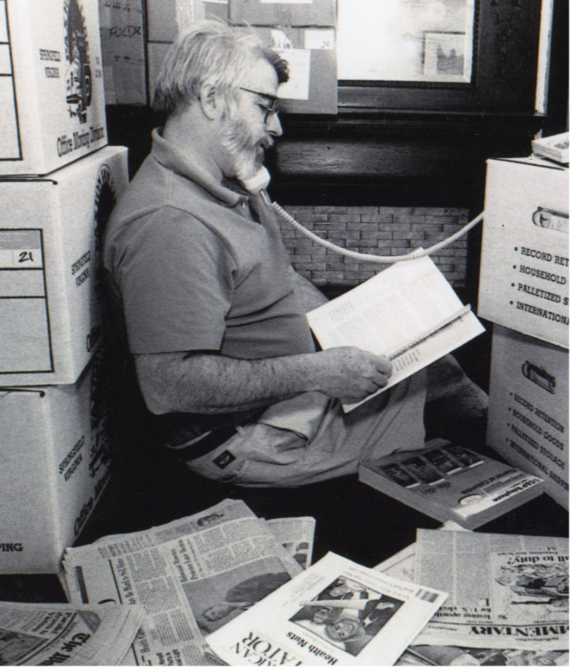

COMPETITIVE ENTERPRISE INSTITUTE

LABOR OF LOVE

A Fred Smith Story

EDITED BY KENT LASSMAN, AMANDA FRANCE, AND IVAN OSORIO

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Competitive Enterprise Institute

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INTRODUCTION

Everyone has a Fred Smith story. Often there is a telling detail coupled to an adjective that is both complimentary and ambiguous enough to draw the listener in for more. Charismatic. Brilliant. Peripatetic. Fun. Entrepreneurial. Charming. Generous. Willful. There are the stories about searches for ice cream sandwiches and Oreo cookies. Travel to foreign capitals. Mentoring. Partnerships with unexpected allies. And, of course, the time he hung up the phone on a cabinet official.

He has been variably called maddening, crazy, unrealistic, idealistic. He believes in institutions and an unbounded capacity for mankind to improve, but not to perfect, life and our relationships. Above all, he is a friend, even if you haven't met him yet.

What you hold in your hands is a labor of love. It is an apt term, labor of love. In three short words, it summarizes Fred's approach, his contagious passion, to a fruitful career.

This volume is a window into the various contributions he has made to the heady realm of ideas. Created to celebrate his 80th birthday, it is also the result of suggestions from friends, former colleagues, and admirers on how to distill the ideas that are most closely associated with Fred's successes in public life. His work would have been so much less if not for the deep relationships created along the way. In its way, it is Fred Smith's story.

Fred Lee Smith, Jr. was born December 26, 1940, in Alabama and raised in rural Slidell, Louisiana. There, on the northeastern shore of Lake Pontchartrain in St. Tammany Parish, Fred's curiosity first took flight. The eldest of five children, he is a product of the bayous, where faith and family are the anchors of place. Today the popular conception of the World War II-era South brings to mind rigid antebellum class structures and nostalgia for rural life that is not typically shared by people who actually lived in a pre-industrial, rural community. But that is not the cultural mindscape of Fred Smith.

He imbibed a deeply egalitarian ethic—you are no better than me and I'm certainly no better than you. New Orleans, home of his alma mater Tulane, was a cosmopolitan melting pot where things were made, traded, loaded, shipped, and exchanged. Music literally rang out in the streets and food holds a near-religious status. Fred met his future wife, Frances Bivona, at a dance. The pair became partners, entering dance competitions for years, and are inseparable to this day. This was the milieu—convivial, energetic, and optimistic—that imprinted on his personality.

Upon moving away from Louisiana, Fred recalls, "For many years, I had no decided political views. Indeed, since I wasn't a southern racist, I thought I must be a liberal." It wasn't until the creation of the Environmental Protection Agency (EPA), where Fred soon joined and became an expert on recycling, waste reduction, and pollution taxes, that he saw firsthand the costs of government failure, a central tenet of the emerging study of public choice economics. From there he launched the career that produced the Competitive Enterprise Institute (CEI) in 1984 and the selections of this volume.

During the 1970s, he worked at the EPA and the Association of American Railroads. Regulatory economics became as much a calling card as his enthusiasm for finding, assimilating, and sharing ideas. Fred spoke quickly, thought more quickly, and engaged debate like an electric charge was forever running through his body—noticeable from the ever-present twinkle in his eye when he found an audience.

The first of 11 selections, "The Morality and Virtues of Capitalism and the Firm," is part of a series of papers from CEI's Center for Advancing Capitalism. The center is a project Fred established for his "third act," for the work he wanted to do after passing on the formal leadership of the organization he had founded, built, and nurtured for three decades.

It is the only piece in this volume written while we were colleagues. He would do his thinking through conversation—in the hallway, working the phones, over lunch. Through numerous conversations and the editing process—which effectively left as much on the cutting room floor as it included—I watched Fred wrestle and clarify until he both understood the material and could communicate it clearly. The result is telling for how it places capitalism in context of both cultural features, like morality, and institutions like the modern firm.

The essay features mainstays of his thought, such as Leonard Read's *I, Pencil* as a substitute for Hayek's lessons on coordination and knowledge creation, Ronald Coase on the firm, Mary Douglas and Aaron Wildavsky on risk and communication models, Deirdre McCloskey on virtues, and, of course, the fount of enlightenment for both moral and economic insight, Adam Smith. It may be the one, best place to start to understand the worldview and values of Fred Smith.

His writing is not homogeneous. The representative pieces here are long as well as short, written for newsletters and academic publications, and presented to popular audiences through magazines as well as to policy makers as expert testimony. If there is one through line, it is the emphasis on both the importance and the techniques of effective communication about ideas. The next three selections, "Are Corporations Suicidal," "The Value of Communicating to Joe and Joan Citizen," and "Countering the Assault on Capitalism," illustrate this focus.

Through the years, Fred wrote scores of op-eds and essays to inform and persuade. In "The Progressive Era's Derailment of Classical Liberal Evolution," he explains the history of a set of ideas but more importantly, the implications. In policy discussions, one must consider the tradeoffs, including the difficult-to-see or hard-to-measure effects.

Writing about progressives' penchant to create a "vast array of 'promotional' agencies—the Army Corps of Engineers, the Bureau of Land Management, the Rural Electrification Administration, the U.S. Forest Service—to dam rivers, build canals, manage timberlands, and string powerlines," he takes the critical next step beyond description, explanation. Fred notes, "The pro-economic-growth biases of these institutions (undoubtedly the popular view at the time) led them to neglect environmental values." And thus, economic growth became associated with low levels of environmental protection. Echoing the essence of free-market environmentalism, the essay makes a clarion call for a reinstitution of private property rights in environmental outcomes.

The next selection, "Sustainable Development—A Free-Market Perspective," is a more fulsome treatment of free-market environmentalism. Along with defense of the institutions of capitalism and values-based communication, developing an alternative to failing command-and-control environmental regulation was a hallmark of Fred's career. His vision relies on property rights and market processes to enlist individuals everywhere in the fight to protect fragile ecological systems and species. Why rely on failing, resource-constrained political systems when an alternative that features individuals who could bring knowledge, resources, and self-interest to bear has a proven record of success?

"Autonomy," written for *Reason* Magazine in 1990, celebrates individual liberty as much as it does mobility and the democratization of technology. A quick read, it is brimming with data on consumer habits, productivity, and manufacturing that are seamlessly married to anecdotes drawn from literature and history.

The next three selections—an excerpt from a book chapter, a study published in *Regulation*, and remarks to Congress—tackle risk, the nature of competition, and in a tightly argued statement, the risks created by inevitable government failures. In each case, an intellectual framework is presented, evidence is marshaled, and the conclusions are drawn clearly. Here we find Fred arguing against a naïve vision of safety, for institutions to deal with risk, and against the existence of antitrust laws that are routinely heralded as a means of consumer protection. With prescience, he warns lawmakers about a financial crisis before it unfolded from the moral hazard created by government interventions in the housing market.

The final selection is more illustrative of the joy and humor that Fred brought to his work and infused throughout CEI. More than anything, his enthusiasm is the most illustrative element of his legacy. In this essay, for *Forbes*, no less, he seeks to vindicate Charles Dickens's unsympathetic capitalist, Ebenezer Scrooge. Ever mindful that wealth cannot be shared until it is created and that ultimately a dynamic society is a healthy society, what we think we know about a classic story is reinterpreted with humor and a healthy dose of economic thinking.

If there is a Holy Trinity in the gospels of Fred Smith, it may be the overlapping ideas of the moral dignity found in individual worth, the acknowledgement of powerful disruptions in life due to forces beyond individuals' control, and the importance of clear, economic thinking about the reality of the world around us. Indeed, audiences familiar with Fred know to expect references to Adam Smith, Joseph Schumpeter, and Ronald Coase with regularity. Just as they know to expect a fresh perspective rooted in empiricism and presented with persuasion in mind. Invariably, his model for persuasion relies equally on the insights of political scientist Aaron Wildavsky and delivering a steady flow of ideas that hit you like a blast from a firehose.

Values-based communication is a talent. It is something to practice and treasure, like a gift from a dear friend. In Adam Smith's most important work he observes:

> Though our effectual good offices can very seldom be extended to any wider society than that of our own country, our good will is circumscribed by no boundary, but may embrace the immensity of the universe.

Smith. Extending to society. Goodwill. The immensity of the universe. These things fit together.

They are like the elements of every good story we know.

Kent Lassman
Alexandria, Virginia
December 26, 2020

THE MORALITY AND VIRTUES OF CAPITALISM AND THE FIRM: DEFENDING CAPITALISM IN THEORY AND PRACTICE

Perhaps the best summary statement on the morality of capitalism was issued by Milton Friedman. Focused on the voluntary nature of market exchanges that comprise it, he noted that capitalism is both "more favorable to the development on the one hand of a higher moral climate of responsibility and on the other to greater achievements in every realm of human activity." What exactly did he mean by that? In a famous *New York Times* column, Friedman provided part of the answer. Responding to demands that corporations pursue social goals outside their central profit-making mission, he noted:

> In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.[1]

Friedman's criteria that the firm should "make as much money as possible" has been criticized frequently by critics who believe the firm should address a whole array of social concerns. But such criticisms miss the point. The economic genius of the market is that it enables a wide array of individuals, groupings, and associations to organize spontaneously and unconsciously to advance their various interests in a cooperative fashion that yields win-win arrangements for all involved.

As Friedman further clarified, the corporation, in order to thrive, must seek cooperation from all its economic partners—customers, employees, suppliers, investors, and the community:

> [I]t may well be in the long run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects.[2]

As a result, corporate managers' pursuit of sustainable profits helps to address many concerns of market critics without a conscious direction.

This essay analyzes how the search for *sustainable profits* encourages corporate managers to address a wide array of social concerns. Capitalism, we argue, is virtuous and the corporation, its most significant embodiment, hones and enhances those virtues within itself and with its economic partners, including employees, suppliers, investors, and customers.

A moral defense of capitalism needs to illustrate how capitalism not only makes people wealthier, but also advances other important values and concerns, such as fairness and justice. In fact, the failure to argue that case has left capitalism, and the firms operating within that system, vulnerable to popular and political attack by anti-market critics, demagogic office-seekers, and overzealous regulators.

Many businessmen may well articulate the quality of their products and services, as well as their record of cooperative relationships with employees, suppliers, and customers. However, they may not articulate quite so well the voluntary, self-organizing nature of the market that allows their businesses to thrive in the first place, or how the evolved human traits of self-interest and empathy are both virtuous and integral to their operations. The ability to communicate those achievements and values effectively is necessary to operate in a government-regulated environment, and to respond to attacks by critics, including hostile politicians and regulators. This essay aims to provide some important guideposts toward that goal.

Free markets address a far greater array of values and concerns than is generally recognized.

Free markets address a far greater array of values and concerns than is generally recognized. Business success depends on enlightened self-interest, but relies heavily on empathy—enlightened regard for the interests of others. Business leaders need to better understand these underlying foundational values in order to more effectively defend their profession as one that is both honorable and ethical.

