, Mill strongly criticised Comte's descent into un-freedom and clearly distanced himself in Auguste Comte and Positivism (1865).

Despite Mill firmly keeping himself on the side of the angels, I think the philosophical, methodological, and political programme of positivism is fundamentally wrong. There have been repeated attempts in the 19th and 20th centuries to oust metaphysics from meaningful discourse, the most radical being the logical positivism of the Vienna Circle. Of course metaphysical musings often vaporise into mystical cant, but much of what we try to formulate about the world and society is not 'scientific' in the sense of being empirical and testable. It was Karl Popper himself who crossed swords with the ultra-positivists, most famously in the incident of Wittgenstein's Poker [book by David Edmonds]. Some of our most important framework beliefs are non-scientific and 'metaphysical' under Popper's classification but full of meaning: the most important is the Theory of Evolution, which cannot be tested as a whole since we can only observe one instance of it (at least for the time being). True, unjustifiable vapours can rise from it, especially when one holds that Evolution has direction and a goal, despite the patchiness of fossil remains, and slips into Neo-Darwinism.

Economics

Mill sought to transform the political economy of his masters from what he thought was a narrow science into an instrument of social progress. He wanted to rescue economics from being seen as a dismal science to turn it into a humane and hopeful one. Of course he started from all he had learnt from his masters, his father James and especially David Ricardo. Two influences must be noted in his endeavour: one negative, one positive. One I have noted, that of Auguste Comte. The other powerful one is Harriet Taylor's. She naturally would have no contribution to make

427 He would later reinforce this opposition to non-positive philosophy with a study of Sir William Hamilton's Philosophy (1865), a huge tome which nobody reads today.

to the scientific side of Mill's economics but was material in the inclusion of a famous chapter on "The Futurity of the Working Classes" in Mill's Principles. He very much sided with Harriet Taylor's belief that the transformation of society would come with the elevation of the working classes through their elevation in knowledge and character, among other forces, by the effect of his 'New Political Economy'.

Again, as with the Logic, one sees a powerful mind at work on a subject he was fully conversant with. From the analytic point of view he showed himself most inventive, though he did not blow his trumpet over those achievements, as George Stigler put it in his piece on "The Nature and Role of Originality in Scientific Progress" (1955). Without the mathematical garb that has become de rigeur in the 20th century, Mill made at least seven path-breaking theoretical contributions: non-competing groups, joint products, opportunity cost, the economy of the firm, the correct formulation of the law of demand and supply and of Say's Law [see John-Baptiste Say], and his masterly discussion of international trade. Economists who read my column will be duly impressed. However, Mill saw these contributions as mere corrections of faults in the model of David Ricardo on which he had been brought up by his father. They were not as important as his endeavour to explain 'Some of the applications of political economy to social philosophy', as he put it in the title of his 1848 treatise. So let me go straight to the non-analytic side of the Principles.

Mill started Book II of the Principles with a momentous distinction between the laws of production and the laws of distribution. "The laws and conditions of the production of wealth partake of the character of physical truths". On the other hand he affirms that "It is not so with the Distribution of Wealth. That is a matter of human institution solely. The things once there, mankind, individually or collectively can do with them as they like."

The crucial phrase is "the things once there", because it takes no account of the effect of redistribution in period 1 on the production in period 2. On this thought Mill based his proposals to reform property rights in Great Britain, to change the laws of inheritance, to make life easier for trade unions, and to examine socialist proposals. More interesting for our time, it is this distinction that is at the bottom of social-democracy, as we have known it all along the 20th century. Despite Mill's solid defence of free trade and economic competition (even among socialist cooperatives), this is what makes him the inspirer and patron saint of the moderate left in the West and indeed the whole world.

Whether one accepts or resists redistribution to reduce inequality of income and wealth, one's view of Mill's economic and social legacy will be fundamentally different.

Socialism, liberty, and the subjection of women

Ah! But where is Mill's discussion of the merits and demerits of socialism, for which he became famous? I want to break new ground by linking Mill's (and Harriet's)

view of socialism with the essay On Liberty and the polemic on The Subjection of Women.

When I wrote my chapter on Mill and socialism in my 1972 book, I came to the conclusion that, as he says in his Autobiography, the influence of Harriet Taylor inclined him towards socialism while she lived but that in later years he drew back somewhat from this position. The phrase has been much quoted:

We were now much less democrats than I had been, because so long as education continues be so wretchedly imperfect, we dreaded the ignorance and especially the selfishness and brutality of the mass: but our ideal of ultimate improvement went far beyond Democracy, and would class us decidedly under the designation general of Socialists. (Collected Works I, page 239)

I do not need to rehearse the analysis of different socialist experiments in the first and third edition of the Principles (1848, 1852). His examination of different socialist experiments and his defence of cooperation are interesting in themselves, in as far as they show Mill at his rational best even when he started from a parti pris position. And his cooling off in the Posthumous Chapters on Socialism again shows his level-headedness.

I rather want to underline what he says about the character of the masses. Mill and Harriet Taylor defended individual liberty as a force for change in the character of a people and a country by a diffusion of excellence and an elevation of custom by the example of the élites. He in fact, under the influence of Comte, repeatedly tried to start the systematic study of 'Ethology' or the character of a society. Though he never advanced much along this way the thought was always present that he wanted to propose reforms in mores and institutions to elevate individuals, classes, and countries away from their present brutality.

And this is where The Subjection of Women comes in. For John Stuart Mill and Harriet Taylor it was not only the injustice of the treatment of women in traditional and modern societies that they were fighting against. They hoped for more. They expected that more fairness in social habits and the vote for women in politics would make for better individuals and a more exalted society as a whole. Today we tend to be less hopeful on the refining effects of liberty and feminism and defend them for themselves rather than for idealistic reasons. But this shows us what kind of persons John Stuart Mill and Harriet Taylor were.

Karl Popper Vindicated

February 5 2018

Philosophy as a problem

On October 25, 1946, Karl Popper read a controversial paper at the small Moral Sciences Club of the University of Cambridge in England. It was a private discussion club. Its most distinguished personality was Ludwig von Wittgenstein (1889- 1951), one of the pillars of 'linguistic philosophy', then an important school in England, soon to have many followers in the United States. This way of practicing philosophy was launched at the Vienna Circle by Moritz Schlick between the two World Wars. Popper took the invitation to speak at the Cambridge Club as an excellent opportunity to confront Wittgenstein, the champion of linguistic philosophising, a practice which Popper, since his youth in Vienna, considered nothing less than frivolous. Popper's admired Bertrand Russell was also a regular attendant; Popper considered him an ally in his fight against linguistic philosophy and positivism and wanted to strike a deeper acquaintance with him on the occasion of the seminar.

Let us imagine the scene. It was cold in the room where the Club met. Post-war restrictions made for a miserly coal-fire, barely kept alive with a poker. Thanks to the fascinating book by David Edmonds and John Eidinow, Wittgenstein's Poker (Harper Perennial, 2001) we know as much as can be known of the meeting that day. Popper wanted to give his talk the title: "Do philosophical problems exist?" Popper thought that philosophy dealt with, and should deal with, true problems. So he wanted to attack Wittgenstein, who, on the contrary, maintained that there were no problems in philosophy, only verbal puzzles.

For Wittgenstein, the philosopher's task was to clarify concepts, correct the use of words, solve verbal confusions, and thus "help the fly to get out of the bottle". That was the task Wittgenstein set himself in his first book, the Tractatus Logico- Philosophicus (1922). Later, in papers posthumously collected as Philosophical Investigations (1953), he moved from wanting philosophers to solve philosophical confusions by using a language without ambiguities to doing so by following popular usage. In any case, he held by the doctrine of the Vienna Circle that propositions with sense could only be of two kinds: analytic propositions, meaning logical and mathematical tautologies; and empirical propositions, verifiable by observation. Everything else was senseless metaphysics.

Popper, on the contrary, always believed that philosophers should face real problems, even if they could not solve them completely: problems such as the failings of induction, the nature of probability, the relationship between cause and effect, the possibility of free will, the sense of ethical propositions, or the dangers of expressivism in music. (I well remember how he always asked, when we proposed a piece of research, "What is your problem?" and how he admonished us that a problem is not fully understood until it is solved.) Indeed the whole of the

logic of scientific discovery to which Popper dedicated a great part of his time, is 'metaphysical' but still full of sense and import.

Edmunds and Eidinow relate that as soon as Popper made the first move, Wittgenstein got up to monopolise the conversation, as was his habit. He started to shout, as also was his habit, stressing his

exclamations of "Popper, you are wrong!" by jabbing the air with his poker. Nobody seems to know what really happened at that point. It seems a voice was heard (some witnesses say it was Russell's): "Wittgenstein, put that poker down!" Neither do we know whether what caused Wittgenstein's brusque exit banging the door, as again was his habit, was Popper's reply to a question from the floor: "Give us an example of an ethical rule." Popper answered, "Do not threaten visiting lecturers with pokers".

Scientific method

In his doctoral dissertation of 1928 and his Logic der Forschung (1934), Popper had posed and partly solved a number of fundamental problems of the theory of knowledge. The first was on the demarcation line set by the positivists of the Vienna Circle between meaningful and senseless propositions: their demarcation line between the two was whether they were empirically verifiable, if they were not they were senseless. For Popper, there were non-verifiable propositions that made sense, especially ethical and esthetic propositions. His demarcation line was not between meaningful and nonsensical propositions but between scientific propositions (refutable) and non-scientific (that one did not know how to refute).

The second problem fundamentally solved by Popper was the problem of induction. David Hume had pointed out that we could not be sure that the sun would rise tomorrow just because it had done so as far back as one could remember. Popper generalised this by saying that it was impossible to assert the truth of a theory by the repeated observation of its instances; it was only possible to refute it when its predictions turned out to be false. One could only assert for sure the proposition that all swans were white by induction after having observed all past, present and future swans, not a very fruitful methodology. From this Popper drew two fundamental conclusions: that it was a mistake to aim at certainty; and that knowledge did not advance through verification or confirmation of hypotheses, but by attempts to refute them.

I vividly remember my excitement when I heard Popper 'solve' the problem of induction in class. My teachers in Madrid had always explained to me that the method of science was a combination of induction and deduction. Not so! You should have seen me speaking aloud and waving my arms in the surrounding streets of the London School of Economics: science is not inductive! (There were no mobile phones then, so the passers-by must have thought I was deranged.)

As Popper himself pointed out, the solution of one problem poses new ones. The scientific method is more than mechanically applying the hypothetic-deductive method. Refutation is rarely final and sometimes one must hold to a 'refuted' theory to give it a run for its money. But this is for another day. I only want to leave

this topic with the literary image on the frontispiece of the Logic of Scientific Discovery (1959): "Theories are nets: only who throws them will catch. Novalis".

Tribal Society and Open Society

I was in the third year of my Law studies in Madrid when a book caught my attention in a bookshop. It was called The Open Society and its Enemies (1945, 1957). On its cover, that Spanish edition carried the portraits of three of those enemies: Plato, Hegel, and Karl Marx. I flipped through its pages, looked at the introduction and the table of contents. I could not make heads or tails of the presence of those three illustrious philosophers on the cover of an essay criticising them. Fast forward. One day I was walking down the corridor towards the refectory when I saw this sign on a door: "K.R. Popper". I knocked and asked the diminutive professor behind the desk, "Are you the author of The Open Society?" So started a great and fruitful friendship.

The book was a sensation in the United States and the United Kingdom when published in 1945. Popper told me once that after the Anschluss he asked himself whether he should try to kill Hitler. He decided to try to destroy the philosophy embodied in the Führer instead. It caused a scandal in academic circles because of the impassioned work of demolition of those three revered figures. Popper dared present Plato as a reactionary enemy of Athens and friend of Sparta, and Hegel as an obscurantist servant of the Prussian State—pure blasphemy! He was accused of an anachronistic misunderstanding of Greek culture and an incapacity to understand German philosophy. In conservative circles, there was further shock at seeing Marx treated more kindly than Plato and Hegel.

I have to take my courage in both hands to dare to differ with those critics of Popper's great book. Still, I would tell the admirers of the Republic that they should ponder the dangers of a philosopher-king and compare that dialogue with the Funeral Oration of Pericles on the commemoration of the dead of the first year of the Peloponnesian War. If they are not yet convinced, they should read the purely Platonic dialogue of The Laws and imagine themselves in the clutches of the Nocturnal Council.

Of Hegel, what can one say that does not paint him in an even worse light than that thrown on him by Popper? Let us move in imagination to Jena in 1806, after the battle in which Napoleon crushed the Prussian army. Hegel wrote, "I saw the Emperor, the Spirit of the World, pass-by on horseback, to go and contemplate his kingdom". To the admirers of Hegel, one could say in extenuation that they must have had difficulty in understanding his peculiar German.

The future of history is not yet written

Popper's analysis of Marx's philosophy centres mainly on the errors of 'historicism' inherited from Hegel. Historicism lays down that history follows a necessary path. Another of my masters in Spain taught me that the object of social science was to predict the evolution of history. Popper's lectures on historicism opened my eyes

to the idea that the future has not been written. He had developed this idea in his book The Poverty of Historicism (1947), in which he distinguished two kinds of theories of history: "anti-naturalist" and "pro-naturalist". The first considered that human societies could not be studied with the methods of the natural sciences; the second that the method of physics could and should be applied to sociology. Hegelian theories belonged to the first kind, since for Hegel, history was the development of the mind or reason. The second kind was proposed by Auguste Comte, for whom the observation of positive data showed that human societies necessarily progressed towards comprehensive and centralised organisations. From the logical point of view, Popper was in the end content with saying that "we could not predict, by rational or

scientific methods, the future of our scientific discoveries". If we could, they would not be future. This consideration is also applicable to technology, as the experience of the last fifty years abundantly shows. One reason why Popper treated Marx so considerately is that Marx unwittingly produced a testable theory of the necessary trend of capitalism towards monopoly and the inevitable immiseration of the working class—and that this theory had been proven false by the path followed by Western society and by the horrors inflicted on millions by Marx's disciples. There was also Popper's soft spot for social-democracy, well documented by Malachy Hacohen (2002), which inclined Popper to lament the cruelty of early capitalism and to show preference for the welfare state.

Small discrepancies

My conversations with Popper later in life threw light on some of our differences on economic questions. To his proposal that social reform should never be wholesale and always open to trial and error he gave the unfortunate name of "piecemeal engineering", which gave the impression that he was ready to have politicians and bureaucrats shape society from above. As time passed, however, the shortcomings and difficulties of the welfare state made him more sceptical of the promises made in the aftermath of the war. We still differed on the shortcomings of free markets, which he thought were larger than I believed. We also differed on his reformulation of utilitarianism, whose measurement difficulties he thought he had solved by substituting minimising pain for maximising communal pleasure. Still, I now think that the logical impossibility of moving from facts to values can be solved by analogy with the refutation of hypotheses. But this again is for another day.

Under the influence of his lifelong friend Friedrich Hayek, he came to view social science as necessarily an evolutionary theory, which is clearly a move in the right direction. He was interested in Darwinism from its early days, as a 'metaphysical' theory that nevertheless provided a suggestive framework for biology and sociology. He always rejected teleological interpretations of evolutionism.

My past criticisms of his doctrines do not detract from my gratitude to Sir Karl Popper for all he taught me over the years and for the treasure of his friendship. I think of all this when I hear my wife and my daughter sing by the piano that the great philosopher bequeathed them.

Language and Liberty

April 2, 2018

Some twenty years ago, I was driving in Belgium and stopped at a petrol station. You must know that I am inordinately proud of my French, so that, though I was in Flanders, a Dutch speaking region, I asked in French for my car to be refilled. Blank stare! I then told the uniformed employee that I was Spanish and did not know any Flemish. Ah, Monsieur! That is a different matter. "Naturellement, je vous servirai en Français". That evening, at a dinner in the University of Leuwen, called Louvain by the Francophones. I related this incident to my companion. He was not surprised or shocked. "These questions of national language can be solved easily", he said. "For example, I was the Librarian of the University when it split along language lines. I am proud to say that we easily agreed on how to separate our holdings of scientific reviews: even volumes would stay in the old French building; odd go to the Flemish".