However, not all businessmen are capitalists. Some engage in cronyism, seeking shortcuts to "success" in the form of subsidies or regulations that hobble their competitors. Those individuals are not capitalists engaging in legitimate business and creating wealth, but simply exploiting others for their benefit. This essay is not addressed to them. Rather, it is aimed at those business leaders who have sought and earned their success rather than having it politically granted to them, who are justifiably proud, and who recognize the value of trust and fair dealing with all their economic partners. The goal is to help them better communicate those values and achievements to the wider world in a way that helps gain public legitimacy for their firm and the free market more widely.

Policy analysts rarely talk about virtue and morality, leaving those esoteric topics to the clergy and moral philosophers. But the greatest policy analyst of all, Adam Smith, thought in both economic and moral terms and saw them as intertwined. The Balkanization of the intellectual community has driven those two elements apart. This essay seeks to reunite them and illustrate how the firm, the practical embodiment of capitalism, can act as an effective tool for advancing both. Firms can include dozens, hundreds, thousands, or even tens of thousands of workers and cooperative external networks of customers and suppliers. The search for mutually advantageous relationships with all these groups drives business leaders to sharpen their empathetic sense, to hone their virtues, and achieve the virtuous goals demanded by capitalism's critics.

In short, business leaders need to defend the institutions and values essential to their existence to counter the steady politicization of the market. Running a business in a politicized economy is not easy. It is up to capitalists to defend the morality of their own businesses and of capitalism itself, if free markets are to continue to thrive.

The Great Enrichment Needs Defending

That capitalism needs a defense when it seems the dominant force in the global economy may seem strange. Most observers across the political spectrum acknowledge the wealth-creating power of markets. But capitalism in its current form is a relatively recent innovation, and many innovations fail. The Industrial Revolution is generally dated around 1750. Prior to the Industrial Revolution, generation followed generation with little improvement in their standard of living. Change occurred around the mid-18th century, when increased productivity and better communications drove innovation, empowering entrepreneurial individuals to create wealth at a faster rate than population growth. Malthus was proved wrong.

Capitalism transformed the occasional upward blips into the sustained growth and improved living standards of the last two-plus centuries. And, as commerce expanded, mankind obtained a more peaceful and non-coercive path to satisfy the human desire to act, to achieve. Self-interest was harnessed to achieve a public good.

Capitalism transformed the occasional upward blips into the sustained growth and improved living standards of the last two-plus centuries.

The economist Deirdre McCloskey refers to this result as "The Great Enrichment"—an almost 30-fold increase in the per capita standard of living over this period.[3] During the early part of the Great Enrichment, the public recognized the value of that vast improvement in living standards. As a result, capitalism enjoyed widespread popular approval. However, as the greater wealth made possible by capitalism spread throughout society, a middle class emerged, and with it an increasingly powerful class of intellectuals hostile to commerce and capitalism.

The economist Joseph Schumpeter anticipated the problems such hostility would create. As he explained, intellectuals—those who craft the narratives that define a society's cultural views—would oppose the free market, in part, from envy, summed in the reaction, "If

When business leaders lose confidence in themselves, others lose confidence in them as well.

we're so smart, why are they so rich?" He also noted that their opposition would be reinforced by their self-interest, since a politicized economy would offer far more powerful and well-paid advisory jobs, positions granting intellectuals the opportunity to direct society rather than serve consumer interests.[4] Ignorance also was an explanatory factor. Intellectuals rarely work in business, and thus have little experience to temper their hostility. Karl Marx never visited a factory, and yet, condemned capitalism's satanic mills at length.

As anti-market intellectuals came into prominence in the mid to late 19th century, they rapidly gained control of the institutions that allow ideas to reach the public—the media, the academy, and the popular culture. As a result, business, even within business schools, came to be viewed as, at best, an amoral activity, useful but based on "greed" rather than any moral precept. Religious elites often echo that view. This increasingly negative portrayal of business leaders, Schumpeter argued, would lead even many in business to doubt their moral role:

> [Business] absorbs the slogans of current radicalism and seems quite willing to undergo a process of conversion to a creed hostile to its very existence. Haltingly and grudgingly it concedes in part the implications of that creed. This would be most astonishing and indeed hard to explain were it not for the fact that the typical bourgeois is rapidly losing faith in his own creed.[5]

And when business leaders lose confidence in themselves, others lose confidence in them as well. As Schumpeter noted, relentless cultural attack would wear down businessmen's confidence in their moral role and reduce their ability to respond to attack. Yet, he also believed that an effective defense was possible for those courageous enough to pursue it:

> They talk and plead—or hire people to do it for them; they snatch at every chance of compromise; they are ever ready to give in; they never put up a fight under the flag of their own ideals and interests. …
>
> Means of defense were not entirely lacking and history is full of small groups who, believing in their cause, were resolved to stand by their guns. The only explanation for the meekness we observe is that the bourgeois order no longer makes any sense to the bourgeoisie itself and that, when all is said and nothing is done, it does not really care.[6]

Business leaders need to push back against such "meekness" if capitalism is to gain the legitimacy its achievements merit. Business leaders must assert the pride, confidence, and knowledge needed to stand proud and resist political encroachments. The economic value of markets as the best way to advance prosperity has long been recognized by many. The challenge now is to illustrate how capitalism and businesses also advance a virtuous moral society.

The next section details how the primary institution of capitalism, the corporation, hones and enhances these moral principles in its operations. The final section provides some suggestions of how business leaders might incorporate these ideas into their management strategies. These insights should make it easier for business leaders to defend their role in society, to better express their pride. It should also allow them to more effectively respond to the criticisms of their associates, those in the media or the academy, their non-business friends, and even their family members. It is my hope that it will encourage business leaders to apply the same entrepreneurial skills they deploy in the private sphere to reach out to pro-market intellectual allies, and make investments for economic liberalization in the political sphere.

The Morality and Virtue of Capitalism

Capitalism is best defined as an extensive system of voluntary exchange within an institutional and cultural framework. It is based on the evolved institutions of private property, right to contract, and limited government that are prerequisites to liberty. It also relies on a cultural awareness that voluntary arrangements create wealth and knowledge and that commerce is a dignified pursuit. When society began to speak more favorably about commerce—when the "merchant" role became an honorable profession—capitalism took off swiftly. Those rhetorical changes weakened the cultural barriers against wealth creation, allowing merchants to converse with wealthy lords in search of mutual economic advantage.[7]

The value foundations for capitalism were outlined by Adam Smith in his two famous books, *An Inquiry into the Nature and Causes of the Wealth of Nations*, which developed the role of enlightened self-interest, and *The Theory of Moral Sentiments*, which developed the comparable role of empathy. Markets integrate these two evolutionary traits, recognizing that individuals are both self-regarding and other-regarding.

Key to understanding capitalism is an understanding of how markets integrate these two basic human traits. Self-interest is essential. Absent that drive, how would humanity have survived or evolved? The genius of Adam Smith was to show how markets channel self-interest into wealth creation, as articulated in his famous remark: "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."[8]

Voluntary market exchanges benefit all parties and result in the vast array of linked cooperative activities that comprise the market. Leonard Read's classic essay, *I, Pencil*, makes that point very effectively. In that essay, Read notes that no one can make a pencil, yet pencils are ubiquitous. The pencil manufacturer must rely on a different party for every element of the pencil—wood producers for the body of the pencil, graphite producers for the lead, still others to provide the metal band and the eraser.

Voluntary market exchanges benefit all parties and result in the vast array of linked cooperative activities that comprise the market.

Many of those people have no interest in pencils but they cooperate with the pencil producer to make pencils possible. As Read noted, that complex interplay of economic activities occurs because each link in the process is voluntary and mutually advantageous. Each link brings together one party in need of a specific item, the other with the ability to supply it. No one plans those interactions. They happen, as Smith noted, "as if guided by an invisible hand" of mutual self-interest.[9]

Adam Smith did not view self-interest as indicating that individuals would focus only on material gains, but as the drive that encourages us to pursue those things that motivate us. Individuals have many interests—achievement, recognition, a love of beauty—and any of these may encourage us to exchange with others. Entrepreneurs often seek to create something innovative and aesthetically pleasing—the iPhone being a case in point. Few business successes are driven by monetary gain alone.

In his other famous book, *The Theory of Moral Sentiments*, Smith argued that mankind also possessed another evolved trait: "sympathy," "fellow feeling," or "other-regarding." Empathy is the more contemporary word for this trait which allows an individual to grasp the pain and joys of others. Just as self-interest was necessary for individuals to survive, empathy was necessary for man to flourish as a social animal. Absent self-interest, how would humanity ever have evolved? Absent an ability to understand the goals and needs of others, how would society—even the family—ever have been possible?

In this regard Smith's views differed with those of Bernard Mandeville, who, in his work, *The Fable of the Bees or Private Vices, Publick Benefits*, argued that the vice of selfishness could prove societally valuable.

Mandeville had argued that private vices—selfishness—could yield public goods in the form of a productive economy. Yet, selfishness is not the characteristic most likely to promote the trusting, friendly, relationships that make business sustainable.[10]

Business is a social activity. Smith saw "empathy"—also known as "sympathy" or "fellow feeling"—as the trait that softens self-interest, ensuring that exchanges were mutually advantageous. Empathy complements self-interest, allowing us to put ourselves in the mind of the other, a trait critical to successful business negotiations—and to society itself. Businessmen who treat business exchanges as zero-sum games are unlikely to find many willing business partners. Humans are social animals, reflecting our ability to empathize with others. A good entrepreneur relates well to her business partners because she has both the skills and the incentive to better understand their goals, motivations, and interests.

Market exchanges bring the self-regarding and other-regarding qualities into balance, aligning private gains with public benefits. The result is a wide array of voluntary arrangements that enable individuals to achieve material success in a way consistent with their own values—and that is more natural and effective than such alternative economic organizations as feudalism, paternalism, and central planning. Smith's synthesis transforms Mandeville's "private vices, public goods" caricature into the more realistic "private virtues, public goods" reality. Self-interest alone might enable markets to emerge, but those markets are enriched by the "other-regarding" traits, which make it easier to share ideas and ideals. Self-interest encourages people to seek out others, but empathy strengthens the social skills that make those encounters mutually beneficial. The synthesis of the self and the other-regarding traits gives us both the incentives and the skills to "make friends of strangers."

Self-interest encourages people to seek out others, but empathy strengthens the social skills that make those encounters mutually beneficial.

As commerce reduced transaction costs, it enabled economic exchanges that also facilitated cultural and social contacts. Craftsmen

Capitalism has enabled billions of people to lift themselves out of poverty.

dialogued with engineers, which made society's dispersed and localized knowledge more widely accessible to more people. Those interactions of people and information allowed, in Matt Ridley's colorful phrase, *for ideas to have sex*. As Ridley notes, the fact that once commerce gained moral standing and legitimacy, the barriers between exchanging ideas declined sharply. Craftsmen and engineers, business leaders and academics could enter into conversation and exchange ideas. The localized knowledge that had been blocked by class barriers and the disdain of commerce flowed together, engendering new ideas, new innovations.[11] The resulting combinations led to ever more exchanges and exponential growth. The Great Enrichment resulted.

Institutions of Liberty

Capitalism is a revolutionary and disruptive force that put an end to the essentially static economy under which mankind lived for millennia. It has enabled billions of people to lift themselves out of poverty.[12] It has empowered people to innovate, to address scarcity and obsolescence by discovering new resources and developing new technologies. And as more people throughout the world engage in cooperative economic ventures, commercial interactions encourage greater tolerance and trust.[13] As family income increased, children could go to school, as survival no longer required that all family members toil as unpaid laborers in the field.

However, markets do not exist in a vacuum. Self-interest and empathy require both a culture and a set of rules and the institutions that make repetitive voluntary exchanges possible. These elements, which evolved over man's history, include private property, enforceable voluntary contracts, and a culture that respects and understands markets' wealth-creating role. Moreover, since capitalism is dynamic, these institutions must constantly co-evolve with shifts in tastes and technology.

Private property has long been recognized as an essential element of a free society. Markets create the information needed to guide market decisions. That information incentivizes firms to move resources to areas where society would most benefit. Attempts to replicate markets in the absence of property rights have consistently failed. If resources are not owned, the exchanges that convey the value of these resources, which managers need to make operating and investment decisions, will not occur.

Contracts allow individuals to determine the conditions of an exchange and often involve mutual risk-sharing strategies, which is especially valuable when the exchange is novel. Since all exchanges entail some degree of risk—such as a manufacturer's failure to transfer the product or to meet the agreed upon product quality standard—binding agreements are often essential if the exchange is to occur.

Cultural attitudes are clearly important. Mankind spent millennia viewing exchanges as zero-sum transactions—often a reality in subsistence tribal societies where economic growth was minimal. Yet, as people become aware that exchange creates wealth, not merely redistribute it, trust can arise, enabling equitable and self-enforcing sharing arrangements.[14] Repeat business becomes easier when one has faith and trust in the actions of one's business partners. In societies where zero-sum thinking remains dominant, trust is hard to achieve because neither party to the exchange believes that win-win possibilities exist. Therefore, trust becomes impossible and there can be no fair exchange.

How Capitalism Advances other Values

Once capitalism has succeeded in granting many a material level of affluence, other values gain in relative importance. Most critics nowadays concede that capitalism delivers the goods, but argue that business has neglected other values—civil and individual freedom, community stability, equality, diversity, poverty alleviation, environmental protection, and other concerns. Business leaders need to find ways to respond to these criticisms, by demonstrating how markets advance these other dimensions of the "good society."

Once capitalism has succeeded in granting many a material level of affluence, other values gain in relative importance.

Capitalism encourages respect and protection of a number of values and virtuous traits. As Deirdre McCloskey, whose work focuses on clarifying the virtues of a business-focused society, has noted, modern capitalism recognizes and incorporates the virtues of earlier social orders—such as early Christianity and feudalism—and guides them into the peaceful world of commerce. The result is an economy that advances both the classic virtues of prudence, temperance, courage, and justice, along with the Christian virtues of faith, hope, and charity. Commerce—"sweet" commerce, in McCloskey's term—encourages honesty, reliability, and creativity, which are all critical for a virtuous society. Moreover, those traits within the business world are likely to carry over into other social spheres, making society as a whole more virtuous.[15]

Capitalism's reliance on peaceful exchange encourages tolerance, making it less likely that value differences will flare into conflict. That value is reinforced by the vast array of competing organizations in a capitalist society, a factor mentioned by Voltaire, one of the world's first economic liberals. In *Letters on England*, he noted that competition, with its diversity and multiplicity of goods and choices, encourages tolerance in areas outside of business. He noted that Spain, which allowed only one religion, launched the Inquisition. In France, where two were tolerated, there was civil war. In England, with its multiplicity of religions, doctrinal disputes became akin to the struggles of rivals on the stage, where once the curtain was drawn, the erstwhile opponents adjourn to a tavern.[16]

Capitalism's reliance on peaceful exchange encourages tolerance, making it less likely that value differences will flare into conflict.

In a market economy, people must be persuaded to accept your offer; they cannot be legally coerced. The negotiation skills developed in market transactions carry over into other parts of life, making it easier to resolve disputes in the political, religious, and other areas.

Markets also offer more peaceful career paths. Mankind, Voltaire asserted, must "act." In pre-capitalist periods, that meant joining the military or the Church. Those career paths often led to war and doctrinal conflicts. Capitalism added a new, less-conflict oriented path—

commerce. Commerce, he argued, provided careers that depended on peaceful persuasion and voluntary agreement.[17]

Capitalism also ennobles work, the activity in which we spend much of our lives. Work in previous ages was seen very differently. To the religious, it was the penance mankind had to endure because of Original Sin. To aristocrats, work was the unpleasant activity relegated to the peasants. The Calvinists and other Reformation doctrines honored work, viewing it as doing God's will on Earth. But it was capitalism and the cultural changes it made possible that truly ennobled work in and of itself as a moral and virtuous activity, making it no longer a duty, but an activity worthy of respect.

Finally, capitalism advances an important form of democracy, where industry produces what consumers want, not what elites believe they should want. Consumers, not politicians or bureaucrats, determine what merchants put on their shelves.

Thus, capitalism not only allows individuals to self-organize to produce the wealth and knowledge that make modern civilization possible, it encourages a host of virtuous trends, promoting a more moral society. But capitalism remains an abstract concept to most people. It is the firm or corporation that is targeted by anti-market critics today. For instance, some communitarian critics of capitalism argue that bringing some goods and services into the market reduces their "moral" value and threatens community cohesion. In reality, markets expand the choices available to everyone, including the poor, of vital services and goods.

The Role of the Firm

Capitalism operates in the real world through its key institution, the firm or corporation. The firm is where most businessmen—the target audience for this essay—spend a large part of their lives. Yet, less attention has been given to the morality of the firm compared to the morality of the market. Many might accept "capitalism" as a concept, but still view business as morally suspect. Thus, the moral case for capitalism must be extended to the morality of the firm.

To generations of economists, the firm was largely a black box, treated much like any other individual actor in the market. It purchased goods and services and sold its products. Mainstream economists largely ignored key questions about the firm—how the firm came to be, why it takes on some tasks but not others, how its managers decide which tasks to include within its ambit and which to purchase from others, how its internal decision processes are structured and managed.

Ronald Coase, who earned a Nobel Prize in part for his work competition, social costs, public goods, and the firm, brought needed attention to those questions. Coase quotes D.H. Robertson, who describes firms as "islands of conscious power in this ocean of unconscious co-operation like lumps of butter coagulating in a pail of buttermilk."[18] The firm is a hierarchic organization. Individuals join the firm voluntarily and accept adhering to management demands in return. The firm's reliance on such "conscious power" differs significantly from the unfettered freedom of both parties in face-to-face market transactions.

Firms are organized to provide some set of goods or services and tend to divide the necessary work for that goal into specific subtasks assigned to different workers. Smith noted that even the production of an item as simple as a pin requires numerous suppliers and involves numerous operations—cutting the pin, creating the head, sharpening the point, polishing it, placing it on a sheet—performed by numerous workers who must be directed and rewarded.

Managing the pin factory entails what Coase termed "transaction costs," costs incurred in reaching a number of agreements, including:

- Search and information costs, finding investors, suppliers, workers, and markets;
- Bargaining and negotiation costs, to gain agreement with these parties; and
- Monitoring and enforcement costs, to ensure that all the parties engaged in the activity perform per agreement.

Coase was the first to note that, if one expected to perform these tasks frequently, the transaction costs might be higher if they are performed via repeated market exchanges than within a firm, an institution organized via longer-term negotiated contracts to achieve these results over time. Firms, he noted, are institutions created to lower costs when:

- The activity requires multiple steps;
- The capital and work skills are specialized;
- The scale of these exchanges is large;
- The exchanges occur frequently; and
- The skills to produce them require training.

The firm can expect to lower many of these costs when one has worked with the same parties and equipment for some time. Coase noted that the boundaries of the firm were defined by where market transactions outperform the firm's employees at the same activity. In modern economies, those boundary lines are shifting constantly. For example, janitorial services may be bid out to specialized service companies, while computer specialty firms may be replaced by new IT departments.

Making the moral case for the corporation should not be difficult for those working in a firm—or anyone involved in business. Business leaders should be able to answer their critics by observing how their own firm operates. As *I, Pencil* effectively illustrates, every firm is primarily a cooperative venture that must consider the values and wants of everyone in its community—the customers they hope to attract and retain, the workers they seek to employ and motivate, the suppliers from whom they wish to buy, and the investors from whom they seek the funds to operate. Effective managers are aware of the extent to which knowledge is localized. The worker on the assembly line or in the office may well have knowledge that might improve the overall performance of the firm.

Making the moral case for the corporation should not be difficult for those working in a firm—or anyone involved in business.

Still, the fact that the firm's intent is to ensure sustainable profitability for its shareholders makes many people suspicious. Addressing those suspicions requires business leaders to sharpen their other-regarding or empathetic skills. They need to clarify that their goal is to have all parties to an exchange to state: *She's a good person to do business with!*

The cooperative nature of the firm means that profits—the surplus, if any, between the costs incurred in providing a product or service and the revenue earned by its sale—are allocated among the various economic partners according to which employees have contributed the most to the firm. Firms that fail to achieve such meritocratic allocations—or fail to convince key cooperators that they have done so—are likely to experience loss of workers, sales, investors, and suppliers.

The corporation has helped society move beyond tribal morality—the face-to-face instinctive moral demands that stem from the family—to the morality of civilization. There are few, if any, cultural barriers blocking the firm from seeking to make economic friends with strangers. Firms are always reaching out for new consumers, qualified workers, and interested investors.

Businesses work diligently to maintain their reputations and strengthen their cooperative arrangements. Consider the ways in which firms seek to ensure positive relations with their customers, providing warranties, take-back offers, product insurance, 800-complaint numbers, and websites designed to gain feedback on "how are we doing?" And then there are the reputation ratings of books and services and products on Amazon, Yelp, and Trip Advisor, with safeguards against self-rating and reputational sabotage. Similar management techniques are used to monitor and maintain positive relations with their employees, suppliers, and investors.

The Role of Specialization

The firm is structured to achieve a specialized set of goals—firms are not general-purpose organizations. Specialization, as Adam Smith well explained, allows management and workers to gain the skills needed to produce that good or service efficiently. The firm then develops the specialized tools, skills, practices, and corporate culture to further that result.

A firm that seeks to "do everything" will end up being effective at nothing.

Some critics argue that the fiduciary responsibility of ensuring profits for investors might lead to short-termism. Managers, it is argued, might shortchange workers or customers or suppliers to provide shareholders higher dividends. However, sacrificing one's cooperative arrangements with customers, workers, or suppliers has a significant long-term cost. The result is that most business leaders and investors seek sustainable profits, which encourages fair dealing with all of the firm's economic partners.

Just as no person knows how to make a pencil, no firm can act as a general-purpose agency, addressing all societal concerns, such as how to eliminate discrimination, address pollution, or reform education. The firm *can* address local manifestations of all these problems—and has every incentive to do so. But a firm that seeks to "do everything" will end up being effective at nothing.

The Role of Competition

Business decisions can be wrong, stupid, or even dishonest. Thus, the firm, like all human institutions, must be regulated. However, that does not mean government is the appropriate agent for that role. The bureaucratic disciplines of politics are far less likely to prove effective than are the competitive disciplines of the market. Competition forces businesses to monitor the performance of their competitors and how

Competition encourages firms toward greater cooperation with all their economic partners.

changes in government policy and their institutional environment might affect them. Competition also encourages firms toward greater cooperation with all their economic partners. Firms compete to gain the favor of customers or to attract a competitor's employees, investors, and suppliers. Such competition benefits consumers, who get the best deals possible, but also workers, suppliers, and investors who are offered more attractive opportunities.

Thus, while competition is often seen as harsh and non-cooperative, it serves an important and steady market-disciplining force. In practice, it becomes less a strategy for destroying one's competitors than a force encouraging all firms to become more attractive to customers, workers, suppliers, and investors. Competition drives the firm to be attentive— to consider how customers might gain better and more affordable products, how employees gain safer and more satisfying work, how suppliers obtain greater predictability and better terms, and investors higher and more reliable returns. Profits provide the guidance to see how well the firm is achieving these goals.

Sharp dealing with suppliers or customers does exist, but such practices are disciplined by competition, the need to preserve reputation, and the realization that such practices rarely lead to sustainable profitability. The business community contains its share of sharp dealers, frauds, and incompetents. Cronyism—the practice of politics to gain special privilege—discredits business, harming the ability of *all* firms to defend themselves. Yet, the firms that others wish to emulate are those that have acquired either a reputation for fair dealing or a creative flair for innovation. The public admires those who have earned their success, rather than gained it by political special favors or sharp dealing. Not all cronyists get caught, and not all experience public disapproval. Tesla has gained much from federal and energy tax credits, but it too has been harmed by other cronyists, mainly auto dealers in New Jersey, who have blocked the company's ability to sell its vehicles direct to consumers in that state.

The public admires those who have earned their success, rather than gained it by political special favors or sharp dealing.

Failure is an unavoidable aspect of a dynamic economy. Failures alert the surviving firms of the risks that led to that failure, encouraging them to greater prudence and temperance. Unexpected circumstances that can lead to failure—changes in tastes or public policy or mistaken business decisions—may require a firm to relocate or even lay off workers. Competition provides the incentive to take those painful but necessary steps to survive. In doing so, that firm and its economic partners can continue to provide goods and services to the public, employ some workers, buy from some suppliers, and reassure investors. Stasis is impossible in a dynamic economy. At the same time, creative destruction increases the likelihood that there will be somewhere for displaced workers to land. The opposite of innovation is not stability but stagnation.