The politics of language

If you believe in individual freedom, you may repine at the idea that the language spoken in a region should be a matter of social imposition or public policy; and object even more strongly that it should become the only legal vehicle for the education of the young. This was the position of the revolutionary governments of France: national education became a duty of the state, a policy continued by Napoleon. Not only in France! The great Prussian linguist Wilhelm von Humboldt, during his brief period as the Prussian minister of Education in 1808-09, put the education system of his country at the behest of government. It would follow a single pattern in all public schools. The University of Berlin, which he transformed (it bears his name even today), should not be content with teaching the professions but be a place of research for the benefit of society. In short, it was for the state to foster the Bildung, or education of the people, and organize the discovery of new knowledge.

The general movement in favor of state education was reinforced by the romantic idea that language is of the essence of the nation. National education became an instrument of acculturation, clearly so in the United States with the common school movement of the second half of the 19th century. We economists have sanctified public education, despite its evident failures, as a strategic element of economic growth and social mobility. The growth and consolidation of state institutions around the world from the last quarter of the 19th century onward has revived the old mercantilist belief that religion, education, culture, the economy, should be at the service of national and political ideals.

It was because of the upheaval of World War I that language fully became an instrument of political affirmation in Europe. The old-style empires overthrown by the war had been places where many languages were freely spoken, even if the imperial administration used one of them as the means of legal communication. Under the Sultan, people were free to speak and worship as they wished, as long as

they paid their taxes. The Tsar and his ministers spoke Russian (and French) but Poles, Baltics, Volga Germans, Turkomans, Sephardim, and Ashkenazim more or less happily conducted their lives in their age-old tongues. The centuries-old Holy Roman Empire officially ended in 1806. In its place sprang the Austrian Empire, transformed in 1867 into the Austrian Empire and Hungarian Kingdom. Hence, Emperor Franz Joseph I, during the long reign that ended with his death in 1916, was titled "Emperor of Austria" (with its dependencies, such as Bohemia,) "and King of Hungary" (with its subject peoples such as the Croats). My point is not heraldic but linguistic. True, the court in Vienna spoke German and the court in Budapest Hungarian, but the languages of the empire and monarchy were manifold. Though there were German and Hungarian nationalist parties, the various subjects of Franz Joseph were not systematically forced to give up their traditional modes of expression. These crazy-quilt constitutional arrangements may look illogical and old hat to modern democrats, and so they must have looked to dear old President Woodrow Wilson when he issued his Fourteen Points program as a justification for entering the war. What could be more logical for an American liberal than selfdetermination of the peoples of the Austro-Hungarian Empire along linguistic lines? The trouble was that the lines separating Italian, Slav, Rumanian, or Hungarian speakers were often tied in hopeless knots. Wilson did not know the hornets' nest he was stirring up.

My readers need not reside in Europe to see language used and abused as a political tool. It may not be much of a constitutional question in the United State, but in Canada language is a political problem: the use of Canadian French (somewhat different from that spoken in France) is more a question of national

identity than one of spontaneous social habit and convenience. The same sort of linguistic questions agitate nationalists across Europe, among whom are the nationalistic minority in Catalonia: they want the Catalan language to displace Spanish in their region, as a first step to independence.

Let me explain that Catalonia (whose major city is Barcelona) has never been an independent state. It has been united with the rest of Spain since 1565, when Queen Isabella of Castile and King Ferdinand of Aragon were married—more than a quarter of a century before Europeans had even heard of America. The Spanish language that millions speak today in both hemispheres was a ,latecomer in the landscape of the Iberian Peninsula. On the Atlantic seaboard, Portuguese was spoken; on the shores of the Mediterranean, it was Languedoc (a predecessor of Catalan). Portuguese and Languedoc showed deep similarities. Then Castilian, or Spanish, wedged itself between the two. In the 16th and 17th centuries, the spread of the Castilian territorial possessions ("over which the sun never sets") made Spanish a world language. It was only after possessions in America, and especially that of Cuba in the Spanish-American War of 1898, that Castilian lost much of its attraction for minorities in Spain. Catalonian nationalist have made a big effort to try to revive Catalan, by making it compulsory in schools, universities, and trade, and presenting the use of Spanish as an imperial imposition. But Spanish is now the language, not of a long disappeared Castilian empire, but that of a kingdom in Europe and eighteen independent republics in America. How did this commonality of language emerge, with no centralized state to impose it?

The answer to that question is apparently easy: the profound effects of three centuries of Castilian lordship over America must surely have extended to the way people spoke. The surprising fact is that the dominance of the Castilian language came only after independence from Spain in the early 1800s.

The transformation of America under Spanish rule

This is not to say that the Spanish conquest and settlement did not have deep, and in a number of fields, regrettable effects on the lives and welfare of the natives, but these effects did not extend immediately to the general use of Castilian. At the more basic level, the so-called "Columbian Exchange" took place, whereby plants and animals passed both ways from one side of the Atlantic to the other. We Europeans gained such staples as potatoes, maize, and cassava; and tasty condiments such as tomatoes, chili peppers, cacao, peanuts, pineapples; and the enjoyment of the 'weed', or Cuban tobacco. From Europe, new plants were sent to America, such as wheat, sugar, and coffee; also, animals, as horses, cows, and sheep; and metals such as iron. Castilians brought back precious wood and red cochineal, and more notably gold and silver. The silver mined in Mexico and Peru helped finance Spain's foreign policy, but turned the metropolis into a case of 'Dutch Disease' and resulted in inflation over the whole of Europe.

Another 'exchange' was little short of catastrophic: the contagion of diseases against which the natives had developed no resistance: smallpox, measles, scarlet fever, typhus, cholera, and malaria; and the other way, the spread in Europe of the deadliest form of syphilis. The depopulation in America was unbelievably severe. The deadly effects of the epidemics on Indian society were multiplied by social disruption and the imposition of forced labor. It took two centuries after the conquest for the native population to stop falling and reach stable equilibrium. Santiago Muñoz Machado (2017) has summarized the steep fall. By 1570 there may have been no aboriginal population left at all in the Antilles. In Mexico, a population reckoned at 12 to 25 million before the invasion had fallen to 750 thousand by 1630. The 9 million initially living in the Peruvian region may have shrunk to 1.3 million by 1570. Some of these reductions can be explained by violent conquest or labor exploitation, but the main cause was epidemic illness. The lack of

hands led to the importation of black slaves, which has also left its mark on the population mix in Iberian America.

The principal aim of the settlers was, of course, laying hands on gold and silver, of which the Crown kept one third. They first grabbed what the locals had treasured over the centuries and, when those hoards had been exhausted, they set themselves to discovering and exploiting mines. So, there soon was a need for laborers in a sharply declining population, not only for mining but also for the rearing of cattle and the cultivation of wheat and sugar—Hernan Cortes, the conqueror of New Spain, as Mexico was then called, was once heard to exclaim, "We are not here to till the land". True, throughout the three centuries of Spanish lordship the Crown made a big effort to better the condition of the Indians by means of detailed legislation (not punctiliously obeyed by the settlers), but they

mainly worried about the salvation of the souls of the subject tribes. The Spanish authorities sent over missionaries of the different religious orders, who not only criticized the methods of exploitation and got the kings to legislate protective measures but also applied themselves to the Herculean task of bringing the Indians into the fold of the Roman Church.

This missionary effort posed the problem of the language in which to preach to the various local tribes. The friars baptized until their arms ached but they were not sure that the natives understood the intent of the ceremony. Speaking to them in Spanish was no use. Interpreters misunderstood the concepts of Christian theology. The friars then made the effort of learning the lingua franca of the different regions, the main ones being n‡uatl in Mexico and quéchua in Peru. But many went further and became experts in countless local languages and customs. Thus, a surprising consequence of the immense effort of the religious orders to Christianize the Indians was that Spanish was not forced on native Indians. It was only in 1755, two and a half centuries after the discovery, that Castilian became the official language of Spanish America, by a decree of King Charles III.

After Independence

The independence of the Spanish lands beyond the seas was gained in a long civil war lasting from 1808 to 1825. It was in fact a war waged by the criollos, the white Spaniards born and bred in America, against the Spanish Crown. The Indian tribes more often than not sided with the King of Spain. The borders of those new republics were by and large those of the vice-royalties and captaincies of colonial times, so that they did not coincide with the linguistic territories of the various tribes and only Spanish could function as the means of communication in the new nations. All this contributed to the unexpected result that it became the policy of each of the several republics to install Spanish as their national language.

The great inspirer of the proper use of Spanish in America was the Venezuelan Andrés Bello (1781-1865). He published a Grammar of the Castilian language for the use of Americans in 1847, full of examples from classical Spanish, which is the grammar I use when assailed by some doubt, because of its clarity and purity. He also wrote singlehandedly the Civil Code of Chile by appealing to the traditional laws of Castile, ascending as far as the Siete Partidas (1256-1265). The Chilean Code had wide influence on the other new republics and definitely established the legal connection with Spanish laws.

Instead of slowly drifting away from the common language, usage in Spain and the new republics moved towards unity in grammar and syntax and acceptance of a varied vocabulary, with no regard to identity politics. In 1714, King Philip V had established a "Royal Spanish Academy" in Madrid a private corporation

to oversee and reflect the popular use of the Spanish tongue. During the 19th century, similar institutions were created in all the American Republics. After long negotiations, all these Academies now jointly publish a common dictionary and grammar incorporated in all the Spanish-speaking lands.

When people are allowed to speak the language they prefer without political preconditions, they tend to seek mutual understanding. This is what has happened with English, too, giving the lie to Oscar Wilde's quip that England and America have everything in common except, of course, language. I am ever thankful that I can read the poetry and novels of five continents because the people have chosen to be creative in English.

Politically correct

Today, political interference with the use of language is back, both in English and Spanish though under a different form. Totalitarians have given up Marxism and communism, in view of the mountains of dead these creeds have bought on the world. Now, it is the oppression of patriarchal capitalism that has to be denounced and fought against, in the name of aggressive feminism.

I have been following with great interest the battle waged by Professor Jordan Peterson in Canada and the United States against the imposition of personal pronouns to address trans-sexual students, if they demand not to be classified in the traditional binary address mode of he and her. He has announced that he will refuse to use artificially constructed words as 'zshe' and 'zher' and more than twenty other sex-neutral modes of appellation. He will resist even if the law demands that he should, as has happened in Ontario and may soon happen in New York. Peterson thinks these impositions are the tip of the neo-Marxist war waged by leftist groups that are taking over the English departments of Harvard and other Ivy League Universities. He advises students not to take degrees in 'Women's Studies' or 'Ethnic Studies', because he sees these post-modern approaches as displacing the traditional critical-rationalism of university life in favor of the pursuit of a philosophy of relativism and power. He should not be left alone in his championing of freedom in our use of language.

Commercial Reprisals Are a Mistake

July 2, 2018

There was a time when I understood the reasons for protectionism better than the arguments for free trade. Then I heard my doctoral supervisor, Lord Lionel Robbins, say in class that David Ricardo's comparative cost theory of international free trade was the pons asinorum of economics, just as Euclid's Fifth Proposition in Book I was the bridge to geometrical knowledge that donkeys refuse to take. This led me to debate with myself the pros and cons of free trade. You should have seen me walk up and down by the colonnade of the British Museum until I settled my doubts and crossed the bridge. Protection was a way for corrupt politicians to favor their clients; countries did not need protection to industrialize; and on balance, the poor fared better when interest groups were not granted powers over international trade. On the contrary, free trade was a part of individual freedom, a power for growth, and an escape hatch from poverty. I had finally reached a position that fully convinced me. My further study of economic history and political economy reinforced these new beliefs.

The issue of free trade is being posed anew with the anti-trade measures being implemented by President Donald Trump. The President is worried about the size of the trade deficit of the United States and so are his voters. He attributes the artificially low prices of some of the imports entering America, especially from China, but also Canada, Mexico, and the European Union to unfair practices. He fears that foreign competition is sending many blue-collar workers into unemployment and stymying the progress of the middle class. As a first step he slapped a 20% tariff on foreign solar cells, thus saving inefficient producers at the cost of harming the state-of-the-art firms. And now he has variously increased the tariffs on imports of steel and aluminum, and may do so on Chinese and European cars. This is leading the governments of the countries that export to the United States to take or threaten reprisals in the form of tariffs and quotas on American goods.428The June meeting of the G7 was thrown into disarray by President Trump refusing to sign a joint trade statement counter to his protectionist measures.

I will address three questions in this unconventional essay: one, whether such reprisals will make the United States change its restrictive commercial policy (my answer is no); second, whether such reprisals will harm the nations taking them (my answer is yes); and whether we are thus running the danger of reducing world trade (my answer is yes again). My thesis is that taking reprisals is a mistake; no reprisals is better; unilateral free trade is best.

Trade as cooperation

Let me start with some elementary points.

428 See among many others the analysis by M. Conthe (2018).

- People trade because they are different: they have different tastes, resources, and abilities. This is why people seek the goods and services offered by others. - A voluntary exchange of goods and services only happens if both sides gain, but they need not gain the same amount. - Trading within a country and trading across borders is substantially the same thing. In fact, it is not countries that trade, only people and firms do, wherever they may be placed. - The mistaken perception that international exchanges are special is due to their taking place between individuals and firms in different monetary and tax zones. - The monetary value of flows of goods and services across borders are summarized in an accounting document called the balance of payments. - A balance of payments in deficit is not a problem in itself. It is a symptom, but symptoms can feel very unpleasant. - There can be losers from international competition as there can be from competitors inside the country. But the net effect of competition in both cases is to increase national income and wealth.429 - In sum, competition is a form of social cooperation.

Buying where it is cheapest

Adam Smith in The Wealth of Nations (1776) wrote that people have an innate tendency "to truck, barter, and exchange". Some of his disciples, mainly David Ricardo (1817), dug a little deeper and, when discussing trade among nations, adverted the differences in tastes, resources, and abilities to explain why people specialized and exchanged goods, when they could have produced them all at home. The classical economists from David Hume to John Stuart Mill started by showing the advantage gained in trading with people of other nations, on the assumption that rational people would trade only if they (and their nation) gained by it. In the course of discussing the gains from trade, they took a second step: to try and explain what goods were exchanged and in what quantities. In sum, the classics researched two questions: (1) the benefits (or the welfare, we would say today) of trade, and (2) the amount of trade flows.

Adam Smith, as regards the advantage obtained by trade, was not as complete as Ricardo (1817). He simply said that nations, like the master of a household, would try to buy where it is cheapest. He backed his argument with a reductio ad absurdum: grapes could be grown in Scotland with hothouses and good wine could be made with them, but at a much higher cost than in Bordeaux.430

429 Costinot and Rodriguez-Clare (2018, page 21) summarize present-day estimates by various authors of the gains from trade obtained by Americans as 2 to 8% of GDP: such gains may look small, but they are "nothing to spit at". Do not forget that the United States is a very large mostly self-contained economy. See note 9 below. 430 As regards trade flows, Elmslie (2018) has shown that Smith understood, and formulated in bits and pieces, what we today call 'the gravity theory of international trade flows". Here we mean 'gravity' in the sense of Newton, not in the sense of composed behavior. Tinbergen (1962) finally modelled this very powerful explanation for trade flows on the basis of cost by saying that trade

Comparative or opportunity cost

David Ricardo saw what was missing in Smith's analysis: he showed that often it could be rational for a country to buy abroad what could be supplied more cheaply at home! This was so in the case of Portugal buying cloth in England at a greater expense than making it locally, if that allowed Portugal to concentrate all its resources in the production of much cheaper wine than the English could make. Even if Portugal was more efficient in the production of both wine and cloth than England, it would be able to get more cloth by concentrating in wine production and trading part of its wine for English cloth. The more productive country would fare better if it specialized in the good in whose production it was comparatively more efficient than in the other good, even if it was efficient in both.

Paul Samuelson illustrated this important theorem with the homely example of an exchange between him and his secretary: he was better at typing and economics, but so much better at economics, that he could specialize in economics and perhaps hire two secretaries. The opportunity cost of typing his own letters was prohibitive in terms of his production as an economist.