A corporation, like the market, can gain public legitimacy only if it is seen as acting in a way that is consistent with the society's prevalent values.

Moreover, as America's economy has grown more dynamic, firms are seeking ways to anticipate and address such downturns.

Some firms now seek to find ways for their employees, including those laid off, to learn from their work experience as part of a longer career. Other firms, aware that their employees may move on if opportunities are not available, arrange opportunities for workers to take academic or work skills courses. The goal of such activities is to make employment at such firms more attractive. Capitalism cannot ensure stability, but it can ensure sustainable growth, which is the best form of stability in a dynamic world.

The Role of Values and Virtues

A corporation, like the market, can gain public legitimacy only if it is seen as acting in a way that is consistent with the society's prevalent values. In today's multicultural world, values vary. The challenge is to demonstrate how the firm's activities are consistent with—in fact, reinforce—those diverse values. In this section, we do not seek to expand on the centuries-old exploration of the question of the ethics of commerce by philosophers, religious leaders, economists, and other social scientists. Rather, we focus on the role of cultural values as heuristic devices to expedite how individuals reach their decisions regarding the ethics of business.

Cultural value theorists have developed a typology of such values. The political scientist Aaron Wildavsky and the cultural anthropologist Mary Douglas noted that a rational approach to persuasion can be effective when addressing a party directly affected by the issue being discussed.[19] However, most issues—and nearly all in public policy and politics— are affected by the phenomenon of *rational ignorance*. It is not that these issues are irrelevant to any given individual (though many may well be), but that the way such decisions are made allows most individuals little direct influence over them. In such a situation, a rational individual may express an opinion, but since she seeks to allocate her scarce time intelligently, she will adopt a position of *rational ignorance*—that is, not devote scarce time to issues over which she has little influence. As I have long said in the political and policy field: *People aren't stupid, because they're stupid. They're "stupid" because they're smart. So, if we try to make them smart, we're being stupid!*[20]

Yet, people express opinions. But since information cannot explain those opinions, whence do they emerge? Wildavsky and Douglas—more recently joined by a growing number of cultural theorists, such as Jonathan Haidt[21] and Dan Kahan[22]—argued that rational ignorance, as a sensible response to information overload, has led to the evolution of several distinct sets of cultural values through which different people process information. Douglas and Wildavsky created a classification scheme which they called Group/Grid.

Group measures the extent to which a subject sees herself as an individual vs. a member of some community. Grid addresses the extent to which a subject views independence on a range from egalitarian to hierarchic. That resulted in four cultural types: Individualists, Egalitarians, Communitarians, and Hierarchists. Other studies in this field added one more category, Fatalists, those with no group loyalty and no belief in causality. This group is rare in developed nations and politically inactive, and thus is not discussed here.

Cultural theory argues that individuals use their cultural beliefs as heuristics to decide on the myriad issues that confront average citizens. If the candidate or issue seems to threaten their belief, they oppose it; if it supports their belief, they endorse it.

Egalitarianism. Egalitarians place great weight on fairness and justice, especially for the least fortunate in society. As mankind gained mastery over the natural world, family groupings merged into tribal societies, which have a strong ethos of mutual aid for their members. Wealth creation was rare, and zero-sum thinking was dominant. Increased wealth by one party was seen as taken from someone else in the community. Thus, resources were to be shared as equally as possible. Moreover, innovations that would disrupt the established order were largely discouraged. Although achievement might be valued, the entrepreneur was expected to share the returns. Egalitarian values remain significant in most societies, although today, they are often pursued at the national level via the impersonal and bureaucratic administrative state.

Hierarchy. Hierarchical values include respect for tradition and authority. Innovators are valued but not if they are excessively disruptive.

Individuals are free to act within the constraints of culture and custom but expected to defer to the experts. Hierarchical values rose in importance as the reality of different people having different skills became widely recognized. More valued individuals gained special status and authority. The "head" of a leading family became the "head" of the tribe, and a tiered hierarchy and bureaucracy evolved. All organizations resort to some form of hierarchic structure to organize the varied skills needed to achieve the group's common goals. Capitalism and markets rely heavily on firms, which are elaborate structures for achieving efficiently varied purposes. Hierarchists respect those who have risen up through the system—in effect, paid their dues.

Individualism. Individualists are opposed to the rules of hierarchy and the wealth redistribution policies of egalitarians. Freedom is their most sought value. As recognition of the value of specific individuals in society increased, so did the recognition that many—perhaps all—people possessed creative capabilities that might prove societally useful. The realization that no one knows who is likely to prove the most effective at various societal tasks encouraged the individualistic value of "let them try." The entrepreneur is the ideal individualist and, thus, a critical force in capitalism and economic growth.

Communitarianism. This group sees civil society, especially community organizations, as the key factor in the good world. They value markets' wealth-creating capacity, but see market transactions as in need of being reined in, lest they become overly individualistic and disruptive. Communitarians, broadly, want to see individual freedom tempered by group solidarity.

The challenge for business leaders is to demonstrate how their firm's activities advance not only the self-interest of people as consumers, but also the vision of the "good society" they seek as citizens.

While seemingly wildly disparate, these cultural values are not necessarily in conflict when a specific policy is being considered. Egalitarians might admire a corporation's efforts to extend services to low-income neighborhoods. Hierarchists might admire the efficiency with which that firm operates. Individualists might appreciate innovation by a firm. Communitarians might appreciate the evolved culture of firms. In a free society, these cultural values can each thrive alongside one another.

The challenge for business leaders is to demonstrate how their firm's activities advance not only the self-interest of people as *consumers*, but also the vision of the "good society" they seek as *citizens*. By allowing each individual the freedom to pursue both of those goals, capitalism can bolster the egalitarian values of fairness and justice, the traditionalist or hierarchic values of stability and respect for custom, the communitarian focus on community and solidarity, and the individualist values of freedom and responsibility. Defenders of capitalism should view egalitarians and hierarchists as challenging audiences.

All of these values are important, but different individuals will weigh their relative importance differently—much like different customers seek different things from a product or service. To appeal to each of these various cultural value types, the corporation must demonstrate that its activities are consistent with all of their values. Since each cultural type has very different values, the firm may need to craft different strategies to communicate how it advances their different goals. *Different strokes for different folks, as it were!* Consider the following narratives seeking that outcome:

Nothing has done more to increase global equality than capitalism.

The Egalitarian Value—Fairness. Nothing has done more to increase global equality than capitalism. Firms have contributed to that process by increasingly relying on global trade, offering the neediest people in the world a ladder out of poverty. Free markets allow the poor to explore opportunities where their talents can provide them the greatest return. The resulting innovation and entrepreneurship enable creative people to explore new opportunities to offset any losses that might occur in mature and fading industries, ensuring that both better products and newer jobs are available for the future. Producers and unions may suffer setbacks, but consumers benefit. Moreover, the potential for more profits encourages firms to continually explore the possibility of reaching out to underserved regions, as Walmart did in rural and suburban America, or as many firms set up programs to find jobs that disabled individuals can fill.

The Hierarchic Value—Stability. If one views an institution as moral, then one naturally seeks to see it survive. The family, religious beliefs, and pride in locality, and ethnicity are viewed by many as moral forces. People who value these institutions seek their survival and devote resources to their defense. Business leaders and their top managers are usually proud and appreciative of their firm and seek its survival. To do so, the firm must remain aware of its internal economic condition—to seek ever improved efficiencies—and external challenges—changing consumer tastes, the quality and prices of the equivalent products

Markets strengthen civil society by providing a template on which individuals can forge social links.

offered by competitors. That competitive discipline forces the firm to continually evolve. Established firms are not immortal, but they can provide stability in a changing economy.

The Communitarian Value—Solidarity. Markets strengthen civil society by providing a template on which individuals can forge social links. At my place of work, several couples have met and married. Is my experience unusual? People are social animals and, when working cooperatively together—whether as employees or as economic partners, they rarely converse only about economic details. They learn about each other's passions and beliefs, their hobbies and pastimes, and sometimes they find mutual interests. One might join a ski club in which the other is a member; they might take a hike or have lunch together. In doing so, the economic links stemming from the economic cooperation of the market blends into the vast array of social networks.

The Individualist Value—Freedom. Consumer sovereignty in the marketplace clarifies for the individual the broader concept of liberty in other fields and tends to foster liberty elsewhere. Capitalism, by dispersing power among many competing private entities and leaving most power with individuals to make their own choices of location, resource use, employment, and purchases, acts as a significant check on the monopoly power of the state as well as established firms. Not all market economies achieve political freedom, but no political democracies exist in the absence of economic liberty.[23]

Cultural values may predispose an individual to approve or oppose capitalism, but much depends on how the issue is presented. In a world of rational ignorance, such value differences are real. Those seeking to defend the corporation should explore ways of presenting the corporation in such cultural value terms to each of these cultural types.

There are actual and potential critics and defenders of capitalism in all these cultural value categories. Some individualists view the corporation negatively, seeing it as too proscriptive and controlling, even as they admire its voluntary nature, efficiency, managerial and technical skills, and productivity. Some hierarchists may see capitalism as too destabilizing and disruptive, while appreciating its capacity to generate order out of uncoordinated action. Some egalitarians may view working and salaries as rights, while appreciating firms' job- creating and welfare-enhancing potential. And communitarians may perceive capitalism as too indifferent to community solidarity, while recognizing businesses' ability to bring people together.

The McCloskey Virtue Arguments

Deirdre McCloskey, a defender of markets, argues persuasively that capitalist morality—which she terms the "bourgeois virtues"—builds upon, and essentially integrates, the Christian virtues of faith, hope, and charity, and the aristocratic virtues of courage, justice, temperance, and prudence.[24] These values are certainly evident in the corporate world. Every entrepreneur relies on hope and faith—she has a dream and rushes courageously to achieve it. Established business leaders exercise prudence daily and, seeking stability, tend toward temperance in investments and justice to their economic partners.

Capitalism's drive for dynamic efficiency creates a powerful slipstream that advances many social values.

In practice, this means a corporation must seek to maintain cooperative win-win arrangements with its customers, employees, suppliers, and investors. In that sense, business managers allocate resources among their partners according to the contribution each makes to the firm's success. Thus, the firm needs to keep its key partners—loyal customers, faithful employees, reliable suppliers, and steadfast investors—on board by treating each in a way that is just—and is seen as just.

That integration is integral to the market process. Capitalism's drive for dynamic efficiency creates a powerful slipstream that advances many social values—for example, reduced waste, outreach for employment to lower skilled or disabled individuals, and greater acceptance and tolerance for ethnic and religious minorities—empowering the firm's various partners to better advance such goals.

Partners for Liberalization

Finally, business executives favorable to capitalism need to put these lessons into practice. Good managers are always alert to entrepreneurial investment opportunities to advance their firms' goals. That should include the political and intellectual. Such investments should include campaigns to gain economic liberalization. Firms have great experience in dealing with *economic* partners. They should exert similar effort to relate and cooperate with an array of *policy* partners if they and all their partners—customers, employees, suppliers, and investors—are to secure the freedom to grow and prosper well into the future. To that end, businesses have much to gain by reaching out to potential free market policy allies in order to promote economic liberalization as a long-term investment.

The nation's freight railroads provide a good example of that type of policy investment. Railroads were one of the first industries regulated at the federal level, a policy that began with the creation of the Interstate Commerce Commission (ICC) in 1887, which set rates for the industry. In the first decades of the ICC's existence, the agency's lack of knowledge of rail operations led it to seek, and often follow, the advice of railroad CEOs. However, as time passed and ICC staff gained greater knowledge, rail regulations became increasingly burdensome. Agencies are sensitive to interest groups, of which the railroads were one, but shippers were also interest groups, and there were many more of them. Shippers soon came to dominate ICC policy, which was characterized by price controls.

By the 1970s, this regulatory straitjacket had brought the nation's freight railroads to the brink of collapse. In response, freight railroads began to fight for economic liberalization, seeking the freedom to price their services, which they had been denied for almost a century. That effort succeeded in pushing through the Staggers Act of 1980, which allowed that once-moribund sector to return to profitability. The result was improved transportation services and increased investment in rail infrastructure. Few purely private investments could have yielded such returns. Other heavily regulated industries could learn from the railroads' experience.[25]

The Great Enrichment is capitalism's greatest triumph.