Ricardo thus showed that two countries would trade with each other even if one was less productive than the other in all lines. This explains why poor, inefficient countries can still find things to sell to advanced countries.431

Sharing the gains from trade What was implicit in Ricardo is that consumers in all trading countries would profit from the greater world availability of wine and cloth, or whatever. But even from the point of view of producers in international trade, both sides gain, though not always equally. The young John Stuart Mill (1828) explained that the country with the keenest desire for the other's good would end with a smaller share of the gain. So that, if the English were great drinkers, they would tend to send more cloth to Portugal for each barrel...6

Whether equally shared or no, the gains of free trade were clearly and unambiguously positive for both nations and the world as a whole: international specialization will always result in an increased world output of both cloth and wine. Free trade will foster growth and is a boon for the poor. A protectionist policy

flows tended to be directly proportional to the proximity and the size of the two markets, and an inverse proportion to the institutional barriers between them put up by authorities jealous of their neighbors'

prosperity. Indeed a 'frontier effect' is observable: so, the net border negative effect between Canada and the US has been calculated as a 44% compared with trade within each country. Adam Smith mentioned that this effect was smaller the larger the respective markets. 431 I will not go down the way of later theories that explain Ricardian trade patterns by predicting that countries will specialize in exporting the goods they use more intensively than the resources they are more abundantly endowed with: this is what the Heckscher-Ohlin theory (1919, 1933) theorem predicts. Dluhosch (2018) however explains that, in the present day world, merely resting on abundant resources may not be very wise, because such an endowment may lose its possibilities through innovation or new markets: suddenly, a shale-oil-and-gas innovation may undercut your traditional resource advantage.

will make the world less productive and will especially reduce the welfare of producers in less efficient developing economies.

Opening of borders to international trade forces changes in the economic structure of production in both countries. The only way to study this effect is dynamically.

Who loses?

At first, textile workers in Portugal will be unemployed and so will wine producers in England. Displaced workers will have to accept lower wages and pensions or seek employment in another industry or even move to another state, at least temporarily. Foreign competition, as does national, forces greater specialization and lower costs, and makes the economy grow.

This is what happened with the motorcar industry in Detroit: it had to be saved with public money so as to sweeten a cut in wages, a reduction of pension rights, and reduction of trade union privileges with a write down of debt. A substantial part of the population had to leave the city and seek employment in other states. All this also harmed auto producers in free labor southern states.432

Joseph Schumpeter called this kind of phenomenon "creative destruction": progress, technological and commercial, results in forced changes on the production side of the economy and the closing down of unsustainable activities. To express it otherwise, foreign competition breaks up domestic monopolies and oligopolies, including unions protected by legislation. The ensuing greater productivity creates new jobs and makes for higher wages for those who find employment under the new dispensation. The argument against free trade can also be used against the penetration of artificial intelligence and robots. Slapping tariffs on foreign goods and services is another way to try to stop progress.

Still, some people do lose, leading many to want their society to progress by kinder or more inclusive means than competition. But will it be possible for America stay at the top in innovation, entrepreneurship, and productivity while stymying competition, foreign or national? The European Union seems to have given up running this race.

Also, as Barbara Dluhosch points out (2018), such protectionist attitudes are an invitation for special interests to band together for the purpose of seeking rents. This kind of overt rent-seeking is less harmful than the more hypocritical kind tending to hide behind false pretexts: thus President Trump has announced that he

432 One negative effect of international trade studied by Stolper and Samuelson (1941) is that it moves low skilled production abroad. This theorem is closely related to the 'factor equalization theorem'.

Trump-minded people want to correct this effect with protective measures that stop low skilled products from being imported and displacing workers. Dluhosch (2016 and 2018) notes that new information and communication technologies (ICT) also threaten high-skilled workers but also that these ICTs so much increase productivity all round that the net effect may be positive for all kinds of workers. This reasoning is similar to Ricardo's conclusion for the world as a whole.

is "taking action to protect America's national security" from the effects of global oversupply of steel and aluminum. He could not justify these measures by a need to reduce unemployment, as out-of-work people today amount to 3.8% of the US population. His advisors must also have told him that Article XIX of the World Trade Organization treaty would limit these measures to a period of four years, give rise to claims for compensation, and be open to retaliation. So he plumped for Article XXI b) which allows a state to adopt all measures deemed necessary to protect "its essential security interests, relative to: (i) fissionable material; (ii) arms, munitions, and war materials [...]; and (iii) in times of war and grave international tension." In what way can cheap steel and aluminum imports endanger the safety of the United States? Beats me.

Another hoary legend is that protection promotes growth and hence free-trade makes industrialization more difficult. This is known as the 'infant industry argument'.433 One of the accepted 'facts' of economic history is that the United States, the German Empire and France were able to catch up with Britain in the 19th century because they fostered their industrialization with protection. However, Bismarck's 'iron and rye' 1879 tariff was a clear surrender to the interests of the great industrialists and the Junkers of East Prussia. The turn to protection by the French in 1881 and the U.S. tariffs of 1864 and 1890 changed the arrangement of industrial sectors but did not increase total production. And I need not say anything about the disastrous effects on the whole world of the 1930 Smoot-Hawley tariff.434 History is replete with examples of the failure of American protectionism.

Balance of payments deficits as a symptom

It is the fond belief of half-baked economists that tariffs and quotas can mend a balance of payments deficit by making imports more expensive and exports cheaper. People forget that the balance of payments is only an accounting document that will tell you that a country is buying more (or less) abroad than it is selling but not what causes the imbalance.

An enduring balance of payments deficit can tell you a number of things. One is that national expenditure is greater than national saving and investment and that domestic expenditure has to be topped up with borrowing from abroad. This can be good or bad. In an underdeveloped country foreign direct capital investment may not immediately and fully be paid for with exports but helps growth. In advanced economies, a sustained balance of payments deficits is largely due to the

433 The infant industry argument is based on the belief that imperfect competition undermines the argument for free trade. See Bhagwati's Harry Johnson's Lecture of 1992. It is curious that developing countries reject free trade because their budding industries cannot compete with the returns to scale of advanced countries industries, while advanced countries want to level the world trade playing field tilted by the unfair labor conditions of the Third World. The result is that every country now complains of dumping by their trade partners. Even oligopolies such as OPEC prove to be evanescent in the face of technological progress and climate ideology. 434 For anybody who may doubt what I say, an easy-to-read

survey of present day research on the fairy-tales of protectionism can be found in Scott Lincicome (2017) Cato Institute no. 819 Policy Analysis.

negative savings of the federal deficit. Hence tariffs will not correct such a deficit – a balanced budget will. Only the fact that the U.S. Treasury is the banker of the world can explain the huge amount of American bonds held by the rest. This is a happy result for American consumers and capitalists since they get foreign goods, both final and intermediate, in exchange for pieces of paper called dollar bills or bonds. This, however, may make life difficult for local firms and workers, who have to face more abundant imports.

Another warning given by a sustained balance of payments deficit is that it will have an effect on the currency exchange. If the rate of exchange is fixed, as within the euro area, the country will have to use its reserves to stop the currency from devaluing, and in the process it may run out of such reserves. This is what happened to Greece after the 2010 crisis when cash disappeared. If it is a floating currency, then it will depreciate with expected budget deficits, as is happening today with the Argentinian peso. A substantive depreciation is equivalent to a large cut in the money holdings of the people.

In sum, enduring balance of payments deficits and sudden excessive devaluations should lead governments to make substantive reforms of populist budget structures and of excessive regulation, especially of the labor market. Moves such as that of President Trump are cosmetic and in the end harmful.

The effects of a commercial war

So protection will not mend the foreign deficit. The effects of protection (and retaliation) will be others. It will make imports more expensive and make the price of substitutes rise. It will also make exports more expensive, in that a tariff on imports is a tariff on imported intermediate goods used by exporters.

The consequences of President Trump's commercial policies is already being felt, both directly and indirectly through third party retaliation. It is clear that Trump's protectionist measures point to a fall in world wealth, starting with America itself, ceteris paribus. The cycle has been on an upward drive for some time now and the cost increases and corporate investments due to action and reaction may ultimately result in the turn to a recession. There will be large increases in costs for industrial corporations in the United States and the retaliating nations. The uncertainty caused by war-monger rhetoric will surely affect investment, especially of international companies. In sum, protectionism and the ensuing trade war will only result in small corrections in balance of payments deficits by reducing trade.435

As to the likelihood of 'victory', a large economic area such as the United States will feel an imposed reduction of imports much less keenly than a small one, such as Belgium or a Baltic country.436 Hence reprisals against President Trump's new

435 F. Pacicca (2018) 436 Costinot and Rodriguez-Clare (2018, pgs. 11-12) compare the weight of foreign trade in the US economy in 2014 with that of Belgium: the US, 8%; Belgium above 32%.

policy have a high probability of failure when the aim is to punish as large an economy as the United States.

Cutting your nose to spite your face

Most people are ignorant of the well-established analysis of international trade I have put forward in the previous paragraphs. The general attitude is, you win when you export, you lose when you import. Instead of seeing the increase in total trade in goods, services, knowledge, and freedom as best for your people and nation, they feel they win when they impose a monopoly on other nations through the exercise of power.

I believe I have given good arguments to prove that Trump's protectionist moves will hurt the American people. But these arguments are equally applicable to reprisals. By waging a commercial war or actively replying to an offensive move, you must be ready to suffer to attain victory. In that case, the least bad (or second best) reprisal strategy would be to do nothing and simply rely on the foreseeable reduction in U.S. exports due to the increase in American prices following the higher degree of protection. If you see the world of business as the imposition of power, yours is the world of President Trump and the retaliating nations. If you see international trade as non-designed cooperation through competition, the intelligent strategy is to let the power-hungry rival nation trip itself up by the brainless use of its own force, in the ju-jitsu tradition of unarmed self-defense.

Unilateral free trade

The best measure for me would be to go further than doing nothing. What I propose is in the spirit of the slow and far from easy establishment of total and unilateral free trade in the United Kingdom from 1823 to 1860.437 Imagine the possible move by Britain as an example after having left the European Union at the end of two years of failed negotiations. 'Hard Brexit' would allow Britain to unilaterally and totally free its imports and repeal non-tariff barriers on services. This would of course greatly benefit British consumers. But it would also reduce UK production costs across the board. As at the same time American steel and aluminum would necessarily increase in price and so would American cars, very possibly President Trump's protectionist measure would have no effect on British trade.

More generally speaking, the best retort against US protectionism would be to bring down the production costs of exports by the other nations. To achieve this, China, Canada, Mexico, and the European Union should unilaterally free imports from all duties, fully alleviate non-tariff barriers, and drastically reduce or repeal regulation on services, especially financial services. Such measures need no compact or international agreement: nations can implement individually. Further to this point, if most other countries harmed by President Trump choose the

437 My conclusion is that free trade is the best reprisal. But if such a move should prove politically impossible, there always is the possibility of lying low and doing nothing. Dixi et salvavi animama meam.

reprisal way, those that do not will be even more favored. This is why Frau Merkel is pleading for all EU nations to join in the reprisals and not undermine the trade powers vested on the Commission in Brussels.

My conclusion is that free trade is the best reprisal. But if such a move should prove politically impossible, there always is the possibility of lying low and doing nothing. Dixi et salvavi animama meam.

The Bother with Brexit

August 6, 2018

Brexit is turning out to be a much more complicated affair than both the "remainers" and the "leavers" initially surmised. The hope of an amicable divorce is vanishing. The British Government and the European Commission are edging nearer the precipice of an unwanted and unplanned total break, which neither side really wants, though in the end it could be the best solution. Theresa May, the tottering British Prime Minister, is trying to devise a way of leaving the European Union without actually leaving it. Michel Garnier, the European Commission's chief negotiator, wants to send a message to other "exiteers" tempted by the British example, but he also strives to keep Mrs. May in office as the least bad UK negotiator he could wish for. And the clock is ticking: the moment when exit must happen is March 19, 2020, 11 pm (Greenwich Time).

The whole question started with the Referendum that former Prime Minister David Cameron called for in June of 2016. His bet was that a majority of the British would vote to stay in Europe, as a majority of the Scots had voted to stay in the United Kingdom. He lost 51.9% to 48.1% and immediately resigned; Theresa May smoothly took his place. She had been a tepid remainer before the referendum but soon turned exiteer, because she said, "it's what the British people wanted." She is now having a hard time sitting on the Brexit fence, because public opinion at home is proving to be as divided as ever, and because her European partners have not offered her a helping hand. The European question has troubled the Tories for the last fifty years and has led them to unseat one Prime Minister after another—from Edward Heath to Margaret Thatcher to John Major to Cameron. We should not be surprised to see Theresa May's name soon on that list. In fact, she recently survived in Parliament on parts of her proposed Brexit deal by only three votes, with eleven pro-EU MP Tories voting against and four pro-Brexit Labour sympathisers voting with her to give her the needed majority.

The negotiations are tripping up on four realities. The first one is how intertwined the affairs of Europe and the United Kingdom have become after nearly fifty years of EU membership. The United Kingdom has always shown itself to be a disciplined member of the Union, so that the law of the British land is shot through with tens of thousands of derivative European laws and regulations. This makes it impossible to review all the outstanding legal texts in good time and to decide what will stay and what will have to go. So Parliament has granted the British government what are picturesquely called "Henry VIII powers" that would enable ministers to amend or repeal the provisions of an Act using administrative orders, without Parliament having to concur. These powers date back to 1539 when the King was given leave to legislate by proclamation.

The second difficulty is that the open border between Northern Ireland and the Republic of Ireland will now become an international border between the United Kingdom and the European Union. So the free movement of goods and people between the two parts of Ireland is now under question. There is little doubt that

free economic communication on the island has helped consolidate the peace brought by the "Good Friday Agreement" of 1998 between all parties in the civil war. I well remember what it was like to be in Belfast during the "Troubles." My great friend and distinguished historian of economic thought, Bob Black, had

invited me to give some lectures at Queen's University Belfast. A number of incidents have stayed in my memory. When we drove to the University, our car was stopped at army check-points and our boot opened, "to prevent possible kidnappings." The entrances to restaurants and pubs were protected with sandbags, so that no one could easily run in or out of the establishment. No posters or banners were to be seen in the corridors of the department of economics and no one there, student or teacher, ever mentioned politics or religion. One saw helmeted and fully armed soldiers walking along the pavements close to the walls of houses for fear of snipers. This is why Mrs. May is so insistent on finding an arrangement to ease tariff or regulatory barriers for goods between the two parts of Ireland.438

A third problem is connected with the United Kingdom wanting to control immigration in the British Isles. The difficulty lies in the fact that there are some 3 million EU citizens living in the United Kingdom and 900,000 Britons in the EU. The British government has unilaterally promised Europeans unconditional resident status if they have been there longer than five years, and to offer them resident status if they have been there less than five years at the time of separation. The EU have offered nothing yet on this chapter, which has peeved the British Government.

And the fourth unsettled point is that the United Kingdom objects to the European Court of Justice having a last say on questions decided by the British Courts. But if Mrs. May is successful in keeping the United Kingdom within the Single Market for goods, at least for a none too short transition period, the Court will still hold sway over the United Kingdom, which is sure to infuriate those who voted for Brexit to have their country recover its sovereignty.

The Chequers White Paper

This is the lukewarm impression I got from reading the White Paper Mrs. May has just had the government publish under the title "The Future Relationship between the United Kingdom and the European Union."439This proposal was presented to the Cabinet in a meeting at Chequers, the residence of the Prime Minister. It is very much middle of the road and has led two senior members of the government, the Secretary of State for Brexit and the Foreign Secretary, to resign without delay. Monsieur Barnier quietly tore it apart.

438 The question is not so weighty for Gibraltar, the small rock on the southern coast of Spain, for there the frontier between the mainland and the British territory never disappeared, since it was not a part of the EU Customs Union. 439 Available online at: https://www.gov.uk/government/publications/the-future-relationshipbetween-the-united-kingdom-and-the-european-union.

What Theresa May wants is to base future relations with the European Union on only three of the four freedoms outlined in the Treaty of Rome of 1957: freedom of movement of goods, services, and capital, leaving aside the free movement of people. This "would ensure that we leave the EU without leaving Europe," wrote the Prime Minister.