Conclusion

The Great Enrichment is capitalism's greatest triumph. As commerce reduced transaction costs, it facilitated social contacts between craftsmen and engineers, making society's dispersed and localized knowledge more widely accessible to more people. The localized knowledge that had been blocked by class barriers and the disdain of commerce flowed together, engendering new ideas, new innovations. The resulting combinations led to ever more exchanges and exponential growth. The Great Enrichment resulted.

Yet, the continuance of the Great Enrichment is endangered. Over the last century, cultural narratives about commerce and business have become steadily less favorable toward free markets. Overly burdensome regulations are slowing or blocking innovation, capitalism's lifeblood. In effect, a form of economic puritanism seeks to stop ideas from "having sex." All this threatens the gains of the last centuries, and a return to the steady-state stagnation of the past.

Apologetic approaches will not work. You get no applause for doing less of a bad thing unless and until you have first garnered legitimacy for your core role. The morality of capitalism is based on its voluntary nature, its creative synthesis of the two basic human evolutionary traits: self-interest and empathy. Those moral traits are incorporated and enhanced by capitalism's most significant institution, the firm. To achieve any sustainable success for capitalism and the firm, it is essential that the morality of these institutions be widely understood and accepted.

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NOTES

1 Milton Friedman, "The Social Responsibility of Business Is to Increase its Profits," *New York Times Magazine*, September 13, 1970, https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html.

2 Ibid.

3 McCloskey uses this term in many of her writings. See, for example, Deirdre Nansen McCloskey, "The Great Enrichment," *National Review*, November 15, 2015, https://www.nationalreview.com/magazine/2015/11/19/great-enrichment/. McCloskey, like many, finds the term "capitalism" awkward and has suggested various alternatives, such as "modern capitalism," "market tested innovation," and "innovationism."

4 Fred Smith, "Countering the Assault on Capitalism," *Economic Viewpoints*, Institute of Economics Affairs, 2012, https://cei.org/sites/default/files/Fred_Smith--Countering_the_Assault_on_Capitalism.pdf.

5 Joseph Schumpeter, *Can Capitalism Survive?* (originally published as *Capitalism, Socialism, and Democracy*) (New York: HarperCollins Publishers, 1942), p. 190.

6 Ibid., p. 191.

7 The notion that changes in rhetoric and language helped propel the Industrial Revolution is explored in depth by Deirdre McCloskey in her trilogy on "bourgeois" morality and mores: *The Bourgeois Virtues: Ethics for an Age of Commerce* (Chicago: University of Chicago Press, 2006), *Bourgeois Dignity: Why Economics Can't Explain the Modern World* (2010), and *Bourgeois Equality: How Ideas, Not Capital or Institutions, Enriched the World* (2016). For a shorter treatment of the topic, see Deirdre N. McCloskey, "It was ideas and ideologies, not interests or institutions, which changed in Northwestern Europe, 1600–1848," *Journal of Evolutionary Economics*, Vol. 25, Issue 1 (January 2015), pp. 57–68, https://www.deirdremccloskey.com/docs/pdf/McCloskeyJEvolEcon2015.pdf.

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14 For a discussion of such arrangements, see Peter Leeson, *Anarchy Unbound: Why Self-Governance Works Better than You Think* (New York: Cambridge University Press, 2014).

15 Deirdre McCloskey, *The Bourgeois Virtues: Ethics for an Age of Commerce* (Chicago: University of Chicago Press, 2006), http://www.deirdremccloskey.com/docs/bv_selection.pdf.

16 Voltaire, *Letters on England* (London: Penguin Classics, 2005) (first published January 1, 1889).

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18 Ronald Coase, *The Firm, the Market, and the Law* (Chicago: University of Chicago Press, 1988).

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20 The term "rational ignorance" was coined by Anthony Downs, an economist at the Brookings Institution. Anthony Downs, *An Economic Theory of Democracy* (New York: Harper and Row, 1957). See also, Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton, N.J.: Princeton University Press, 2008).

21 Jonathan Haidt, *The Righteous Mind: Why Good People Are Divided by Politics and Religion* (New York: Pantheon, 2012).

22 For more on Dan Kahan, see the website of the Yale University Cultural Cognition Project, http://www.culturalcognition.net.

23 Robert A. Lawson, "Examining the Hayek–Friedman hypothesis on economic and political freedom," *Journal of Economic Behavior and Organization*, Vol. 74, Issue 3 (June 2010), pp. 230–239, http://www.sciencedirect.com/science/article/pii/S0167268110000430.

24 It is difficult to do justice to the richness of McCloskey's work on capitalism and virtue. Her research and writings are impressive and merits greater attention from the policy community. One of her major themes is that the utilitarian/efficiency/prudence arguments for capitalism are inadequate, and that capitalism cannot survive on such narrow grounds.

25 For more on railroad deregulation, see Fred L. Smith, Jr. and Marc Scribner, "Reviving Capitalism—Lessons from the Near-Death and Rebirth of American Railroads," *Profiles in Capitalism* No. 2, Competitive Enterprise Institute, November 2015, https://cei.org/content/reviving-capitalism.

ARE CORPORATIONS SUICIDAL?

Joseph Schumpeter once asked the question—Would capitalism survive? His answer: Probably Not! Schumpeter believed that many factors mitigated against the survival of a free market economy. Among various debilitating factors, he cited the loss of political and social support for capitalism that he believed would likely accompany the emergence of the modern corporation, including the emergence of an intellectual class that would prove inherently hostile to its survival. History bears out Schumpeter's pessimism. It seems that every crisis of the last hundred years has ratcheted upward the power of government over the economy. Power continues to gravitate from business to political centers, from the world of voluntary agreements to that of coercive mandates. America has traveled far along the Road to Serfdom.

A free society is not stable. There is always a tension between those groups now enjoying power and prestige and the emerging forces of change. The status quo forces always seek the continuance of the old regime and use political means to that end. Since politicians naturally respond to the visible present rather than the promised future, politics generally supports yesterday against tomorrow or today. The result is that the conditions for a free society have rarely been met and even more rarely sustained for any length of time. Only unusual conditions—strong restraints on government, commitment by significant groups of intellectual and moral leaders to decentralization and free markets, a vigorous and independent business sector, rapid technological change—have permitted the dynamism which is necessary (but of course not sufficient) for a free society.

Somewhat surprisingly, corporations have abetted the enemies of capitalism. In his book, *The Suicidal Corporation*, Paul Weaver challenged the business community to play a more active role in the defense of the marketplace. Academics and free market ideologues are critical to this fight, but they lack the resources to mount a full-scale battle. And free market intellectuals will always be a minority—most intellectuals benefit in the short term, at least, by the expansion of the state.

Weaver's central and most controversial point was that the major problems faced by business today result from its own suicidal behavior. He argued that business has acted against its own best interests and fostered an anti-corporate climate. A prime example of this can be found in corporate giving trends. The work of the Capital Research Center shows that corporate charity is bestowed primarily on groups hostile to the free market system. It is simply incredible that so many corporations are willing to finance organizations that seek their destruction.

Business needs strategic allies if it is to take on some of these very difficult battles. This is the conclusion of Menlo Smith, Chairman of the Sunmark Capital Corporation. He makes a powerful case that business should do more to support those that defend a free society, rather than funding its adversaries. Indeed, he would suggest that corporate officers are so bound to protect shareholder investments.

Corporations will not win this battle alone. In today's world, anyone having an obvious economic stake in a policy area is seen as suspect.

Drug companies have little standing in any dispute with the Food and Drug Administration (FDA); oil and chemical company research is rejected in the environmental arena; automobile companies are discredited in the debate over highway safety. If capitalism is to be effectively defended, market-oriented businessmen must develop creative new arrangements with their ideological friends in the free market community. Just as a firm seeks third party endorsements to market its products, it will need such independent supporters to advance its policy interests. As in other conflict situations, allies will be vital in the war for economic freedom. Capitalism is too valuable to be endangered by the continuation of suicidal corporate practices.

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THE VALUE OF COMMUNICATING TO JOE AND JOAN "CITIZEN"

Michael Kelly, the columnist for *The Washington Post* who was tragically killed during the Iraq war, had many good lines, one of which is relevant to improving political communication. He started his career as a television journalist and was doing quite well. But one day he quit. He was later asked, "Why did you leave? It seemed like such a promising career." He replied, "Well, yeah, but one of my co-hosts said to me one day, 'Michael, you just don't get it. In television journalism a hair dryer is every bit as important as a pad and pencil.'" While that comment prompted Michael to leave broadcast journalism, his story brings up an important point: The way we present ourselves is as important as the content of our messages.

CEI and National Media work very closely with many businesses, trying to persuade them not to apologize for being capitalists. That work is important because industry is a significant channel of political communications.

Corporations spend more than half a trillion dollars a year selling products. Their messages and ads are trying to reach Joan and Joe "Consumer," and yet they are also reaching Joan and Joe "Citizen." In other words, business not only reaches its customers in the private competitive world, but also communicates (sometimes unwittingly) in the political policy world.

This raises the question: When you talk to Joan Consumer, what are you also saying to Joan Citizen? Business doesn't ask this question very often. Why not? Because the people who handle product sales are in the marketing division, while the people who handle policy concerns and monitor political threats to the industry are in the government relations division.

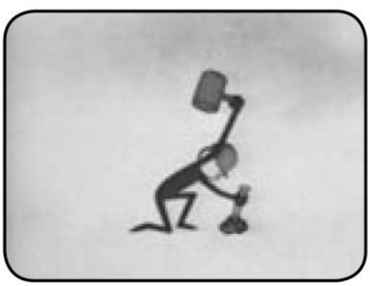
Business has not yet integrated these two separate worlds into a consistent strategy. This situation exists for a couple of reasons. First, the two divisions are far apart within the organization of the company, and second, many CEOs don't like politics. They want it to go away.

If we could find ways of encouraging companies to think of a dual message, to sell not only products but also the moral legitimacy of a free enterprise way of producing, distributing, and pricing, I believe that would make our policy work much, much easier. At CEI, we're conducting research to understand the way people go about making decisions, to find new methods to create and distribute free-market messages, and then convince the business leaders of the need to legitimize both their products and their industry.

Business generally uses two institutional advertising strategies. CEI has labeled those "apologetic" ad strategies and "legitimizing" ad strategies. The apologetic ads say, "Yes, I know we did horrible things. We're very sorry about that, but you don't understand. It was a different time, technology wasn't developed and we're really sorry. We're going to do better. We're really going to do better in the future."

An example of this type of ad can be found in Figure 1.1. The chemical industry spent over $ 10 million producing and distributing this ad year after year after year. But what message did this ad convey? You heard nothing about why chemicals might be useful things to have. All you heard was that we got rid of 93 percent of the toxic ones. Meanwhile, the 7 percent seems to be indestructible and obviously very dangerous because they're trying to get rid of it. The ad ends with a new slogan for the industry's approach—"Responsible Care."

Responsible Care? Imagine this scenario: You're sitting at home and your teenage daughter or son walks into the room. You look up from reading the paper, and your child says, "Dad, Mom, I want you to know, from now on I'm going to be responsible." Then your teenager walks out of the room. You're all relieved at this point, right? Think again. The whole concept that from now on you're going to be responsible suggests that up to now you have been irresponsible. That is a typical apologetic ad.



Voiceover: In a single year, 93 percent of our toxic chemical waste was treated, converted to energy or recycled. What about the other 7 percent?

We're working on it!

FIG. 1.1: Chemical Manufacturers Association Ad

Legitimizing ads, the ads that we think have value and occasionally are done by industry, discuss the benefits derived from a product. This type of approach is important because people are "rationally ignorant." They have real lives and no real reason to spend lots of time reading policy reports or learning about issues that have no apparent impact on their lives. So, we are all "rationally ignorant" about most things.

If people are going to understand that a world without chemicals might be a scarier world, you're going to have to give them some reason to believe it. Industry equates profitability with legitimacy, because that is the standard by which businesses judge each other. But if profitability were the only moral yardstick, cocaine dealers, prostitution rings, and other similar "businesses" would all be legitimate. Evidently, some nonbusiness people are applying different standards to business than business applies to itself.