The first point of this proposal is a free trade area for goods, which would avoid tariff and regulatory barriers between the two parties and which, by the way, would dispense with a hard border between the two Irelands. The second is no limitation to the supply of services, especially financial, a major export of the United Kingdom, of course including capital, which would stop Paris from trying to step in the City of London's shoes. However, a major point of contention would be the demand that the British control immigration from the Continent. This was a principal initial reason for the Brexit vote, but it would play into the hands of central European nations, such as Poland and Hungary, who want to stop Brussels' imposed free circulation of migrants.

The freedom to supply services is subject to special and recondite complications. The easiest solution has been rejected by Brussels—the mutual recognition of rules, institutions and operations by the two parties. Neither is Brussels ready to automatically grant a "financial passport" to British banks and financial institutions. The fall-back solution in the White Paper is an "equivalence model," as the United States and Singapore enjoy in the European Union. No deal. Brussels wants to be able to decide unilaterally who can enter the European financial market so as to control competition—an old habit of the Commission.

Hard Brexit

I said above en passant that "a total break could be the best solution". I was not trying to shock my readers. What would be the costs and benefits of no agreement? Let me point out that Mr. Jacob Rees-Mogg, who is the voice of the hard-brexiteers in Parliament, has suggested a radical solution for the question of the Irish border. He suggested that the United Kingdom open the border totally and unconditionally on the Northern Ireland side and see who takes the blame for the disruption thus imposed by the EU.

I would apply this idea more generally. Instead of looking for reciprocity, the United Kingdom could open its borders to all imports of goods and services with zero tariffs and regulations enforced ex-post. After all, the average EU tariff is 2.5% (though cars and clothing are higher), and most of the European health and safety regulations are nothing other than non-tariff protection against foreigners. True, the opening of UK borders would cause a sudden increase in competition that would make some UK producers suffer. But consumers would gain (especially after leaving the Common Agricultural Policy); and the cost of British exports to the whole world would fall markedly. The same reasoning is valid for financial services, scientific, and technological services.

Do not forget that the United Kingdom has in principle to pay the EU £39 billion as a settlement, even if the divorce were amicable. Refusing to settle that amount would be an added bonus for the United Kingdom in case of a Hard Brexit.

The Plight of the Central Banker

September 3, 2018

The Bank of England has decided to increase the interest rate at which she lends money to commercial banks from a very low 0.50 percent to 0.75. Not a breathtaking rise but still a change from the policy of keeping the base rate at 0.5 or below since March 2008. The federal funds rate of the United States has been rising very slowly since the middle of 2015 and now is at 1.19; the U.S. Federal Reserve Chairman has signified his intention to keep it going up. This indicates that the various central banks are beginning to see a danger of inflation, now that the money pumped into the economies since the 2007 crash is finally beginning to enter circulation.

The reasons for raising the basic interest rate only slowly are two; that such changes must be explained and announced, so that the public adapts to the new circumstance with as little pain as possible; and that interest rates must be brought back to a level that rewards saving and allows industries such as life insurance and pensions to keep their long term engagements.

We do not really know why the financial economy of the western world failed so dismally in the three years from 2007 to 2010. Or was it to 2014? It was such a deep and long downturn that we now know it as 'The Great Recession'. Many economists had thought central bankers and state treasuries knew by now how to manage the ups and downs of the economic cycle. After this grave recession, those wise men are under a cloud.440During a visit to the London School of Economics, the Queen of England asked an economics professor an embarrassing question: "Why didn't anybody see it coming?" The professor—let him stay unnamed—was left desperately looking for an answer.

It is a feature of our modern economies that they go through repeated bouts of boom and bust. What causes this phenomenon is under dispute, and so is the efficacy of the remedies used—especially those applied by the Governors or Presidents of central banks.

Alan Greenspan, during his long tenure as Chairman of the Fed from 1987 to 2006, was the reborn Wizard of Oz; he seemed able to iron out the business cycle of the U.S. economy by discrete interventions in the money market. Any sudden dip of activity was countered by reductions of the discount rate and expansions of the money supply. This he did with some success when the flash crash of the stock markets in 1987 and the dotcom crisis of 2000-2002. The Fed was always ready to rescue the economy from too lasting a downturn. His prestige was shored up by the tranquillity of the period that came to be known as 'the Great Moderation'; from

440 Well do I remember Gary Becker in 1978 sadly noting the failure of the main models used by macroeconomists to predict the evolution of economies, namely the 'Dynamic Stochastic General Equilibrium' models. A great deal of work is being still being carried out with these DSGE models without, to my knowledge, coming to a convincing explanation of what caused the Great Recession.

1985 to 2006 real GDP grew steadily in the United States between one and five percent annually, instead of moving wildly between minus five and plus ten as in the previous decade, and this with a low average rate of inflation of around three per cent. Moderation was thought to have become permanent, so much so that Nobel laureate Robert Lucas was led to say in 2003 that "the central problem of depression-prevention has been solved".441 Now we see, however, that reacting to all temporary dips with strong and immediate monetary countermeasures may be stoking up trouble for the future. As in the MGM film, the Wizard of Oz turned out to be a mere puppet with a loudspeaker and no powers.442

What are central banks supposed to do, suppliers of money that they are, when the economy stalls? Should central bankers try to apply direct economic measures to reduce unemployment? Should they help banks in trouble? More generally, what is the role of a central bank in an advanced economy? The answer to these difficult questions can only be found if we have a good theory about what makes an economy tick.

Keynes takes a dim view of central bankers

As I have often said in these columns, John Maynard Keynes, for good or for ill, was the most influential economist of the 20th century. His public spirit spurred him to find remedies for the sorry state of the British economy in the interwar years. Throughout the 1920s, Britain had been stuck with ten percent unemployment. With the Great Depression, the rate of unemployment doubled. The General Theory (1936) is a difficult book that has given rise to contrasting interpretations, as behoves a sacred text. In my view and whatever people say, he did not propose monetary remedies to pull the United Kingdom out of unemployment equilibrium.443 His fundamental idea was that investment was the power needed to sail the economy out of the doldrums. Private investment, however, could not be relied on, for entrepreneurs were driven by their capricious 'animal spirits'. Merely lowering the interest rate at the Bank of England would not help revive the

441 Robert Lucas' article, "Macroeconomic Priorities" American Economic Review. Feb 2003, Vol. 93, No. 1: Pages 1-14, where this assertion is to be found, is despite everything essential reading for macroeconomists, for the pointers it contains on future research. 442 L. Frank Baum, it is said, wrote The Wonderful Wizard of Oz (1900) as an enchanting children's tale but also as an allegory in defence of the populist case for gold and silver bimetallism. At a time of deflation, such as the 1890s, adding silver to gold in the monetary circulation of the United States could have been a relief for the agriculturists of the Midwest and the South, worried by debt and falling prices as they were. See "The 'Wizard of Oz' as a Monetary Allegory", by Hugh Rockoff (Journal of Political Economy, August 1990). 443 His main monetary proposal was to take the United Kingdom out of the gold standard.

economy.444 Only government-funded public works would do the trick, financed by debt if necessary.445

So the neo-Keynesians of today are not following Keynes when they propose lower interest rates or an increased money supply as remedies for a recession and unemployment. These remedies are typically monetarist and would have more likely been approved by Milton Friedman, I think. The essence of the Keynesian remedies is rather debt-financed public expenditure.

The role of central banks

The best way to understand the role of a central bank is to see it as presiding over a club of commercial banks which need support and security when performing their task of funding the economy with credit. The central bank supplies them with new money that they then multiply within limits by lending it out to their clients. The business of a commercial bank is risky, since their loans are long term whereas the funds deposited with them are on sight. Even if their investments are sound, a sudden withdrawal of deposits might leave them short of liquidity and force them to a fire-sale of assets. The central bank is there as a 'lender of last resort'. However, the commercial banks of the club will want to be sure that none of the members will free ride dishonestly or imprudently; hence the powers they grant the central bank to inspect them and regulate them.

The role of a central bank is impaired when it tries to use the function of supplying money to foster the growth of the economy or to create employment directly. Such an endeavour is understandable but in the end useless or even harmful. The task of the central bank is another: to maintain the purchasing power of the currency it issues and oversees. In other words, it must prevent inflation from eroding the value of the currency.

Now, what causes an inflation? What makes the price level rise continuously? "Inflation is always and everywhere a monetary phenomenon" as Milton Friedman famously said. If the supply of money increases more quickly than the real economy grows, then the price level starts to rise, whether there are idle resources in the economy or not. Life would be easy if the increase of the supply of money by itself brought about sustained growth and full employment.

The unreliable Phillips curve

444 He did accept that a small amount of inflation, when not noticed by workers, could result in a reduction of the real wage and hence a limited increase in employment. But this was not the centre of his policy proposals. At bottom however, Keynes may have been more of an inflationist than is believed. Abba Lerner was reported to have elicited from Keynes agreement in principle to 'printing' money as a way to redress a recession. See "Was Keynes a Keynesian or a Lernerian?" David Colander JEL Dec., 1984. 445 Allan Meltzer, in Keynes's Monetary Theory: A Different Interpretation (CUP 2005) explains that Keynes held scant belief in the effectiveness of interest rate reductions to bring the economy to full employment. Ignorance, uncertainty, and risk inevitably added a large risk premium to long projects: this made the equilibrium rate of interest too high even if the authorities pressed it down. When it reached the bottom, the liquidity trap would kick in.

In 1958, New Zealand economist A.W. Phillips observed an inverse relationship between unemployment and money wage rates in the United Kingdom from 1861 to 1957. The data covered a very long period and lent credence to the belief that inflation rose when unemployment fell, and vice versa. If this was the general case, it was within the power of a central bank to reduce unemployment; and further, if consumption drove the economy, then higher nominal wages were a force for growth. In that case, the central banker had a magic wand in its hand to multiply the welfare of the population. But the Phillips correlation may have been due to the fact that during most of that century inflation was low and difficult to perceive. However, if the unemployed came to expect inflation then they would not be attracted to work more by mere increases in nominal wages. These only tend to foster employment in the short term while the information about the sleight-of-hand of the central bank has not extended through the markets. When information spreads, the public will stop confusing increases in nominal prices with higher rewards for greater productivity. 446 Real growth is not brought by monetary expansion but by increases in population, by productive investment, by technical progress, by freer trade and greater competition.

Money as a factor of production

This, of course, does not mean that money is not important, quite the contrary. Adam Smith wrote that a modicum of cash is necessary for the proper conduct of business. And again, Milton Friedman famously unfurled the banner of "money matters" in reaction to the Keynesian obsession with state expenditure. Of course, we all agree that money fulfils the role of a means of exchange and of a measure of relative prices, but it also has the function of providing liquidity for when income promised does not arrive in time. Without a store of ready money for an emergency, business becomes difficult. So, what monetarists claim is that a liquid reserve of stably valued money is necessary for a smoothly working economy.

Hence, the role of a central banker is first and foremost to keep prices on a constant and stable growth path mirroring the rate of real growth, as Milton Friedman in his time and Tim Congdon today have suggested. The discretionary use of the tools of a central banker, as did Alan Greenspan, is a recipe for ultimate

instability. Rules rather than discretion is the proposal of economists of a classical bent. There are many candidates for such a rule, starting with 'inflation targeting' all the way to the 'Taylor rule'. The question is still under discussion.

446 Another way of expressing this delayed effect is that workers temporarily suffer from a 'money illusion'. This is how Milton Friedman put it in his acceptance speech of the Nobel Prize in 1976. Edmund Phelps (another Nobel Laureate) did not accept that rational individuals suffered from the money illusion: for him it was the oligopolistic character of modern business, with monopolies, monopsonies and labor unions that explained the temporary Phillips effect. For Phelps this evanescent Phillips effect could lead to a wage and inflation spiral, which would only continue if the central bank financed it with money creation.

In today's world of free capital movement, there is an ultimate safety net when the national bank does not play by the rules—international monetary competition. It permits individuals, firms, and investment funds of all descriptions to spread the risk by moving at least some of their assets to safer monetary zones. In this way, monetary stability, an essential element of a free society, is minimally preserved despite from the vagaries of central bankers.

Democracy and Its Discontents

November 5, 2018

Democracy today receives the general assent of humanity, yet it also suffers from infirmities that make others doubt its very survival. Is democracy mainly the political expression of the principle of individual sovereignty? Or is it rather characterised by the levelling of the rights and condition of the citizens? Or must it be understood as the expression of communal and national feelings?

As regards the procedural side of political arrangements, constitutions are increasingly seen as expressions of class struggle to be set aside as soon as a new popular coalition attains power. Representative democracy, whereby citizens delegate political decisions to deputies, senators, or presidents, is considered elitist. Referenda, which should help the people make their voice heard on questions of great import, often turn into plebiscites and become instruments of confrontation or even oppression. The separation of powers, devised as a barrier to stop precipitous decisions to satisfy short term opinion, is continually sidestepped by demagogues greedy for power.

If we look at the material rather than the formal content of politics, the picture is also dismal. The welfare state, adopted by so many nations after World War II, is a dream that can easily turn into a nightmare. The belief that the state should protect individuals 'from cradle to grave', if taken seriously, results in infringements of individual liberty. Art and science must be protected and financed by the state. Education should be principally delivered by the public administration. Health services should be universal and free at the point of service. The 'precautionary principle', especially as applied in the European Union, justifies growing regulation. In sum, democracies must try to foster the happiness and well-being of the population by any means at hand or at whatever cost.

My thesis is that the only way to save democracy from the contradictions that cause so much discontent is to take individual liberty as the basic principle and reinterpret the other two elements as subordinate to the principle of individuality.

The individual and democracy

Logically speaking, democracy is a corollary of individual sovereignty. Individualists who see individual freedom as the basis of a well-ordered society will be naturally led to defend the participation of citizens in public affairs. They will want their voice to be heard and their vote to count in communal questions that affect them.

However, classical liberals face two kinds of problems in the practice of democracy. One is that political decisions always have an element of imposition that can lead to the oppression of minorities. The other is that the complexity of political mechanisms allows small groups to exploit the democratic system to their own benefit.

The step from individual private action to collective democratic decision is not an easy one. How different it is to take decisions in the private sphere from decisions in the public field was well expressed by Milton and Rose Friedman in their book Free to Choose (1980)

The ballot box produces conformity without unanimity; the marketplace, unanimity without conformity. That is why it is so desirable to use the vote in as far as possible only for decisions where conformity is essential.

Market choices and private contracts are fundamentally different from authoritative decisions and communal agreements. In family life, in personal friendships, and in the marketplace a special kind of unanimity reigns, unanimity 'nemine discrepante', when two agree and the rest abstain. This is to say, in the private field, when two persons or two firms reach a free agreement to their mutual benefit, the rest of society abstains.447 Economists since John Stuart Mill and Arthur Pigou have over-insisted on the idea that all private agreements have 'externalities' that must be corrected. One should follow Ronald Coase instead in saying that so-called 'market defects' are optimal adaptations by individuals to defects of politics and institutions. As James Buchanan has remarked, the concept of externalities assumes that some authority outside those implied in an agreement can define what the optimal outcome should be. Rather, if those implied find defects in the result they will question the institutional framework in which they function.448

The essence of politics is that the majority imposes its will on the minority in pursuance of a social objective. Classical liberal constitutions must therefore agree to entrench the respect of human rights, the defence of private property, and the performance of contracts. However, there is always a remnant of questions that demand to be agreed upon by a majority, at least in matters of justice and defence and the taxation needed to finance them. Here is the origin of the defects of public action and of the danger that majority decisions result in the oppression or exploitation of minorities, and even in a populist tyranny.

Saving democracy from itself What is to be done? We could try to change our electoral laws. Senators and Representatives in the U.S. Congress, for example, could be subject to term limits. Frequent referenda could be tried, along Swiss lines. And while we are at it, we could also decentralise power radically as among

the cantons of Switzerland. Or rewrite our constitutions to move them away from the catalogues of rights without

447 A business deal such as the sale of a house results in the mutual benefit of the parties concerned, which in principle does not affect the rest of society. This is not to deny that such a contract has consequences for third parties, in so far as it (even if minimally) influences real estate prices. But it is a rule to be abided to, that the pecuniary effect of transactions should not be interfered with, because the information gathered in prices is necessary for the correct and rational behaviour of individuals 448 See James Buchanan (1984): "Rights, Efficiency, and Exchange: The Irrelevance of Transaction Cost."

duties they have become. And reinforce the checks and balances on executive power that used to be their essence.