If people are going to understand that a world without chemicals might be a scarier world, you're going to have to give them some reason to believe it.

Figure 1.2 is almost the epitome of a legitimizing ad. The plastics industry has several others like this. Some of you have probably seen the one in which a mother is warming a baby bottle. The mother looks down at her

FIG. 1.2: American Plastics Council Ad

child, and the bottle slips from her hands. Then, in slow motion, it falls toward the tile floor where the baby is lying. When the bottle bounces off the floor instead of shattering, you think, "Thank God it's plastic."

This ad came about because the plastics industry was getting hammered. Those of you who know the movie *The Graduate* may remember the scene at Dustin Hoffman's graduation party in which this particularly irritating neighbor, a businessman, looks down at Dustin's character and says, "I just want to say one word to you ... plastics." That phrase quickly came to symbolize a faddish contempt for the modern world. What soon followed was a whole array of anti-plastic policies.

After a while, the plastics companies decided to go on the counterattack. Their initial ads featured downhill skiers who talked about the benefits of high-tech plastic skis. This prompted us to say, "Well, that's good, but if you can go skiing in Aspen and drive Corvettes, you're probably already aware that capitalism is a good idea." These companies really needed to reach out to people with the egalitarian value that plastics are not only good for society at large, but they're particularly good for the individual—in this case, a heart attack victim, and in the case of the plastic baby bottle, mothers and children. In many ways, it's not just a benefits message, it's a benefits message that carries the fairness value, the egalitarian value.

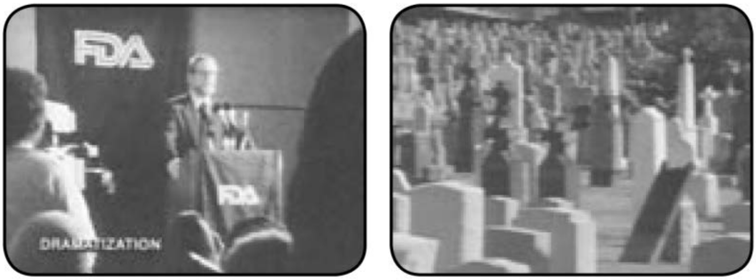
CEI has done focus group research on legitimizing versus apologetic ads, and made some interesting findings. Apologetic ads tend to make a rationally ignorant public more likely to support greater regulation than legitimizing ads. The former tend to create new doubts in the mind of the audience, leading to exactly the sort of government intervention we seek to avoid. We need ads that drive home the point that a world with more regulation, more taxes, and more restrictions is a world that is not only less free and less rich, but also less fair.

Apologetic ads not only don't work, they also exacerbate the very problems they seek to address.

In our focus groups, the ad on chemicals, for example, raised all kinds of questions. What is this stuff? Why is it so hard to get rid of? Why are they pretending that they've done a good job when the hard part of the problem lies ahead of them? And so on. The participants in the focus group were concerned that toxic waste was an insurmountable problem, that companies may not be "following the rules, and that maybe the 7 percent of waste not yet cleaned up was created by those bad actors who are never going to do it on their own. Furthermore, they did not find the information presented in the ad credible.

Apologetic ads not only don't work, they also exacerbate the very problems they seek to address. Legitimizing ads, by contrast, can be very effective. Another example of a legitimizing ad is one CEI developed regarding the pharmaceutical industry during the debate over reforming the Food and Drug Administration.

The ad in Figure 1.3 delivers a general message about the value of drugs: People die if drugs are delayed by regulation. This message is not one that industry would feel comfortable delivering directly. If the FDA regulates you, you can't be overly critical of it in public. Our ad essentially took the benefit message, the egalitarian message, and targeted a particular policy group—FDA reformers.



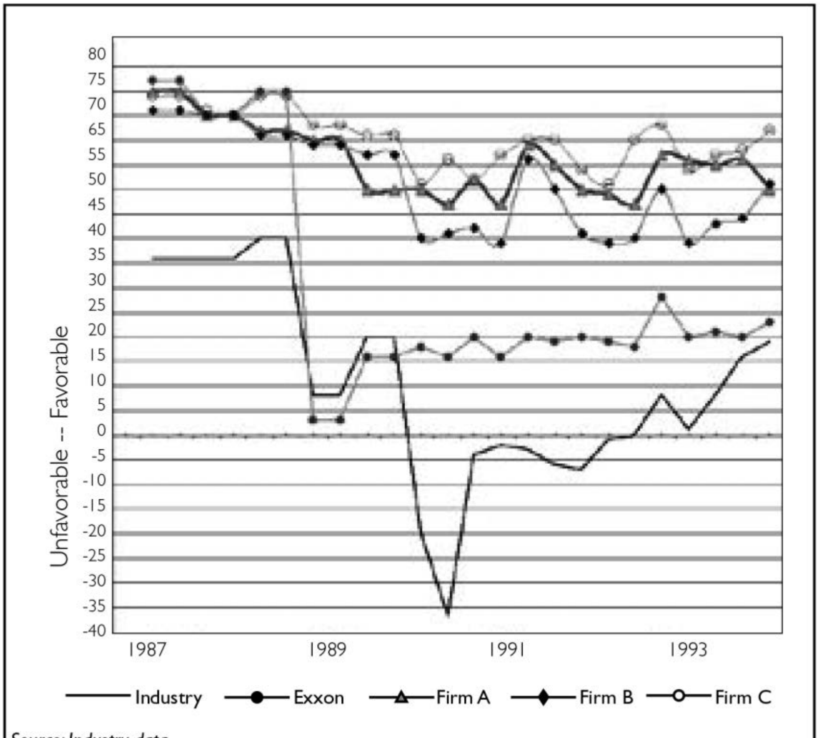
Speaker: The Food and Drug Administration proudly announces its approval of this major new drug. By our estimates, this drug will save over 8,000 lives per year.
Voiceover: If the government approves a drug that will start saving lives tomorrow, how many people died yesterday waiting for the government to act? Shouldn't we know the answer to that before we start applauding?

FIG. 1.3: CEI Ad about FDA

So far, I've talked about the importance of a company legitimizing its products. As, or more, important is the need for ads that legitimize the entire industry. The graph in Figure 1.4 shows the reputations of various firms in the oil industry. The bottom set of curves shows the reputation of the oil industry in general.

The graph indicates that some companies have better reputations than others. Branding is one way by which a company can raise its reputation, but the industry overall always has a lower reputation than specific companies do. It's the industry that gets regulated, not individual companies. The only way you can protect your company ultimately is to protect your industry.

Another example of that same point is the March 1989 Exxon Valdez oil spill. As you can expect, when this happened, Exxon's credibility dropped dramatically with the public. The credibility of other companies, however, dropped a lot less, demonstrating that there is value in maintaining the reputation of your company. But while certain individual companies suffered less than Exxon, the oil industry's reputation suffered almost as much as Exxon did. Politically, this meant the oil industry as a whole was damaged in the end, not just Exxon. If you want to defend yourself against the regulating regime, you have to defend your industry and not just your particular company.



Source: Industry data.

FIG. 1.4: Public Attitudes Toward Oil Companies and the Oil Industry

Companies have not always been so slow in defending their industries. In his wonderful book, *Creating the Corporate Soul: The Rise of Public Relations and Corporate Imagery in American Big Business*, Roland Marchand suggests that industry in the early 1900s was aware that the world was moving into a socialist period. When governments nationalized many sectors of American industry in World War I, companies were terrified that they might have no future in America and responded over a period of decades by developing a moral defense of themselves. Industry did that reasonably well by disseminating messages that created a corporate soul. But, after World War II, when industry could make money by doing almost anything, it went to sleep again. In a sense, industry needs to wake up and revitalize its understanding that companies are always operating in a hostile environment, and if these companies can't make a moral defense of themselves and their industry, they won't have a future.

A current example of creating a corporate soul comes from a popular ad for cell phones (See Figure 1.5). The interesting thing about the ad is that, according to *Creating the Corporate Soul*, AT&T has had it right for a long time. The first AT&T institutional ads in the early part of the 20th century were filled with information about how marginal costs operate for public utilities. The idea was that if the public only knew as much as AT&T did, it would be much more sympathetic to AT&T's pricing and network structures. That didn't work. AT&T then went quickly to egalitarian themes and to reach out—"Reach out and touch someone." Ads like this one show how the cell phone becomes a solution to a problem for working mothers. It captures an element that the cell phone is not only an instrument of freedom, not only an

FIG. 1.5: AT&T Cell Phone Ad

instrument of wealth creation, but also an instrument that makes it a little easier to have fairness in a world with a lot of stress.

AT&T has some advantages. It was a very large part of the telephone industry, so the value to the industry was captured by the company. It also was a company very much in touch with consumers, so it had to communicate. It did, and arguably, as a result, it resisted some rather strong regulatory attempts in the 1920s and 1930s. At the same time, the company was spending tens of millions of dollars to legitimize itself. Virtually no company is spending anything like that today, and it shows.

The free-market community can learn much from the successes and failures of industries. If we apologize for who we are and what we stand for, people will find faults with our ideas. If we legitimize what we do and demonstrate how people can benefit from our proposals, however, then we might start winning some skirmishes in the ongoing battle of ideas.

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The expansion of the market has not only increased freedom and spurred economic growth, it has also lifted more people out of poverty than any system in history.

COUNTERING THE ASSAULT ON CAPITALISM

Capitalism has been the most successful institution in human history, yet it has never gained the legitimacy it merits. As Milton Friedman stated: "Everywhere capitalism has been tried, it has succeeded. Everywhere socialism has been tried, it has failed. The lesson learned? We need more socialism!"

One of capitalism's greatest champions, the economist Joseph Schumpeter (1942) asked, "Can Capitalism Survive?" He responded that the failure of capitalism to gain popular legitimacy would lead to its replacement by some form of state socialism. Yet Schumpeter's thesis does offer some cause for hope. Capitalism has great vitality and can regain ground lost during the last century. Albeit aided by the inherent weakness of statist policies, the advance of capitalism will require a far more strategic offensive than has yet been waged.

Capitalism is robust. It remains strong, despite the reach of its naysayers. That is because it advances all the disparate cultural values of mankind—freedom, order, and fairness. As Schumpeter noted, the triumph of capitalism isn't in providing silk stockings to queens and princesses, but in making such former luxuries accessible to the shop girls of Europe. It does so in the only way progress can be attained—incrementally. It does not purport to create Utopia.

The expansion of the market has not only increased freedom and spurred economic growth, it has also lifted more people out of poverty than any system in history. Even with such success, capitalism has failed to cultivate resolute defenders. Everywhere capitalism is under assault. Why is this? Capitalism has many beneficiaries, yet it finds few spirited defenders among the masses liberated from poverty, intellectuals, or even entrepreneurs whose success is only made possible by capitalist institutions.

Schumpeter's Argument

Joseph Schumpeter argued that the very success of capitalism would plant the seeds of its own destruction. Capitalism liberates the "creative destruction" of entrepreneurial change. The resulting wealth frees most people from subsistence levels, creating a middle class. Most enjoy the better life but some become agents of change: the "doers"—the entrepreneurs—and the "thinkers"—the intellectuals.

Entrepreneurs are the drivers of economic and technological growth. They are the heroes of our society—from Eli Whitney to Bill Gates—who thrive by making our lives easier and more productive.

Intellectuals develop the societal narratives that seek to explain changes in society. Their storyline: Change is disruptive. As witnessed during the Industrial Revolution, the vast changes that swept through Europe and America ignited resentments. Most intellectuals disparaged capitalism for its disruptive nature, neglecting to take note of the value added by its immense wealth-creating capacity.

Capitalism, the intellectuals argued, may address man's material needs, but fails to advance higher order needs—community, environmental protection, equality, and justice. Economics Nobel Laureate Friedrich

Government regulations impose costs that are off-budget, but no less real.

A. Hayek aptly described the fatal conceit as intellectuals' belief that they can direct social change for the benefit of mankind (Hayek, 1988). These intellectual critics of capitalism argued that the gains were concentrated too heavily, that the benefits diffused too slowly, that not all benefited equally, and capitalism must be modified to better address poverty, inequality, pollution, illiteracy, public health, and other societal problems.

Intellectuals craft the narratives, stories, and metaphors framing and shaping what become the popular views of societal change. As the anti-capitalist narratives gain in popularity, the view of capitalism as an immoral means of creating wealth and knowledge becomes ever more entrenched. As those ideas influence public policy, freedom declines and statism rises.

The "Third Way" Folly

Government has certainly grown relative to the private sector since Schumpeter published his essay. At the end of the 19th century in the United States, government comprised less than 10 percent of the economy. Today, government either consumes or directs nearly half of the economy, with direct government spending alone reaching almost 40 percent of GDP. Still, the costs of expanded government intervention extend far beyond the direct costs that are readily visible in taxing and spending.

Government regulations impose costs that are off-budget, but no less real. They stifle innovation and entrepreneurship. At the U.S. federal level alone, regulatory costs now approach $2 trillion. Vast swaths of the economy are constrained by mandates and bans, government-subsidized competitors, and pervasive moral hazards.

Yet, rather than fight for economic freedom, many in the business community have responded to this growing threat by seeking to use government to their own advantage. The corrupting influence of political regulation on business has led to a system of crony capitalism in which vested economic interests protect their positions by undermining competition through the wielding of political power. To that end, they forge powerful alliances with other forces with a stake in the status quo—from the politicians on whose favor the crony capitalists depend to the fashionable-cause activist groups and establishment media whose approval the *bien pensant* so crave.

Today, we see the end result in a statist status quo—known as "managed capitalism," "capitalism with a human face," the "third way," and other nebulous monikers—in which established political and economic interests stand athwart the Schumpeterian process of creative destruction yelling "stop" and have the force to back up their admonition. That is what we have in America today: a mixed economy, far down the *Road to Serfdom* against which Hayek warned (Hayek, 1944).

Thus, the innovative and pro-market intellectual upstarts who represent a brighter tomorrow are political orphans. They represent the best hope for forging a strategic alliance for the defense of capitalism.

Most individuals interpret the world through the narratives presented to them.

Why Hasn't Capitalism Found Defenders?

Why haven't more intellectuals defended capitalism?

Intellectuals from the time of the early Industrial Revolution onward were quick to seize upon the shortfalls of capitalism. Based on their utopian standards, they saw "market failures" everywhere. Most Americans were acquainted with the portrait of capitalism created by the muckrakers—a world filled with robber barons, driven by greed, and harming the powerless. That capitalism lifted more people from poverty faster than ever before, that literacy rates and life spans were rapidly expanding, and that purchase prices were dropping did not interest most intellectuals.

Still, how ideas move into reality is the critical challenge to reversing this trend. Therein lies the true power of intellectuals—their narrative-crafting role. Most individuals interpret the world through the narratives presented to them. They have responsibilities and commitments that preclude them from becoming deeply involved in and informed about public policy. Economists call this choice of political non-involvement "rational ignorance." There is little reason for most individuals to spend scarce resources—time and money—to analyze and understand issues about which they can have little to no impact. Most political opinions, therefore, are influenced less by information than by narratives that link issues with people's core values.[1] In other words, most people are too busy living life to devote time and effort to crafting their own narratives.

Most of us are familiar with the anti-capitalist canards that are prevalent in the media, academia, and the arts: Capitalism creates monopolies, threatens freedom, rewards greed, destabilizes communities, destroys traditional values, and creates a polarized society where the rich get richer and the poor get poorer. Meanwhile, government failures receive little attention.

Why doesn't business defend capitalism?

Businessmen are the likeliest candidates to realize their interests are best advanced by an expansion of the market. Their greatest skill being wealth creation, it should be logical for them to want to promote a larger economic sphere free of politics. Yet, few businessmen have joined ideological defenders of the market. If this pattern can be reversed, the future of capitalism will be much brighter than Schumpeter predicted.

With a comparative advantage in the private marketplace, businessmen have few drivers to learn the skills of the political sphere. For that reason, many often take a self-defeating approach. CEOs, like everybody else, seek public support and often even affirmation. They swim in the waters colored by intellectuals as do their children, partners, and board members. Thus, it should not be surprising when they are confronted with questions such as: "Daddy, why are you destroying the planet?" "Dear, my friends at the country club think you should be doing more about AIDS or poverty or global warming!" that many are quick to appease their critics.

As Schumpeter foresaw, the outcome of this cultural bias:

> [Rather than educating its] enemies, [business] allows itself ... to be educated by them. It absorbs the slogans of current

> radicalism and seems quite willing to undergo a process of conversion to a creed hostile to its very existence. … This would be most astonishing and indeed very hard to explain were it not for the fact that the typical bourgeois is rapidly losing faith in his own creed.
>
> [Business leaders] talk and plead—or hire people to do it for them; they snatch at every chance of compromise; they are ever ready to give in; they never put up a fight under the flag of their own ideals and interest.
>
> (Schumpeter, 1942, p. 161)

Entrepreneurs doubt the morality of their own endeavors and accept political restraints. They internalize the accusations flung against them and become, as Schumpeter described, "state-broken." It need not be this way; an alternative is clear to see. Businesses spend vast sums crafting and disseminating narratives to reach consumers, to persuade them that their products and services are good and worthwhile.

Why don't businesses seek to direct their advertising narratives to gain legitimacy? They are under political attack from government regulations as well as intellectual ideologues who blame them—and capitalism—for all of society's problems. As much as they employ vice presidents of environment, community relations, public and government affairs, employee relations, and a host of other political positions, businesses should similarly hire agents to legitimize their social role.

An automaker, for example, will find it worthwhile to convince Joan Consumer that her car is a good buy.

Convincing Joan Citizen of the societal value of the automobile can go a long way toward making her less willing to accept the assertions of political attacks.

Properly mobilized, forces for economic liberty can mount a vigorous defense of capitalism.

Was Schumpeter Right?

Schumpeter's gloomy prognosis for the future of capitalism carried a silver lining of hope, even if he did not see it at the time. Properly mobilized, forces for economic liberty can mount a vigorous defense of capitalism and possibly even recapture some of the ground they have lost over the last century. What Schumpeter failed to consider was that some intellectuals would resist the allure of statism. Indeed, many have, and have provided the founding stores of intellectual ammunition on which we can draw today.

In the years following World War II, an array of classical liberal intellectuals emerged—members of the very class which Schumpeter warned would bring about capitalism's demise. Today, many of their names are well known: Ludwig von Mises, Ronald Coase, Milton Friedman, Friedrich Hayek, and many others. These "traitors to their class" fostered the creation of the public policy institutes, publications, and advocacy organizations that have helped define the free market movement as we know it today.

But they did not do it alone. Prompted by Hayek, Antony Fisher opened Britain's first think tank, the Institute of Economic Affairs (IEA), in 1955. Over the last 60 years, a flowering of classical liberal organizations has helped win some victories in the war of ideas.

Classical liberal forces must ensure that, when public policy recrystallizes, it is shaped in a freer mold.

The resources of our groups and the numbers of pro-market intellectuals remain much smaller than those of statist groups. Expressing them as a fraction of the total wealth of the world—wealth that economic liberal policies have made possible—illustrates the disparity well. The world's wealth is around $60 trillion, whereas the cumulative budgets of all market-oriented policy groups optimistically amounts to only $600 million. That ratio is 10 to the minus five! If the human body devoted such a small fraction of its energies to fending off bacterial and viral threats, to repairing damaged organs, to replacing dead cells, our survival would be doubtful.

Despite the imbalance, victory in the war of ideas is not determined by money but by the quality of the arguments, and free market ideas are received resoundingly well.

Crises create opportunities. As the economist Herbert Stein famously noted, "If something cannot go on forever, it will stop." The current pace of government growth cannot go on forever. The welfare-regulatory state is unsustainable as witnessed by Greece and Portugal in Europe to California and New Jersey in America. There is now a realistic opportunity, for the first time in decades, to restore rational policies.

Classical liberal forces must ensure that, when public policy recrystallizes, it is shaped in a freer mold.

If we accept the criticisms of the dominant intellectual class, capitalism will fade, as Schumpeter predicted. For that reason, we must create a counterreformation of classical liberal intellectuals and business leaders, who work together to promote legitimizing narratives about capitalism and instill its virtues in the hearts and minds of our global society.

Statists have been far more aggressive in uniting both their economic and intellectual forces, but that fact creates a template that could readily be followed by free market forces. Neither business nor classical liberal intellectuals need wage this struggle alone. There are, after all, intellectual defenders of capitalism. The IEA, CEI, and a growing number of policy groups around the world are devoted to this cause.

Schumpeter presciently warned that capitalism would create an unholy alliance of anti-market intellectuals and rent-seeking businesses. But he did not envision challengers to that view—a holy alliance of classical liberal intellectuals and pro-market entrepreneurs. Competing on a more level playing field, integrating more effectively with like-minded classical liberals offers a promising resolution to Schumpeter's gloomy prediction.

Business and free market intellectuals together could create robust strategies to encourage experiments in the private sphere. To do so, the business community must understand the scope and consequence of their value in the political sphere. Incremental reforms that remove the rocks from the path to the future are the most likely way to restore capitalism and ensure a prosperous tomorrow. Emerging concerns and resources must be evaluated in the market—the world of voluntary exchanges—rather than in the public sphere.

If business is to become an effective ally, those of us in the intellectual world must find ways to reach them, alert them to their stake in the policy wars, the tsunami-size threats to their future, instruct them on more effective battle tactics, and demonstrate our value in that struggle. Business need not accept its role as a villain. As Schumpeter noted, "[H]istory is full of examples of the success of small groups who, believing in their cause, were resolved to stand by their guns."

Businesses must respond more strategically to the political predation they face in the public policy world. Capitalism is the most efficient system for solving problems and advancing human welfare. Yet business seldom advocates policies that would remove some of the obstacles to wealth creation and economic growth. If business leaders would push for "liberate to stimulate" policies, they might succeed in creating a freer tomorrow and solving more of mankind's problems. A small cadre of resistance fighters allied with the free market policy community could begin to liberalize sectors of the economy and encourage innovation.

Business also needs to focus not just on their products or services but on their value to broader society. Business spends vast sums on communication strategies to gain customers. They should craft narratives to communicate their contribution to society, use their resources to disseminate these messages, and seek out allies in that legitimization effort. If those communiqués were also directed at Joan Citizen, if firms' marketing skills were used to legitimize business, the climate for balancing the private and political worlds would be much better.

1. The literature on the factors that influence public opinion is extensive. Since the pioneering work of Aaron Wildavsky and Mary Douglas, however, there has been a major shift toward the view that cultural values largely influence that process. In effect, the views one holds about things one doesn't think about are largely self-selected to reinforce one's values. That process will be influenced by the "narratives" or "frames" that link values to the policy or issue under consideration.

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Civilization evolved familial institutions, which allowed diversified management units.

THE PROGRESSIVE ERA'S DERAILMENT OF CLASSICAL LIBERAL EVOLUTION

It is true that where a considerable part of the costs incurred are external costs from the point of view of the acting individuals or firms, the economic calculation established by them is manifestly defective and their results deceptive. But this is not the outcome of alleged deficiencies inherent in the system of private ownership of the means of production. It is on the contrary a consequence of loopholes left in the system. It could be removed by a reform of the laws concerning liability for damages inflicted and by rescinding the institutional barriers preventing the full operation of private ownership.

-Ludwig von Mises, *Human Action*

This statement captures the core dynamic nature of the classical liberal view of civilization. Civilization is the slow evolutionary process by which a rich framework of institutions evolves (private property, contracts, the rule of law) and enables individuals to engage in exchange. By so doing, individuals advance and protect the values they hold. As new values emerge, as older resources become scarce, classical liberals envision the institutional framework expanding to encompass them. The framework is always in flux, gradually growing as mankind's interests and challenges also expand.

Civilization evolved familial institutions, which allowed diversified management units—experimental entities that could take chances without endangering the tribe. Land moved from the tragedy of the commons to private property. In more recent times, the initial bundle of concepts comprising the idea of private property was unbundled to allow separate ownership of subsurface rights and then later ownership of even the electromagnetic spectrum. As discussed below, environmental resources are the latest challenge to this evolutionary process.

Classical liberals do not see the market as failing; rather, they see inadequate resources making it difficult for individuals to express their preferences. That tension creates the opportunity for institutional entrepreneurs to advance reforms that might better allow those preferences to be expressed. In the classical liberal view, we are not charged with protecting the environment or anything else. There is no social utility function. Rather, individuals gain the right to own newly valued resources and to determine individually what sacrifices—what tradeoffs—they find worthwhile to protect those resources.