I am afraid I must express scepticism regarding these reforms. All electoral laws in their diversity are imperfect and changes satisfy few people. Referenda have been a force for good in Switzerland, a bearable process in Canada, and rather unsuccessful in California. Devolution is positive when not transformed into metaphysical nationalism. Even a Constitution like that of the United States, which appears as an immoveable bulwark of liberty, has changed, sometimes for good, sometimes for ill, by the Supreme Court following the moods of public opinion. Thus, I find Buchanan's belief in constitutional reform and constitutional limitations perhaps a little naïve.

Three forces for freedom

Democracy plods on thanks to three powerful antitoxins. First, there seem to be automatic political stabilisers at work in the system. I find it striking that the size of the state in even the most interventionist countries is pulled back to an average of 40 or 50 percent of GDP when voters find that going beyond that seriously endangers growth. While still a large proportion of our yearly production, we must be thankful for small mercies: in the long run, competition between democracies with regard to personal freedom, economic progress, and scientific prowess strikes a chord with many voters. When it becomes evident that 'liberal' or 'social democratic' policies have become an obstacle to prosperity, there frequently arise movements in favour of free market policies. Such reactions against the drift towards the 'dormant society' of socialism took place in Britain with Margaret Thatcher, in the United States with Ronald Reagan, in New Zealand with economics ministers Roger Douglas and Ruth Richardson, in Poland thanks to Leszek Balcerowicz, and in Sweden under Carl Bildt. But for a person of democratic convictions and free market beliefs there are another two more powerful reasons for hope: international trade and technological discoveries.

The first is free trade. In a large country such as the United States or a sizeable area such as the European Union, international trade and migration will, despite the regulators, always be a force for competition. This is even truer of small countries whose size forces them necessarily to be open to the world. In both cases, international trade will be a potent antitoxin against coalitions of rent seekers. It is only in middle sized economies with a national market large enough for established firms to prosper that interest groups with political clout will be able to hold their ground against international competition. Anti-trust will be used as a fig leaf to cover their privy parts against prying eyes. In the same way, these protectionist countries will use international aid to cover up the harm caused to developing countries by their import restrictions.

This is one of the reasons why people who defend a 'hard Brexit' would like to see Britain leave the European Union with no more ado and open its commercial borders unilaterally to all comers.

The second reason for hope is the immense development of the digital world. The new communication technologies, big data in the cloud, the growing abundance of

open information, internet manufacturing, 3D printing, and so on, seem unstoppable. The balance of Joseph Schumpeter's creative destruction will be positive, despite the efforts of state authorities to control the internet and the people who use it.

Democracy can be learnt

I do not want to sound too pessimistic because it is an observable fact that democracy at higher stages of civilisation is less imperfect than in countries that are just beginning to learn the strange ceremonies of free speech, independent courts, private property, and respect for the dignity of individuals. I unashamedly hold it that it is better, as Karl Popper used to say, to be able to change your government without bloodshed: it is quite an advance in political mores to send your adversaries to the opposition benches rather than to shoot them at dawn, or condemn them to life imprisonment after a spate of torture. Voting is in itself a curious procedure that we have agreed to put in place of the more natural ideology expressed by the dictum that power comes out of the mouth of a gun.

For all its faults, democracy is better than other political arrangements. I would rather live in one of those rickety western commonwealths than in China or Russia, let alone Cuba. It takes a long time and much forbearance to acquire the habits of tolerance and of distaste for oppression, even of one's political enemies. But these habits can be learnt. Experience and criticism can help countries avoid the worst blemishes of popular governance.

A precondition for the three forces I mentioned to succeed in purging democracy of its worst habits is never to cease in the effort of discovering of new ideas for progress and new arguments for liberty.

Lord Robbins the Lion

February 4, 2019

When Lord Lionel Robbins accepted to become the supervisor of my Ph.D. thesis I felt lucky, but did not know how lucky I was. I had been studying for a degree in Political Science at the London School of Economics. I wanted to go further and dig under politics to uncover the economic strands of the social fabric. When Karl Popper had suggested that I write on John Stuart Mill, I immediately agreed, for Mill was not only a political philosopher but also and fundamentally an economist. The School then saw I needed much help to tackle the economic side of my chosen topic. So, here I was, in some trepidation, in Robbins's small room (Baron Robbins, of Clare Market in the City of Westminster, to give him his full title). At this our very first meeting my supervisor told me to start by reading Alfred Marshall's Principles and Joseph Schumpeter's History of Economic Analysis, from beginning to end, a fortnight for each! Each took me a month and I only scratched the surface. I remember his remark when I expressed my despair at not having read all the books that were awaiting my study: "Pedro that is a feeling you will never get rid of in your life".

This was characteristic of the great teacher that he was. He stretched you to the limit. He demanded analytical precision and at the same time broad historical perspective. Another trait was his exquisite but firm courtesy. When I produced a draft of my first chapter, which was on Mill's methodology of the social sciences, he said: "Pedro, I found your paper very interesting. But why don't you put it in an inaccessible cupboard?"

Robbins was born in 1898 in a strict Baptist family and died in 1984 after a gloriously fruitful life. His father Richard was a prosperous market farmer who cultivated as much as 300 acres of the land that now is part of Heathrow Airport. He did not attend boarding school but rather the local secondary School, where he took more to writing poetry than to studying mathematics. He was wounded as a very young soldier in World War I. Then, encouraged and financed by his father, he started study at the LSE, which would be his spiritual home for the rest of his life.

Here I wish to show what he meant, not so much for me, as for economic science (as he strongly believed it was a science), for his country in war and peace, for the universities, and for the arts, the ballet, and the opera. He was a person of conviction and character, but his most precious trait was a warm and caring personality, which shone through his unfailing courtesy. I have been led to recall the life of this outstanding man by reading Susan Howson's immensely detailed biography, where his life is related als es eigentlich gewesen war—as it actually happened—in no less than 1,161 pages.

The young professor

Robbins was made a junior professor at LSE when he was not yet 31 and soon became a full professor. He set about transforming the teaching and cultivation of

economics at the School. He rightly gave much more importance to lectures rather than tutorials, as he experienced in Oxford during his brief stint there. Another essential element of his work and influence was his famous Seminar, which he convened regularly all the years when he was teaching at LSE. His vision of economic was quite different from the type of analysis set forward by Marshall and used by his many

disciples. Robbins wanted economics to be based on theory, by which he meant the use of logical reasoning based on general equilibrium,449 while Marshall was more of a partial equilibrium theorist.450 Now, this is contrary to the accepted view of the Austrian School of Economics, focussed on their refusal to formulate economic theorems in mathematical terms. One must not overlook their insistence that one should always account for the indirect repercussions of the solution for the whole of the economy when trying to solve an economic problems. While Robbins, in his lectures on the history of economic thought, unfailingly mentioned Leon Walras as an originator of general equilibrium he rather followed Friedrich von Wieser, the other founder of the method, in eschewing mathematical models.451 Robbins always applied the theory in its logical verbal form. His skill in the use of language allowed him clearly to present the manifold consequences of changes in initial conditions but he saw no need to formulate theorems and their proofs: deduction from the premises of rational behaviour was enough.452

Robbins, however, was also an applied economist. He was adamant in logically separating is from ought but this did not keep him away from political economy: he judged social situations as a moderate utilitarian; and he applied statistics when proposing policies. The crowning example of his statistical bent is how he led the Commission charged with the Report on Higher Education (1963) to collect the facts and figures of Universities and similar institutions, and to use them to forecast the needs and costs of the large expansion they would propose.

Robbins and Keynes

The main external circumstance that influenced the teaching and application of economics in the 1930s was the 1929 recession, later the Great Depression. In 1931 John Maynard Keynes publicly abandoned his free trade stance and proposed a tariff to help fight unemployment. Robbins lamented this recantation and never followed Keynes in his commercial heresy. With the Great Depression the rift between them widened. From 1931 on Keynes explained deflation in the

449 An instructive example of his application of general equilibrium can be seen in Robbins's theory of opportunity cost (1934). It is worth the visit. 450 It was Robbins himself who called my attention to the general equilibrium analysis in the mathematical appendix Note XIV of the Principles. But Marshall added that, "[...] while a mathematical illustration of a definite set of causes may be complete in itself, [...] it is otherwise with any attempt to grasp the whole of a complex problem of real life [...] in a series of equations. For many important considerations, especially those connected with the manifold influences of the element of time, do not lend themselves easily to mathematical expression." I take this to mean that Marshall thought Walras overplayed the notion of equilibrium. 451 Robbins only used two charts in all his published writings, to illustrate the backward bending supply curve for labour. (Howson, 2011, pg. 172). But he did use them in his classes. 452 He expounded the logic of his method in his most famous book, the Essay on the Nature and Significance of Economic Science (1935, 2nd edition)

United Kingdom by an excess of saving over investment. He argued that a slump should be corrected by more expenditure and started proposing a programme of public works to revive demand. Robbins, on the other hand, argued that he could not see the usefulness of public investment without regard to what the funds were being spent on

In the 'thirties Robbins's friendship with Ludwig von Mises and later F. A. Hayek helped him become growingly fascinated by the Austrian theory of the economic cycle—'a monetary over-investment theory of

the business cycle', as Howson aptly calls it.453 Robbins blamed the excessive boom of the 'twenties on the artificial lowering of interest rates in the United States because it had led to mistaken investment decisions not backed by savings. The slump was a painful but necessary purge those mistakes and should be let rip. He wrote the only book of which he later in life said he repented: The Great Depression (1934). No artificial inducements were to be applied to reverse the slump.

A different explanation came from Chicago. Milton Friedman relates how there they explored a third possibility in the explanation and correction of the Great Depression. Whatever the initial causes, sitting on ones' hands was not the solution. What had started as 'a garden variety business recession' became a chasm because the Federal Reserve allowed the money supply to shrink catastrophically. It had not acted as a lender of last resort in good time and had allowed scores of banks to fail. However, this more hopeful monetarist explanation was not fully formulated until the 'forties. The Austrian solution looked too miserable, so Keynes provisionally emerged triumphant.

Robbins in fact never gave up the Austrian theory as an explanatory frame-work but after working with Keynes during World War II, he did move to using aggregate economic variables rather than insist exclusively on analysing relative prices as Hayek did. And instead of focussing on measures to increase the flexibility of the labour markets and the economy as a whole, as he had done in the 'thirties,454 he accepted the Keynesian public investment proposals to revive aggregate demand.

Service during World War II

Robbins served in both world wars; he was wounded as an artillery officer in the First War and worked as an economist very near the seat of power during the Second. He started as one of the economists attached to the War Office, his more noticeable contribution was helping establish war rationing of consumption goods to a point system. He then became the Director of the Economic Section in the underground warren of offices under Whitehall from where Churchill directed the war. These offices can be paid an enthralling visit today. He was material to transforming the British economy into an effective war machine.

Around 1943 he increased his collaboration with Keynes, who was working at the Treasury nearby, principally on the design of the economy of the post-war world.

453 Howson (2011), pg. 176). 454 The 1930 Committee presided by Keynes and studied by Howson (2011), pages 179-193.

With the other economists of the group, he had to travel frequently to the United States. With Keynes, he made a signal contribution to the British side at Bretton Woods. When the war ended he helped negotiate the American loan, whose intent was to help the United Kingdom to keep a fixed exchange with the dollar, despite the UK's twin deficits of the balance of payments and the budget. The loan was frittered away in trying to keep the pound at the over-valued rate. Luckily, the Marshall Plan intervened and the United Kingdom together with the other European allies received large additional fund for reconstruction.

Return to the LSE

In December 1945 Robbins left public employment and returned to his beloved LSE. He soon started teaching his regular Principles of Economics course. It was essentially a microeconomics course, using graphs and even cardboard models but very little mathematics. I well remember that, when he came to speaking of the economy in aggregate terms he assumed we were all familiar with (Keynesian) macroeconomics, so he did not dwell on them. This shows the extent of Keynes's influence on him. We know that he had abandoned Hayek's reliance on changes in relative prices as a remedy for the slump, so that he would not rely on lowering wages to reduce unemployment as he used to. He did mention money and artificially low interest rates as two factors of inflation but for him they were not the main arguments as they would for Milton Friedman.

He also retook the chair of Economics Department and of many administrative committees but more momentous was the care he lavished of postgraduate school. He restarted his famous Seminar to which he had invited so many distinguished economists when they passed through London. Questions were studied intensively, as for example happened during the 1946/7 session wholly given to the discussion of public utilities at the suggestion of Ronald Coase. 455 And he was material in engaging many distinguished staff for the School, as he had done for Hayek before the war and Popper on the return of peace.

The Mont Pelerin Society

In 1947 Hayek was able to convene a small band of philosophers, historians, and economists high up on the shores of Lake Geneva to examine classical liberalism anew, then at its lowest point since the middle of the 19th century. Robbins was of that group of thinkers, as were Frank Knight, the young Friedman and more. His old friend Mises was there too; charming in private, but making "a dreadful exhibition of himself" and "his prickly temperament" in the discussions.456 One can perhaps understand some of Mises' reactions (at one point Mises left the meeting in a huff calling the rest "a bunch of socialists") because many of those gathered there wanted to free classical liberalism from the taint of absolute laissez faire. Even Hayek, when preparing the meeting, had said he wanted a new version of liberalism.457 The Society, bent on waging an intellectual battle, has in fact gone

455 Howson (2011), page 653. 456 Robbins to his wife April 3rd 1947, quoted by Howson (2011), pages. 662-3. 457 Robbins to his wife April 3rd 1947, quoted by Howson (2011), pages. 662-3.

nearer to the unyielding stance of the Austrian School of economics. An important contribution by Robbins was the drafting of the Statement of Aims of the MPS, which is still the official Statement today.458 It takes note of the dangers to human freedom posed by the spread of intolerant creeds and the undermining of private property and competition over large parts of the earth. It does not propose the formation of a propaganda group or a body to impose orthodoxy. It calls for an intellectual effort and a defence of values needed to preserve civilization and outlines some of the fundamental questions that should be further studied by the membership.

The History of Economic Thought

During his 1950 sabbatical year Robbins engaged on a new line of research and publication, where he excelled: the history of economics. He had had an abiding interest in the past of the subject, witness his initiative of having the School republish classical texts. He started teaching the subject in 1953. His first book in this field was The Theory of Economic Policy in English Classical Political Economy (1952) where he undid the usual presentation of the Classical School as a single orthodox movement for non-interventionism. He reinforced this line of thought with Robert Torrens and the Evolution of Classical Economics (1958), a book that was special in many ways. It underlined Colonel Torrens's discrepancies and coincidences with other economists of the time. It threw a new light on the evolution of economic analysis, especially in the field of international trade. And it was an outstanding exercise in scholarship. He later published The Theory of Economic Development in the classical period (1968), when growth and development were becoming hot topics. His work was a paragon of historical empathy without falling into the temptation of doctrinaire anachronism. I was lucky to attend his LSE lectures on the history of economic thought and have read with great pleasure the publication of the notes of this course by [Warren J.] Samuels and [Steven G.] Medema (1998). All these, I must say, were precious lessons for the historian I was trying to be.

The arts and other occupations

One of the outstanding traits of Robbins's personality was his love of the arts— paintings, the opera, the ballet were not only enjoyed but the object of his administrative care. He was immensely knowledgeable; he cared deeply for that part of civilised life. I especially remember a visit to the Prado in his company and that of Iris his wife. Among other requests his principal wish was to see Rogier van der Weyden's "Descent from the Cross". He stood transfixed before that supreme work for a long time and I saw tears welling up in his eyes.

At some point in his life he was Chairman of the National Gallery, a trustee of the Tate Gallery, the Director of the Royal Opera House Covent Garden. His contributions to these institutions were not only based on his vision and good taste

458 Hartwell (1995), pages 41-2.

but also on his excellent relations with Governments and civil servants and the administrative capabilities he had honed during his war service.

This was not all. He was also simultaneously Chairman of the Financial Times and a director of British Petroleum, while he went on presiding the Economics Department at LSE, with all the administrative and academic work that implied. He took it all in his stride but the University. Authorities decided he had to give up his chair, a move that made him very unhappy. There was more to this move than meets the eye: a number of the economists at LSE thought that Robbins's conception of economics was somewhat passé and that the School had to move into the mainstream by becoming much more mathematical and econometric.

The Higher Education Report

One of Robbins's main contributions to the progress of his country was chairmanship of the Committee on Higher Education, whose Report was done and published in 1963. In fact, Robbins was much more than a convener of the Committee. In the end, the Committee held 111 meetings over two years.459 With due respect to the other members he not only suggested the topics to be covered, organised the visits in Britain and abroad, led the cross examination of the witnesses, wrote the drafts of the different chapters and finally the draft of the Report itself.

It was the belief of Robbins that the British University system was too restrictive and wasted a great deal of potential in the young population. His aim and that of the whole Committee was to increase numbers without lowering quality. The reaction of many at the time (unfortunately including myself) was that more meant worse. I must say I was wrong. If we take a long view to the present, there is little doubt that the goal of the Report has been attained and surpassed. British Universities are of world quality in teaching, research, and for their contribution to civilised society.

One distinguishing aspect of the Report was its use of statistical analysis. In this he deviated from Austrian School orthodoxy. Robbins called in Claus Moser to help with the use of data. Moser suggested a statistical construct to measure ´the total pool of ability' in the student population. This pool not only included the young who did attend university but also those who had the ability and not the means, and those who did not even aspire to proceed to further education though they were of the level for it—especially women. To correct such wastage the Committee proposed greatly to increase the supply of places and even examined the possibility of student loans. The estimate of the Report was that the student population including the overseas contingent would grow from 216,000 in 1962/3 to 607,000 in 1985/6. Howson adds that this turned out to be an underestimate of the actual expansion of student numbers.

459 Howson (2011), page 867.

The Report for all its qualities and boldness was clearly set in the statist mode. The main source of funds was to be government, though they should be supplied through a non-political intermediary, the University Grants Committee. This is very much within the British tradition of correcting the Oxbridge duopoly by creating public universities mainly funded by government. In the 19th century two new universities, University College and King's College were launched in London through civic or Church efforts. But soon public money acquired the greater role. In the Report the role of institutional competition to as a method of maintaining quality was almost absent. The aim was uniform quality of the system. Quality was kept up by regulation. The Report thus moved away from the American system of freely competing self-governing establishments, both private and public, where competition does not result in uniform quality but the supply is more obedient to the varied kinds of demand.

The Troubles

Though Robbins had spent most of his adult life connected with LSE, he had to give up his professorship, as related above, and when nearing seventy simply kept giving some lectures there. It is ironic for an educator so caring for the cultural and professional aims of University that he should have been involved again in the School's affairs during the 'troubles' of 1966/7 and 1968/9. In those years the Universities of the English speaking world went through a time of conflict, which in 1968 spread to France and Germany. At LSE they took the form of objections by the more radical students to the appointment of a new director, whom they accused of racialism. Robbins was Chairman of the Court of Governors during the second period of troubles coinciding with demonstrations against the Vietnam War, matters came to such a pass that the School had to be closed for twenty five days.460 This was a bitter pill to swallow, later sweetened by the success of the Appeal for a new Library. That facility was named after him and is now in full swing.

He crowned his life as an economist and a historian with a last book: Political Economy, Past & Present (1976), where he reviewed the leading theories of economic policy. And in 1998, as I said, the notes of his course on the history of economic thought were published, much to the satisfaction of those of us who had had the pleasure of attending along the years.

The Old Lion

I hope I have painted Lionel Robbins's portrait 'warts and all' but recalled the reasons for his greatness. A mane of hair that had turned white when I met him crowned his imposing figure. His strong carrying voice had traces of earthiness as became the son of a farmer. He spoke with clarity and conviction and, as many said who knew him, he had a capacity for concentration and a prodigious memory that helped him in the many intellectual battles that he waged in his academic, political, corporate, and administrative posts. His ability for lucid exposition, elegant and precise pen, outstanding capacity for marshalling evidence and argument, great

460 Dahrendorf pages 443-477.

powers of concentration and memory, contributed to making him the outstanding public figure he became.

In his way he was an arch-establishment figure but one that never sounded hollow. He truly understood and respected the civilisation in which he was born and grew. He loved paintings, opera and ballet and was able to help reform and finance the museums and theatres that he advised and directed with the same effectiveness as he applied to his war service. A restrained sense of beauty shone through his prose and increased its power.

As an historian he was a meticulous scholar who did not commit the solecisms of so many of his peers, who today for example invent denominations such as 'neo- Keynesian' that Keynes would have repined at.

As an economist, which is after all what he essentially was, his achievements were mixed though he may have been less out of line than he appears today. He was an inspiring teacher and lecturer. He was a political economist who did use statistics to understand and predict the situations he studied. He is out of favour today because he shunned using mathematics, his models were verbal, and he was born too early to incorporate econometrics to his reasoning. It is a pity that on some crucial questions he moved away from the Austrian School of his youth. For example, his famous definition of economics as the science which

studies the relationship between given ends and scarce means with alternative uses lacks the dimension that Hayek would underline in his 1945 on "The Use of Knowledge in Society", that ends may be unformulated and means undiscovered, and that therefore economic calculation was far from an engineering problem. Again, his move nearer to Keynes during WWII by stressing aggregate demand as the mover of the economy was a plain mistake that Mises could have warned him against.

Let me conclude that I was indeed lucky to have him as a mentor.

Hume, Smith and Darwin

December 2, 2019

Two years ago, Dennis Rasmussen published a book that he says "was an absolute joy to write" and indeed is a joy to read: The Infidel and the Professor. It is the biography of a "Friendship That Shaped Modern Thought", as the subtitle explains. This deceptively anecdotal story of how David Hume and Adam Smith became the fastest of friends over the years allows Rasmussen to throw new light on their epoch-making contributions to the science of society

Smith and Hume probably met in 1749. Smith had come down from his six years at Oxford where he had read Hume's Treatise, much to the scandal of the Balliol College authorities. He was asked by Lord Kames to give a series of lectures on Rhetoric and Belles Lettres in Edinburgh. Hume may have attended the second set of those lectures and, from later remarks, must have been impressed by Smith's delivery and content. Smith was greatly admired for his pure English when compared with the Scottish voices of his compatriots who had not studied south of the border. He also shone with practical erudition in his analysis of Greek and Roman eloquence. Such was the starting point of the friendship. Recalling the many years that it lasted allows Rasmussen to discover for us hidden dimensions of their personalities and their thought, which were a revelation at least for this reader who believed he knew his Adam Smith well and his David Hume pretty well.

The two friends were very different people. Hume always saw the good side of life. Ever an optimist, he was full of fun even when circumstances were not propitious. The reader of these parallel lives will be surprised to discover that in his more prosperous later years in Edinburgh he cooked meals for his guests from recipes he had learnt during his time in Paris. The famous letter he wrote to Smith on the reception of The Theory of Moral Sentiments in 1759 deserves Rasmussen's praise of it "as one of the most charming letters in the entire history of philosophy." The playful humour of Hume must have amused Smith, despite his more restrained manner.

Their attitudes and writings on religion bring out that contrast best. Hume almost welcomed the tempestuous reception of his books and essays where he argued for his religious infidelity. Smith was much more careful of "his own quiet", as became clear from his advice to Hume that Dialogues Concerning Natural Religion (later published by Hume's nephew in 1779) should remain unpublished—a piece of advice also given by other friends. This did not mean that Smith was showing a lack of courage, for in the letter he wrote after Hume's death to William Strahan, the publisher of both writers, he extolled the character of his friend "as approaching as nearly to the idea of a perfectly wise and virtuous man, as perhaps

the nature of human frailty will permit". Smith's words of praise for an infidel deeply shocked religious opinion, but he never took them back.

Differences between Hume and Smith

Rasmussen, with his light manner, has much to say on Smith's and Hume's doctrines in matters of rhetoric, ethics, and the sociology of capitalism.

Adam Smith's Lecture on Rhetoric at Glasgow were among the manuscripts he had burned just before he died; luckily, for us two students had kept very detailed notes of his course, as also happened with his Lectures on Jurisprudence. One can guess what impressed Hume in those Edinburgh lectures, though the art of speaking and writing does not receive today the same kind of detailed attention as in the 18th century. Adam Smith's use of examples from classical Greece and Rome make reading difficult for people not familiar with classical languages and literature. Rhetoric has morphed into public relations and, with the help of the new communication technology, has a much wider (though less refined) economic and political presence in society. What interests us now is the confirmation the lecture notes afford of Smith's ability as a lecturer, well noted by his contemporaries. Also, we are surprised by complaints at the time that the prose of the Wealth of Nations was inelegant in contrast with his other writings. 461This is an early example of the barrier that economics encounters from the use of the long chains of abstract reasoning typical of our speciality.

One of the points that Rasmussen illuminates is the differences in the ethical theories of Hume and Smith. Neither thought that ethics was a product of reason; both thought it was a social phenomenon resulting in 'sentiment'. However, Hume's ethical theory was what later would be called utilitarian: moral approbation had its origin in what was convenient for the survival of society. Smith's theory was more individualistic: the fountain of social rules and people's approval or disapproval was an innate feeling of sympathy for one's fellow men. The opening phrase of The Theory of Moral Sentiments is justly famous:

How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives from it nothing but the pleasure of seeing it. As Dugald Stewart underlined in 1793, Smith felt that the sentiment of the utility of a moral rule could enliven the obedience to its precepts but was not "the principal source of moral approbation" (Stewart, page 29).

More fundamentally, Hume and Smith differed in the nature of 'sympathy' from which moral sentiments flowed. For Hume, Rasmussen says, feeling sympathy with other persons is "a kind of emotional contagion," or involuntary vibration. For Smith, sympathy would better be described as empathy. Depending on what we find when we 'enter' the sentiments of another person, we may end disapproving of their sentiments if the anger, let us say, is unjustified. (Rasmussen, 90-94)

A third difference between the two friends is underlined by Rasmussen in chapter nine of the book. It concerns their attitude towards the kind of commercial society

461 "... [h]is own didactic style in his last famous book [The Wealth of Nations] (however suited to the subject)—the style of the former book [Moral Sentiments] was much superior—was certainly not a model of good writing...". James Wodrow to the Earl of Buchan, after 1776. Introduction to Lectures on Rhetoric and Belles Lettres, 11. OUP, 1983.

that was growing before their eyes, or, as we say today, their attitude to 'capitalism'. Of course, Smith fully agreed with Hume on commerce not only being the fountain of prosperity but also of "virtue, liberty,

civility, knowledge, and happiness" (169). They concurred when relating the dissolving effect of commerce on feudal society, and when maintaining that the prosperity of neighbouring countries was to be wished for (or prayed for, said Hume) to secure the well-being of one's own country. Hume did see dangers in commercial societies, especially the temptation of colonial adventures and the accumulation of debt. Smith agreed on both counts. Both defended American independence. Excessive public debt was an immediate menace under the gold standard, but this is true even with today's fiat currencies for its effects on long-term inflation. But Smith went unexpectedly further when underlining the possible drawbacks of a commercial society. While Hume welcomed its toil and trouble, Smith lamented the pursuit of the baubles of wealth that characterise commercial society. And more radically, the division of labour, the main cause of the wealth of nations for Smith, tended to maim the spirit of ordinary workers and make them unfit for the defence of the country.

Still, both Hume and Smith saw the progress of commerce and manufacture as the principal force for the establishment of "order and good government, and with them, the liberty and security of individuals" (Wealth of Nations book 3, as quoted by Rasmussen, page 162). The fact that, as Rasmussen underlines, "neither Hume nor Smith was a free market absolutist" (168) does not detract from their contribution to the epoch-making change of Western society the 18th century. They thought government was necessary to guarantee order and, explicitly in the case of Smith, to ensure national defence, the Courts of Law, and the construction of public works: or, as Smith put it, "peace, easy taxes, and a tolerable administration of justice". But they both rejected attempts of politicians to try to promote national prosperity or to defend special interests.

Smith at the Customs House

The fact that Smith actively sought the position of Commissioner of the Scottish Customs and performed it during the last twelve years of his life, from 1778 to 1790, has been a cause of surprise and even scandal for his followers. The problem is that the duties charged by the Customs of the United Kingdom were a fundamental instrument of the mercantilist policy that Smith so clamorously opposed. Rasmussen argues that "Smith was not simply opposed to all tariffs [...]. He opposed using them as an instrument of monopoly or as a means of favouring domestic industries over imports" (229). Tariffs were an important source of funds for the state. And his father had been a customs officer in Kirkcaldy.

Still, doubts persist as to why he sought the position. Gary Anderson et al. (1985) have made a careful study of the activity of the Scottish Custom Board during Smith's tenure. Their conclusion is that Smith did not behave as if the post were a sinecure. Four meetings a week and full attention to complicated and varied business was not the behaviour of an economist bent on streamlining or even lightening the mercantilist regulations of the Scottish Customs. In that post Smith was "a hard-nosed bureaucrat", "not a radical reformer who transformed the

service" in accordance with his anti-mercantilist doctrine. No echo of his work at the Customs can be heard in the last revised editions of the Wealth of Nations in 1784. Perhaps, as Stigler is reported to have said, Smith was tired of economics. In those final years, he put all his effort into revising and adding to The Theory of Moral Sentiments for the 1790 edition. He also read to the Literary Society of Glasgow some of the Essays on Philosophical Subjects published after his death in 1795. So, he was fully occupied without turning his attention to his experience at the Custom Board.

Smith, Hume, and Darwin on the ethics of social life

Adam Smith starts Moral Sentiments by noting that "there are evidently some principles in [man's] nature which interest him in the fortune of others". Though he confirms this with various examples, he does not explain the origin of, or reason for, this natural trait. This is what Charles Darwin tried to supply in The Descent of Man and Selection in Relation to Sex (1871). He started chapter III by declaring that "of all the differences between man and the lower animals, the moral sense or conscience is by far the most important"; and that, as far as he knew, "no one had approached it exclusively from the side of natural history".

Interestingly, Darwin presented a theory of ethics quite similar to that of Hume who mostly based moral sentiments on general utility. His main explanation for the evolution of social norms is that they have "certainly been developed for the general good of the community".

The term, general good, may be defined as the means by which the greatest possible number of individuals can be reared in full vigour and health, with all their faculties perfect, under the conditions to which they are exposed. He did separate this definition from that of the political utilitarians of the 19th century, by underlining the internalisation of social norms: "... the general good or welfare of the community, rather than the general happiness." The steps by which a moral sense evolved in any animal "with well-marked social instincts" were the following. Firstly, an animal would take pleasure in communing with its fellows thus develop a feeling of sympathy with them. Secondly, it would remember and feel dissatisfaction when it had allowed a passing need to overpower social instinct. Thirdly, the ability to speak, once acquired, would reinforce the expression of common opinion. Finally, habit would strengthen the sway of communal behaviour.

As Rasmussen notes (98-9), Hume did himself little good when he excessively stressed that utility is "a foundation of the chief part of morals", somewhat passing over agreeableness as another quality contributing to moral approval. Be that as it may, Smith cast his net wider than the utility of the group when explaining ethical norms. Merit and demerit depend on the intended or realised effects of actions, to which Smith allowed a role in moral sentiments. But what Smith calls 'propriety' depended on the quality of actions in themselves, as judged by the impartial spectator we carry in our breast. In our time we would judge in favor of the propriety of the captain of the Titanic choosing to sink with his ship, for the utility of no one but as a demonstration of the proper thing to do.

Later advances in biology have deepened Darwin's explanations and made them less mechanistic, so to speak. Ants and bees sacrifice themselves for their hive or heap because they are sisters. We men trade with strangers and extend our moral attitudes to individuals who do not belong to our tribe.

Hume's razor

One last question remains to be discussed. I call it "Hume's Razor" because it reminds me of Occam's razor: the injunction that Entia non sunt multiplicanda praeter necessitate, (explanatory assumptions should not be multiplied unnecessarily). In this case this is the caveat formulated (irony of ironies) by Hume, that it is illogical to go from propositions with the verb is to injunctions with the verb ought. It would seem, then, that Hume and Smith and Darwin should have used a razor to cut ethical prescriptions loose from social psychology or evolutionary theory. Should one not refrain from deducing ethical rules from factual evidence? What is the logical connection between morality and the observation of human sentiments or of natural evolution? Should one disobey Hume the logician and follow Smith in discriminating among values by looking at their consequences? I will leave these difficult questions for another day.

Climate Change: A Tragedy of the Commons?

March 2, 2020

A growing number of people see climate change as an example of the tragedy of the commons: the 'over-grazing' of collectively owned open lands by an unstructured group of people. The logic of individual self-interest will lead each and every individual to try to steal a march on the rest of the group before the rest overexploit those open lands. In other words, individuals in a free market cannot be trusted to refrain from over-grazing common lands. The Earth's atmosphere is the commons of the future. One of the earliest climate change activists, Nicholas Stern, has called global warming 'the greatest market failure of all time'. By this he meant that free markets, left to their own devices, have failed and will continue to fail to control behaviour leading to a harmful and continuous increase in the temperature of the world's atmosphere, oceans and continents. Present day public opinion subscribes to this black-and-white presentation of the problem of climate change and comes to the following conclusion: people who try to apply critical rationalism to climate alarmism must be condemned as unscientific 'deniers', who are helping bring about an immediate climate catastrophe.

We are being deafened by calls to change our ways, even at the cost of trillions of dollars and at the risk of gravely endangering our freedoms. The global warming programme is being sold with snake oil marketing techniques: after showing TV images of droughts, hurricanes, floods, and polar bears adrift at sea, the climate lobby claims that humanity is on the verge of extinction and that something dramatic should be done. It is video game science—we only need to press the United Nations key, send in the blue helmets, and save mankind from the wicked deniers.

I am no climate scientist. However, I believe that I have a say as a political economist about the arguments of the alarmists, despite the current denigration of anybody who dares criticise the political measures proposed to fight global warming and climate change. What I will do in this and the following article is analyse and debate the kind of interventions proposed and do so in the light of present-day economic theory of common goods.

We humans have indeed had and are still having an effect on the Earth's climate. We need only look at forest clearing and the intense cultivation in 19th and 20th centuries in the United State leading to the Dust

Bowl years of the 1930s; or today's urbanisation of world population and the multiplication of the megalopolis in Asia and Latin America. But is present day global warming man-made, as a great number or even a majority of climate scientist say? As Colin Robinson (2008) puts it: There is scientific evidence that, other things being equal, increasing emission of carbon dioxide and other greenhouse gases will bring rising world temperatures. In the absence of complete scientific knowledge, however, the list of the 'other things' and their effects is long but incomplete. (page 50)

The following questions should be asked before we rush to impose solutions that may jeopardise our commercial and democratic way of life: 1) How prevalent are human actions in causing climate changes? 2) How reliably can the future course of the Earth's climate be predicted? And 3), how large are the opportunity costs of the measures proposed by the interventionists? In this first article of a series, I will start by trying to gauge the extent of the damage to our climate due to human action. I will then examine the alleged imminence of a climatic catastrophe. In the next piece, I will explore whether a spontaneous correction of impending climate tragedies is possible through the piecemeal innovations of the free market and the growth of cooperative solutions.

Climate Change Alarmism

What are the issues I see with climate alarmism? They fall into six general categories.

Sounding ecological false alarms. Russell Lewis (2008) critically compiles a long list of false alarms in recent history. One was Rachel Carson's engagingly written Silent Spring (1962): she warned of the poisonous effects DDT was having on the environment and the food chain. She went as far as to say that DDT would cause "practically 100 per cent of human population to be wiped out from a cancer epidemic in one generation"—and this after the birds had all disappeared. Another scare was acid rain, a contamination of the atmosphere believed to be widespread but to which in the end the United Nations and the European Union attributed only a minimal part of the alleged forest damage—it was rather local pollution that was to blame. The case of the ozone depletion due to CFC emissions is a mixed one, to which I shall return. I find it especially interesting because the return of the ozone layer to its normal role as a shield against cosmic rays in a considerable degree has been a natural phenomenon; the other, because its correction may indicate the conditions for the success of large scale collective action.

Committing Malthusian mistakes. These are predictions of resource catastrophes that have proved wrong. The original one, of course, is Thomas Malthus' Essay on the principle of Population (1798), where he contrasted the capacity of population to grow geometrically, against an (at best) arithmetical growth rate for food, an evolution inevitably leading to vice, famine and war. He underrated the possibilities of agricultural productivity, which has allowed world population to reach seven billion, and the human capacity to control fertility, especially with the help of medical science. The result is that, despite still growing numbers, living standards have been rising since Malthus published his essay and that the rate of growth of world population is at last reducing.

Another example of Malthusian mistakes is that of Paul R. Ehrlich, who, together with his wife Anne, published a sensational book in 1968, titled The Population Bomb. They trumpeted that

[t]he battle to feed all of humanity is over. In the 1970s hundreds of millions of people will starve to death in spite of any crash programs embarked upon now. At this latedate nothing can prevent a substantial increase in the world death rate. 462

Among other drastic measures, they proposed starving out countries that did not control population growth and fertility; and launching forced sterilisation programmes, as were applied by Indira and Sanjay Gandhi in India. Ehrlich is quite unrepentant of his failed predictions. "We didn't make predictions, even though some idiots think we have." 463 Another instance of his failed predictions was his wager against Julian L. Simon in September 1980. Ehrlich had famously said: "If I were a gambler, I would take even money that England will not exist in the year 2000". Their disagreement boiled down to Simon to bet Ehrlich $10,000 that the real prices of five industrial metals (copper, chromium, nickel, tin, and tungsten, chosen by Ehrlich himself) would show no rise over the following ten years: they all fell. Ehrlich and his followers have now morphed into global warming prophets.

I need not go into the Club of Rome's Limits to Growth (1972) and its catastrophic predictions. I need only say that Julian Simon was one of its first effective critics; and that the idea of this report was that population would by 2030 have grown to a peak followed by rapid decline due to the depletion of productive resources—a catastrophic framework still present today in climate prediction.

Ignoring the difficulty long-term climate prediction. Edward N. Lorenz, one of the founders of complexity analysis (and the formulator of the famous 'butterfly effect'), has abundantly shown that climate predictive models soon turn chaotic, i.e. soon become noise (1996, 2006). Though we generally use models try to understand nature, climate change specialists find models difficult to specify, for, apart from the atmosphere, they have to take account of the Earth's crust, and of the sea surface and deep currents. When trying to foresee the evolution of the weather and the climate with the help of those models, they need to measure the rate at which predicted states deviate from reality, so as to know the moment when the forecast becomes chaotic. This can only be induced ex post and for whole classes of predictions.464 Errors will compound arising from two kinds of circumstances: failing to determine the initial state of the meteorological phenomenon under study; 465 or mis-defining the laws that govern the phenomenon. In any case, the prediction of the evolution of regional weather is still in its infancy; and so is that of extreme weather incidents. And, as regards more

462 Ehrlich, Paul, and Ehrlich, Anne H. (2009): "The Population Bomb Revisited". The Electronic Journal of Sustainable Development, 1(3).

463 Grist Magazine, August 13, 2004. 464 In fact, the usefulness of the models for each case is measured by the doubling of the initial error, known as the Lyapunov exponent. 465 Exact knowledge of initial conditions may in some special cases not be too important: this is the case of oceanic tides, for which predictions can be made precise by using established relations between tides and independently known motions of the sun, earth and moon. Equally, in the case of El Niño known periodicities allow us to formulate macro-predictions, such that the phenomenon will appear every two to seven years; thus also, the quasi biennial oscillation (QBO) of trade winds in the midlevel stratosphere near the Equator.

mundane short-term predictions of the weather, Lorenz (tongue in cheek?) adds that "we may some day forecast a week in advance as well as we now forecast three days in advance, and two weeks as well as we now forecast one week ahead." (page 57).466 Edward Lorenz also makes sobering remarks about the concept of 'climate'. In the case of El Niño, the weather complex in South America, he notes: "To some climatologists, the climate changes when El Niño sets in. They posit that the climate changes again, possibly to what it had previously been, when El Niño subsides." [...] To others, the climate [...] is something that often remains unchanged for decades or longer and is characterised by the appearance and disappearance of

El Niño at rather irregular intervals, but generally every two to seven years. (page 55)". Imagine how easy it must be to predict the Earth's climate thirty, fifty or a hundred years hence. The expression 'climate change' instead of 'global warming' is used to accommodate the fact that atmospheric temperature may get off the warming trend: it would not be the first time. Also, the connection between global warming and harsher hurricanes and other extreme incidents is less than clear. Attributing global warming mostly to man-made or anthropogenic factors. In his book on what he calls the climate casino, William Nordhaus [Nobel Prize winner] includes a graph, Figure 1 below, indirectly illustrating the unknown forces that influence the climate. If we take the estimates of the temperature of the island of Greenland as an indication of the warming of the world, it seems that some 10,000 years before our time the climate suddenly became warmer and has stayed there.

Figure 1.- Global warming before the Industrial Revolution. Nordhaus (2013).

466 William Kininmonth, the Australian meteorologist (2004), points out that climate warming alarmists tend to concentrate on the vertical temperature structure of the atmosphere and hence on warmth retention on Earth; and too little on the horizontal energy transfer between the tropics and the arctic zones of our planet. In his view the efforts of climatologists should make good the neglect of regional weather phenomena and concentrate on better forestalling and resisting meteorological and climatological phenomena that are recurrent and natural. He also foresees a cooler climate in this coming twenty or thirty-year period due to changes in solar activity, to wit, the sunspot cycle, solar insolation, and the inclination of the Earth's axis. In fact, the temperature rise in the first ten years of this century has been slower than the IPCC predicted by looking only at greenhouse gasses because natural factors such as La Niña and less sun the small drop in sunlight reaching the Earth as part of the natural solar cycle.

As Nordhaus notes, this period is that of the socialisation of homo sapiens and the emergence of our cultures. Most of the warmer period that came after the end of the glaciations was free from industrialisation and man-made warming. Young and Steffen (2009) give some detail of what this warm tail has meant for humanity.

Figure 2.- Homo sapiens flourished in warmer weather.467

Failing to give natural factors their due weight. This leads me to stress that climate models cannot be confined to the connection between human activity and increases of atmospheric temperature: they should be multivariate models, where the main 'causes' of climate change are non-human: the first, the sun and its spots, since their non-occurrence coincides with cooling periods. Secondly, Earth's orbital variations influence annual insolation, which is a likely explanation of the warm period in the early Holocene. Neither can humanity be blamed for volcanic eruptions, earthquakes, tsunamis or meteorites. Other non-anthropogenic causes are wind driven surface currents, such as the Gulf Stream; and, at a greater depth, currents driven by differences in temperature and salinity; these deep currents eventually sink into sea water wells in the North Atlantic and the Southern Ocean, with transit times of around 1,000 years. I have already mentioned the rough regularity of the Trade Winds around the Equator in the Atlantic and Pacific Oceans. The conclusion is that natural causes also play a big role in climate change.

The debate on whether increases in temperature in the last years of the 20th century and the beginning of the 21st are anthropogenic or due to natural causes is heating up, because the IPCC 3rd Reports of 2001 and later take it as given that the increases are man-made. The source of this position is to be found in the

various versions of a paper by Mann et al. (1998). The opposition is led by McIntyre and McKritic (2003). It is poetic that the discussion should have centred around a metaphor, the representation of world climate as a "hockey stick". The idea proposed is that temperatures of the Northern Hemisphere were appreciably

467 Young, O. R., and W. Steffen. 2009. "The Earth system: sustaining planetary life-support systems"; Figure 1. In F. S. Chapin, III, G. P. Kofinas, and C. Folke, editors. Principles of ecosystem stewardship: resilience-based natural resource management in a changing world. Springer, New York.

stable during the 1,000 years up to the year 2000 (the handle of the hockey stick) and have suddenly shot up in the present period (the blade of the hockey stick).

This metaphor was broadcast to the world courtesy of Al Gore in 2007: "Our civilization has never experienced any environmental shift remotely similar to this."

Figure 3.- The Mann-Bradley-Hughes hockey stick468

Figure 3 shows 'temperature anomaly' since year 1000. This means departure from the mean temperature of the current millennium. The light blue area shows the confidence margin of the indirect (or proxy) calculation of temperatures of remote times. Proxies are ice-cores, tree-rings, northern tree-line, pollen, insects and so on.

The question has now become the following: were temperatures appreciably stable and cool during the millennium before the 21st century? Or did sharp ups and downs happen during that long period making the 'handle' rather unserviceable? If the latter, then the alarm at the averred present sharp increase in temperature (the 'blade') could turn out to be exaggerated for we would be observing only a temporary upward movement in a natural cycle.

Let us turn to lo the 'handle'. McIntyre and Mckritik (2003) hold it that the temperature pattern from year 1000 to 1950 looks too jagged to fit the metaphor.

468 Mann, Michael E.; Bradley, Raymond S.; Hughes, Malcolm K. (1999), "Northern hemisphere temperatures during the past millennium: Inferences, uncertainties, and limitations" (PDF), Geophysical Research Letters, 26 (6): 759-762.

Figure 4.- McIntyre and McKritik (2003) throw doubt on the 'Hockey Stick'

handle.469

It is generally agreed that there seems to be a connection between the frequency of observed sunspots and earth warming and cooling. Cold periods usually correspond with a low number of sunspots. For instance, the so called 'Maunder' period of very low sunspot frequency from 1600 to 1760 coincides with the deepest part of the 'Little Ice-Age'.

Figure 5.- Solar irradiance inversely related to sun-spot frequency.

McIntyre and McKritik (2003)

Though I cannot adjudge on the scientific debate, as an economic historian I can assert that the 17th century was indeed a time of very cold and rainy weather. In 1763 the Thames froze. Crops failed repeatedly all over Europe. In Spain it was a century of poor crops and repeated plagues, starting with the 1598 epidemic that

469 McIntyre, S., and McKitrick, R. (2005), "Hockey sticks, principal components, and spurious significance", Geophys. Res. Lett., 32, L03710, doi:10.1029/2004GL021750.

ended the relative prosperity of Philip II reign. The Black Death had also come in 1346-53 at the end of the medieval warm period, when unusual cold pushed the black rats to spread in search of sustenance and their fleas invaded humans weakened by hunger. So much for the hockey stick hypothesis.

The possible influence of natural causes on the climate has lately been used to explain the observation that during the first ten years of the 21st century the increase in temperature turned out to be lower than predicted by climate models. We have been going through a period of very low sunspots, similar to the period of the Maunders reduction of solar activity coincidental with the Little Ice Age. The surmise is that we now are in another such period and that we are not fully experiencing its effects at present thanks to the production of Green House Gases. Mild cooling could turn to excess due to natural causes. The future of our planet principally would then depend on the Little Age not turning into a full glaciation.

Nordhaus's tipping points. A crucial question in this disputation is whether we face a gradual effect of atmospheric warming or are at the edge of a no-return abyss. The rhetoric of extreme interventionists such as Greta Thunberg is that of the high probability of an impending catastrophe. Such is the Declaration of Climate Emergency by the European Parliament.

The scientific attitude should be quite different. The evidence and explanatory models of the scientific community may indicate upward trends (temperature, gas concentrations, sea levels). However, there seems no base for the prediction of violent and irreversible disruptions triggered by some supposed threshold.

In my next article, I will turn to the economic science of collective action, in search of appropriate responses to the climate 'crisis' with which we seem to be faced.

Climate Change: What is (Not) To Be Done

Arpil 6, 2020

In my previous column, I did my best to gauge the extent of the damage done to the climate as a result of human action, as well as the likelihood of an imminent climatic catastrophe. In this piece, I intend to explore whether a spontaneous correction of impending climate tragedy is possible through the piecemeal innovations of the free market and the growth of cooperative solutions.

Russian Roulette

In his 2013 book, The Climate Casino,470 Nobelist William Nordhaus takes the marketing path rather than demonstrating the prudence he shows in his scientific papers.471 He sees the possibility of a catastrophe so grave that he indirectly owns up to the fact that he thinks a better title might have been 'Climate Russian Roulette'.472 He then tries to justify what in essence is his catastrophism when he gives the whole of Chapter 5 to "Inflection Points", by which he means moments when 'good equilibria' suddenly turn into 'bad equilibria' with a crash. He lists four points of climatic inflection:

• The collapse of large ice sheets; • Scale changes in ocean currents; • Temperature feedbacks, whereby warming by itself causes more warming; • Continuous warming over the long-term.

Why exactly one should read these vague menaces as hinges of inflection of world climate to a lower-level equilibrium, he does not say. All those points have yet to happen. That a Nobel Prize winner should be

content to prove his case with these vague premonitions fills me with dismay. Science is not a matter of casting horoscopes.

What is (NOT) to be done

1. Uncritically applying the precautionary principle

The cost of imposing measures to fight climate change is often presented as equivalent to paying an insurance premium (in the form of prohibitions, charges, loss of personal freedom) to compensate future generations for the possible harm we may have inflicted upon them. The 'premium' is really a tax imposed on this generation to honour the 'precautionary principle.' This principle is a characteristic

470 William D. Nordhaus. The Climate Casino: Risk, Uncertainty, and Economics for a Warming World. Yale University Press, 2015. 471 See Nordhaus' 1993 paper, "Rolling the 'Dice': An Optimal Transition Path for Controlling Greenhouse Gases". 472 Nordhaus (2013), chapter 4 in fine, footnote 27, approvingly mentions some MIT researchers who speak of "Russian Roulette". Compare with "Revisiting the social cost of carbon," by William Nordhaus.

of the European Union, whereby some action is forbidden 'just in case'. The decrease in economic growth caused by this 'insurance contract' may reduce the well-being of future generations. This premium may turn out to be very high if the restrictions we suffer do not markedly change the world temperature trend. Also, the precautionary principle by implication assumes that self-correcting forces in human society are very weak.

2. Using dual discount rates

A question that goes to the bottom of how to predict in the field of economics and finance is bringing future values to the present. Money today is worth more than money tomorrow, if only because when we are paid money that is owed us some time in the future, we could invest that sum temporarily and make a gain until the agreed date. In the same way, a loss or harm expected months or years hence must be translated into today's value by discounting it at a given rate of interest, normally the rate applied commercially to investment plans. The smaller the discount rate the higher the present value of the future sum. Nicolas Stern, in his warnings about climate change, uses an especially low discount which makes the catastrophe loom larger to the present generation (a zero rate of discount would make the present value of a future event infinite). Applying a different and lower discount rate to climate events would mean that we are hopelessly myopic—a tall assumption to make.

3. Overlooking opportunity costs

The proposal that the present generation should finance climate change of future generations conceivably much richer than us seems a strange idea. True, we may leave those generations a problem for which they are not responsible; but, if we listen to the climate catastrophists and change our productive structure to zero growth so as not to pass on the consequences of global warming, those future generations may find that they inherit a stationary economy, which they may not like. In other words, we must make sure that the benefit to future generations does not turn out to be smaller than the cost of climate policies to the present.

4. Taking climate knowledge as given

Prior (2008) presents a long list of known unknowns that officials think they know, such as:

• the precise relationship between greenhouse gases and local and global climatic conditions; • the possible impact of solar and volcanic activity; • the role of the oceans • tipping points • the contribution of future technology advances • that the harm caused by today's constraints will be less than the benefit to futures generations

• how to share the costs of mitigation among sectors and among nations.473

The first step in the right direction is to know what we don't know. And my considered view is that we still know too little about the natural sources of global warming, despite the efforts of the IPCC to present it all as settled.474

5. Unwittingly freezing technological progress

The last two consequences of climate change fears are the crucial ones. One is that climate models seem to assume that humanity will be living with today's technology far into the future, or that technological progress has come to a virtual halt. From what we are witnessing at this very moment anti-capitalists fear rather than welcome theoretical and applied advances in knowledge. An indication of how technology can help us with the climate problem is the fact that in the United States (today blamed for much of what is wrong in the world) the use of energy per unit of product is falling markedly. Economic progress spontaneously makes for a fall in energy use per unit of GDP, among other reasons because of the increase in the importance of services in the national product. As the U.S. energy Information Administration notes:

U.S. energy expenditures declined for the fifth consecutive year, reaching $1.0 trillion in 2016, a 9% decrease in real terms from 2015. Adjusted for inflation, total energy expenditures in 2016 were the lowest since 2003. Expressed as a percent of gross domestic product (GDP), total energy expenditures were 5.6% in 2016, the lowest since at least 1970. (Monthly Energy Review; Nov. 2019.)

This is evidence that the GDP of advanced nations is becoming less material and resource bound. Paul Romer (the 2018 Nobelist, with Nordhaus) introduced the concept of endogenous growth, that growth is principally brought by new ideas formulated and applied within the production process—not by resource exploitation. And ideas are non-rivalrous, which means that the more people use them, the more productive they become.475 Rather than stopping the economic growth we should let science and technology rip. 476

473 The 2008 IEA study on Climate Change Policy carries an interesting "Foreword" by Bruno Prior, a director of Summerleaze Ltd., formerly a gravel company, now adapted to waste management and renewable energy. 474 David Henderson (2008) has given a detailed description of some of the malfunctions of the IPCC. One should also see the more favourable view of the IPCC by Dr. Zillman in his review of Dr. Kininmonth's book: Climate Change: A Natural Hazard?. [PHP file]. 475 See Jones (2019). 476 The U.S. Government agencies calculate a yearly figure called the "Social Cost of Carbon" (SCC), "an estimate of the impact of climate change on consumption—the value of goods, services, and even environmental amenities climate change forces society to forgo enjoying". If a measure such as a carbon tax of $40 per metric ton of CO_2 is applied avoiding the emission of that given amount of greenhouse gas, so

much will consumption be increased in the future: the tax today will equal the future marginal betterment of consumption. But, says Broughel, the cost borne with the tax does not include the effect of such a regulation on investment and technical progress. It should do so. Broughel (2019).

An instance of the attitude of climate change alarmists towards scientific and technological advances is the widespread policy to do away with nuclear production of electricity. The contribution of these processes to CO_2 emissions is very low, apart from the greenhouse gases emitted in the construction and maintenance of the equipment and the production of the fuel. The safe storage of nuclear waste is a 'not-in-my-backyard' problem and could be solved at an infinitesimal cost compared with other climate change policies. As was said at the 2020 Mont Pelerin Society meeting at the Hoover Institution, climate change positions are not respectable if they do not include the defence of a sizeable increase in nuclear power for electricity. Further, the possibility of electricity production by nuclear fusion could turn out to be a much more promising procedure than is usually allowed.

6. Sacrificing personal and political freedom

I have left for the end the greatest cost of these climate policies: the loss of large swathes of our personal and political freedoms. After the Berlin Wall was pulled down in 1989, it seemed that a new era of freedom had dawned on the world: capitalism and democracy had scored a great bloodless victory; socialism and central planning were on the defensive. Climate policies are a rebirth of the totalitarian ways we thought humanity had forsaken. Unfortunately, the forces of primitive authoritarianism are coming back in force with the help of global warming.

My central thesis

Interventionists have agreed on the need for measures that will make our lives uncomfortable and reduce our liberties. The climate problem is presented as the utmost market failure of all time and the only solution, it is said, must be putting the food we eat, the size of our families, our means of travel, the way we organise our cities, how we govern ourselves, and indeed most aspects of our lives, in the hands of unelected officials and of populist politicians.

Very much to the contrary, I hold that: (1) climate catastrophe is not around the corner; (2) we know too little about the climate to predict it long term; and (3) imposing drastic solutions by political diktat will make the world less productive, less safe, less free, and less democratic.

Once we escape the fear of an imminent climatic catastrophe, we can look at the possibility that either private business initiative or social cooperation can help solve the climate problems—given time. Indeed, apportioning the use of natural resources with the help of the discovery procedure of the free market and the discipline of local cooperative agreements will, I think, work better than avoiding the ills of the climate commons by central planning.

In general, climate alarmists do not understand the role of social institutions and their emergence in the solution of negative external effects: they only think of taxes and administrative regulation. They worship A. C. Pigou and misunderstand

Ronald Coase. Societies are continuously solving the external effects of selfinterested private action. As Andrew Shotter (1981, pg. 22) has said, social institutions or norms have appeared or evolved to ease

problems of coordination, to exit prisoners' dilemmas, to preserve necessary inequalities, and to foster cooperation. 477 Institutions such as the respect of private property and its voluntary transmission or the enforcement of international contracts by merchant consulates or the use of money in place of barter, and many others, contribute to reduce possible causes of conflict and disorder.

How Ronald Coase lights our way

Climate planners act as if Coase never existed. They are arrant Pigovians. Before they speak of market failures they should read "The Problem of Social Cost" (1960) and understand it as an incitement to analyse new situations of (apparent) market failure. Rather than leading us to blanket condemnations of free exchange-based self-interest, he enjoined us not to give a verdict without observing the details of the case. The counter-intuitive Coasian framework of such analyses is applicable but has not been applied to climate change:

• Cases should be examined carefully before politically imposing a comprehensive solution. • It may be a mistake to make the originator of a nuisance pay for it; charging a tax on the originator of a nuisance is a Pigovian, not a Coasian solution and may be the wrong decision. • External effects may be optimal, given transaction costs. • Removing transaction costs through institutional change may be a better solution than intervention, regulation, or taxation.

The work of Elinor and Vincent Ostrom is very much in the Coase tradition. Though neither Coase nor Elinor Ostrom dealt with the climate question, fervent greenhouse gas believers could do worse than trying to see what a Coasian interpretation might contribute. A famous example: the work on lighthouses by Coase (1974). The 'public' character of lighthouses, due to the fact that they give a public service may be the wrong conclusion to reach. Arthur Pigou and Paul Samuelson believed that they should be subsidised or even run by the State because passing-by vessels could not be reached and charged for their services. Coase then discovered that British lighthouses were not loss-making at the time when they started to be nationalised in the early 19th century. A majority had been built, and were operated by, private enterprise. In 1834 a State institution started to purchase them for a considerable price, which meant that they were profitable. However, critics of Coase have underlined that payment for lighthouse services were collected by port officials when ships berthed at the nearby port; and that therefore, Coase's was not a free-market solution. But this is not understanding that publicness is a continuum and that goods should be separated into two categories, private and public. There is nothing wrong with the authorities helping

477 Apart from Andrew Schotter (1981) one should read Ullman-Margalit, Edna (1977, 2015): The Emergence of Norms. Oxford.

enforce the rules discovered by the private suppliers and users of a semi-public good. This is exactly what the Ostroms maintained.

Markets and polycentric solutions v. central planning

In March 2012, Elinor Ostrom gave the 21st Hayek Memorial Lecture at the Institute of Economic Affairs. This was shortly before her death and that of her husband and long-term collaborator Vincent. The title of her lecture was "The Future of the Commons—Beyond Market Failure and Government Regulation". The point of the lecture was that the free market worked well for goods, services, and resources that could be appropriated privately by individuals or firms; but that in the case of common pool resources in danger of over-harvesting, as is the case of the atmosphere, the best solution was not to move over to management by government. The community itself, by trial and error, could often define rules for use, access, monitoring, exclusion, and enforcement (Ostrom, 2004, table 2), and so avoid the depletion of the common resource (Booth, 2012). It was important that centres of power be dispersed, especially when, as we saw with private British lighthouses, government played a role in helping to enforce rules. Avoiding the centralisation of power and decisions of experts from above, and relying as far as possible on community arrangements are of the essence of their method.

Elinor Ostrom herself specialised in cases of common waters, fishing grounds, and forests. She said at the IEA (2012) that she had not looked at questions of climate change, but found the thought intriguing. This task remains for us to do. I would say that, leaving aside the mad rush to govern the Earth's climate as a whole, much useful work is waiting to be done on regional climates and local extreme weather problems, whether man-made or natural. The way London smog was got rid of in the 1960s could be relevant for New Delhi or Peking, duly preceded by rearrangement of municipal power; ditto for California bush-fires. In the case of Australia, it is well known that aborigines had developed a traditional system of controlled burning to reduce the amount of dry tinder in the form of eucalyptus bark on the ground. Room must be left for the spontaneous emergence or reform of institutions to tackle common pool problems.

Starting to apply polycentric solutions

Jagers et al. (2019) are especially interesting because the authors start from the majority point of view that the climate problem is principally man-made. The paper presented by this group defines a problem of collective action as "a situation in which actors are motivated to take a course of action that is more beneficial than costly to them individually but is more costly than beneficial to society".478 According to these authors, the methods used by Ostrom in local collective

478 By the way, this definition of Jagers et al. is preceded by the assertion that, according to Elinor Ostrom (1997), "Problems of collective action permeate societies on all levels, from the very local to the global, and they cross both political borders and generations". She is less holistic, for in fact she says that her reflections concern "the study of social dilemmas and collective action", not the whole conspectus of social action. If we were so permeated it would be a miracle human society should have at all survived across the centuries.

problems are difficult to apply to large-scale failures of collective action. Spontaneous solutions are more difficult the larger the number and the heterogeneity of the people involved; the greater the spatial or temporal distance between action and result; and the amount of uncertainty of the process: all these obstacles stand in the way of spontaneous solutions of the climate problem, to which must be added the strength of the resistance of opponents or 'stressors'. In their view, the case of ozone layer depletion illustrates some of the conditions for a successful collective solution. They say that Montreal protocol was successful in reversing ozone depletion because the problem was easily communicated, there was a large

scientific, and there were reasonable substitutes for CMF aerosols. But they discount the possibility of a spontaneous correction of the ozone hole because of unnaturally warm air in the stratosphere over the Antarctic. All this is very interesting and deserves study. In my view, they underestimate our capacity to sidestep common property problems. After all, human society is still prospering and progressing, despite the warnings of ever-present doomsayers.

In general, climate alarmists do not understand the role of social institutions in the solution of negative external effects: they only understand taxes and administrative regulation. They worship Pigou and misunderstand Coase. Andrew Shotter (1981) explains that "social institutions are entropy-minimizing devices" (page 18).479 Human beings "are capable of developing trust, creating rules of the thumb, and [evolving] social institutions". Social institutions or norms emerge to solve problems of coordination, to exit prisoners' dilemmas, to preserve necessary inequalities, and to foster cooperation (page 22). Societies are continuously solving the external effects of self-interested private action. Given time, I say again, what was discovered to reduce possible causes of conflict and discord or the enforcement of international contracts by merchant consulates, or the use of money in place of barter, could happen again in the question of the climate.

Conclusions

My warnings:

• Humans have had an effect on the climate, but the climate also seems to be governed by natural forces, whose consequences we must learn to mitigate. • Cries that the climate is near a catastrophic tipping point are a marketing device to force humanity into hurried political decisions. • The premium proposed to insure against the climate catastrophe (in the form of either regulations or taxes) may be larger than the future pay-out. Predicting the climate is risky:

• Foretelling the evolution of the atmosphere demands taking account of dry land and ocean data. Vertical analyses of the atmosphere should include those of compensating horizontal currents of the seas and winds. • The rate at which we discount the future is critical. A very low rate of discount makes future doubtful events appear to be immediate and certain.

479 Apart from Andrew Shotter (1981) one should read Ullman-Margalit, Edna (1977, 2015): The Emergence of Norms. Oxford.

• The GDP of advanced nations is becoming less material and resource bound. This explains why energy expenditures in the United States and other advanced nations have been falling at least since 1970. • Central planners wrongly take much of climate knowledge as given. We still know too little! • The possibility of technical progress, as in nuclear fusion, scarcely enters the calculations of climate alarmists. Few seem to note the grave dangers to which climate alarmism is exposing our personal and political freedoms.

• Also, imposing climate mitigation policies on developing nations hinders the reduction of world poverty. The 'tragedy of the commons', whereby collectively owned resources are overexploited, is not inevitable.

• Applying the precautionary principle assumes that self-correcting forces in human society are very weak. • Malthusian prophecies assume zero technological progress. • Given time, market and cooperative solutions to avoid a climate tragedy of the commons could be tried and tested. ◦ Climate planners act as if Ronald Coase had never existed, when declaring that global warming is the greatest market failure of all time. ◦ The polycentric solutions proposed by Nobelist Elinor Ostrom for failures in common pool markets such as

irrigation water, fishing grounds, and forests, should be seriously studied for tackling global warming and climate change.