Precedents—in history or in other societies—guide that evolution. Innovators invent new ways of "fencing" the commons (barbed wire), devise methods of unbundling the "sticks" making up established property (creating divestible rights in subsurface minerals), and extend property rights to newly homesteaded resources (the electromagnetic spectrum). Institutional innovation is the process of creative construction, integrating an ever-greater fraction of the world's resources into a system of voluntary exchange. That integration liberates the creative destruction of the extended market, making it possible for man to resolve more and more disputes without conflict or the risks of collectivism. Civilization is the trial-and-error process in which these experiments are validated or rejected.

This classical liberal evolutionary process accelerated during the Industrial Revolution, as man's creative energies found ways of working with nature to yield value. That process was weakened with the success of the "progressive" belief that planned order would better advance the human condition than would the spontaneous order championed by economic liberalism. Progressives have largely succeeded in derailing institutional evolution for the last century or so. Resources not integrated into the classical liberal order before 1900 are still not integrated today.

Much of the western United States is the property of the federal government, as are almost all offshore areas. The electromagnetic spectrum, which Ronald Coase noted was actively being homesteaded privately, was brought back under collectivist control. And the airsheds, rivers and lakes, and wildlife—all of which became valued in the later 19th century—remain totally under political control. The fatal conceit that motivated progressives ensured that centralized political management would replace the evolutionary approach that had prevailed. The result is the mishmash of public policy today.

Approach to the Environment

Contemporary environmental policy illustrates the result of that derailment. Today, most policy analysts (even libertarians) addressing environmental problems raise the possibility of private ownership of environmental resources (water, wildlife, air sheds) as a means of addressing environmental concerns, only to swiftly dismiss that approach as unfeasible. The transaction costs associated with environmental resource ownership, we are told, are too high.

The classical liberal challenge is to reexamine this history and to assess what institutions might have evolved had America not adopted collectivism. The roots of most modern public policy problems stem from the destruction of the evolutionary process.

The classical liberal challenge is to reexamine this history and to assess what institutions might have evolved had America not adopted collectivism.

The implications of this thesis are important. It explains many of the fallacies of modern economics: market failures, "natural" monopolies (never, one might note, found in nature), public goods, externalities, lack of competitive grids. All stem from the impoverished state of institutions throughout the modern economy. Only areas where government was too slow to block the evolutionary process (the Internet, for example) have escaped this stagnation. I develop this theme in the environmental area.

As the quote by Mises suggests, it is not obvious that any environmental problems would have emerged—or if they had emerged, would have persisted—had the Progressive Era not prevailed. After all, economic issues are as old as mankind. The first cave dweller who dragged home his kill must have suffered some criticism from his neighbors as the carcass began to decay. Those early environmental problems were dealt with by the evolution of cultural rules—carry away offal, pollute waters only downstream of the tribe, move fires safely away from the huts. Traditional societies evolved some sophisticated procedures for managing environmental issues.

The key question is: Why, as wealth increased and allowed this greater appreciation of environmental values, didn't new institutions evolve that would have empowered individuals to express their changing preferences?

The answer, I believe, lies in the undermining of the classical liberal evolutionary process that occurred during the Progressive Era. Progressives believed that markets and private property slowed progress, and that collective management of resources would more surely advance the public interest. Thus, they blocked the extension of private property to resources that had not yet been privatized (indeed, in the case of the electromagnetic spectrum and some arid western lands, rolling back fledgling homesteading efforts).

Progressives also transformed the rule of law, making it more utilitarian, more willing to ignore individual values to advance the "common good." Social concerns trumped individual rights. Earlier common-law defenses of individual property rights that might have encouraged economic development along more environmentally sensitive paths were weakened or abandoned.

New Agencies

Progressives also created or expanded a vast array of "promotional" agencies—the Army Corps of Engineers, the Bureau of Land Management, the Rural Electrification Administration, the U.S. Forest Service—to dam rivers, build canals, manage timberlands, and string power lines. The pro-economic growth biases of these institutions (undoubtedly the popular view at that time) led them to neglect environmental values. Progressive views came to dominate American culture, leading courts and legislators to weaken nuisance trespass. Economic activity became associated with low environmental protection;

it is not surprising that many Americans saw economic development as "causing" disasters.

Thus, when a wealthier America began to place greater value on ecological concerns—when, in fact, the effective political majority began to demand that the environment be protected—pollution and other environmental problems were viewed as a result of economic activity. The "market failure" explanation was accepted, even by most "free market economists."

Had classical liberal institutions evolved, environmental values would have been integrated gradually into individuals' varying preferences.

Yet, as the initial quote by Mises suggests, this line of thinking is confused. Had classical liberal institutions evolved, environmental values would have been integrated gradually into individuals' varying preferences. In earlier eras voluntary exchanges would favor economic development over environmental preservation—poverty leaves little room for aesthetics. But, even then, some minority interests would have preferred the tranquility of their undisturbed properties to wealth. Thoreau was not unique, even in his time. In a system that honored private property, Thoreau would have been able to enjoin those whose activities would have disturbed his peaceful use of his property.

Such preferences enforced by legal remedies would have encouraged economic developers to devise methods of alleviating environmental damages. Railroads would have acquired larger buffer zones around their lines; technologies would have evolved earlier to suppress noise, odors, and emissions. Noxious industrial activities would have been sited in areas far from sensitive individuals. Methods for re-aerating oxygen-depleted waters or restocking damaged hunting or fishery areas would have been explored by firms seeking to reduce costs.

Moreover, private property would have been extended earlier to ensure those protections for environmental resources as they became more valuable to the citizenry. As an example of this evolutionary process, consider the way property rights evolved to protect and advance the development of underground liquid resources. America had departed from the European tradition of transferring ownership and control of all underground mineral resources to the state. In America individuals privately owned subsurface mineral rights and could sell those properties to economic developers if they wished. That slight shift encouraged a far more aggressive entrepreneurial exploration for things of value. Privatization of underground resources made possible the rapid development of the modern petroleum industry. (I am aware that oil wells had existed far earlier—in China around 1000 A.D.)

The result was that oil was always managed as a sustainable resource. From the time of Colonel Drake's first gusher in Titusville, Pennsylvania, in 1859 until today, America's private petroleum industry has aggressively spent vast sums mapping subterranean resources, seeking geological formations in which oil might be found. A new science, seismology, was developed to make this exploration more efficient.

Once oil was discovered, owners sought to map the boundaries of each pool. Firms developed creative ways of contacting and negotiating with surface owners to acquire integrated ownership of these pools. One creative innovation was "unitization"—the acquisition of all initially dispersed subsurface rights and their economic reorganization into integrated physical units, allowing more efficient drilling, pumping, and extraction. The result of bringing this once-common property resource into the classical liberal institutional framework has been spectacular. Oil has become an ever more abundant resource as we've become ever more skillful at discovering, developing, and refining it.

Note, however, that the evolution of property rights in petroleum occurred prior to the Progressive Era. Classical liberal policies were still dominant; there was no force to block the creative evolution of rational institutional arrangements. Progressives had not yet derailed the process by which newly valued resources were gradually integrated into the market.

Groundwater and the Progressive Era

In contrast, groundwater became a scarce—and therefore valued—commodity after the progressives gained control. Groundwater was abundant in the 19th century—moreover, surface water was generally a more economical source of this resource. The value of groundwater in this early period did not encourage anyone to incur the costs of promoting the institutional arrangements that would have allowed it to be owned privately, as was oil. Thus, property rights were never extended to groundwater, so it never became a "private" resource like oil.

The result of these different treatments of comparable underground liquid resources is striking: The relatively scarce commodity (petroleum) has become ever more abundant, while the relatively abundant commodity (water) has become ever scarcer.

In some environmental areas, fragments of a classical liberal institutional order did survive.

Another cost of the Progressive Era has been the increasing conflict surrounding water policy. If oil is discovered in a region, the residents are elated. There exists a well-established way in which the value of that resource can be exchanged with the outside world, creating wealth for the local region and greater resource availability for the consumers of the world. In contrast, for example, a bottled-water facility in a basin may find demand for its products growing dramatically, but face great opposition if it seeks to expand output. The lack of any agreed-on exchange method of transferring water ensures conflict rather than cooperation. Economist Terry Anderson of the Property and Environment Research Center notes that this explains the saying "Whisky is for drinking; water is for fighting!"

Of course, in some environmental areas, fragments of a classical liberal institutional order did survive. In England, fishermen formed associations that were able to force reductions in harmful pollutants from both industry and municipalities. In some regions, custom and culture produced property-rights arrangements to protect shellfish in bays and estuaries.

But the broad outlines remain dismal. Resources that were outside the private sphere in the 1890s remain so today. And resources that were only beginning to enter the private sphere at that time—the electromagnetic spectrum, fisheries, and western lands—effectively reverted to political control and suffered the tragedy of the commons. The gradual emergence of the environment as a valued aspect of life occurred in a world bereft of classical liberal institutions. Older defenses of property rights were slowly eroded, and their newer adaptations were blocked. The result was that when environmental values became majority values, few realized that they might better be protected privately via a creative program of ecological privatization.

What would the world look like had the Progressive derailment not occurred?

The Challenge

The challenge to classical liberal scholars today—and to all those championing environmental values—is to revisit the evolutionary steps that were underway before the Progressive Era. Our goal must be to gather up those embryonic threads and extend them to today. The difficulties of doing so are great. Absent the incentives and the innovations that would now exist, we are forced into an imaginative and difficult *gedanken*, or thought, experiment: What would the world look like had the Progressive derailment not occurred?

As discussed, leaders of the modern environmental movement are not only unaware of the value of private property in protecting environmental values, they are often antagonistic to the market and its institutional underpinnings. We must not only present reasonable steps toward a system of ecological privatization, but also work to legitimize this approach. One path to such reforms is to recognize the over-centralization of current environmental policy (the view that only the federal government has the wisdom and concern needed to protect environmental values) and reopen the Green Laboratory of the States. Most environmental problems are local and regional in nature, and even those larger-scale problems occur somewhere before they occur nationally.

Restoring the classical liberal order in the environmental field (or anywhere else) will not be easy, but there is no alternative.

Steps that would allow local owners to protect their properties would have positive spillover (external) value to the nation as a whole. An effort should be made to identify and remove the barriers to classical liberal environmentalism. The traditional common-law defenses of property—trespass and nuisance—should be reinstituted in areas where current practices permit, and phased in where past locational decisions would block any immediate reform. The direction that reform should take is clear—to think creatively about the changes that would likely have occurred had the progressive tide not derailed the evolutionary process.

Restoring the classical liberal order in the environmental field (or anywhere else) will not be easy, but there is no alternative. To manage the modern economy via centralized control is impossible; to "perfect" the market via pervasive government regulations is even more impossible. Yet the absence of property rights in environmental resources—wildlife in America, air sheds, rivers, lakes, and bays almost everywhere—means that we must begin the reform process almost from scratch.

Indeed, in the ecological field, the problems faced are similar to—but perhaps even greater than—those addressed by Hernando de Soto in establishing private property rights in such conventional resources as land and buildings in the developing world. In both cases, we know where we wish to go, but we have no roadmap to guide us. Indeed, the problem in the environmental field is far more complex than that in the economic sphere. In the economic sphere, there are working approximations of the classical liberal world, while in the ecological field, there are only fragments.

We must repair the impoverished state of our institutional framework for addressing the environmental concerns that we all share. To fail in this task is to risk further losses of economic liberty. Eco-socialism is even more complex than traditional socialism. It will fail. Our challenge is to ensure that as this occurs, a free-market alternative is available and is understood. There is much work to do.

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SUSTAINABLE DEVELOPMENT—A FREE-MARKET PERSPECTIVE

Introduction

Political approaches that rely upon the coercive power of the state are the dominant means of advancing environmental values today. Indeed, environmental policy is political policy. Few discussions about environmental policy proceed without the underlying assumption that political institutions must be mobilized in this effort. There is another path, however, that of Free Market Environmentalism (FME). FME is premised not on political action, but on the voluntary actions of free individuals and the associations that they create. FME recognizes that the greatest hope for protecting environmental values lies in the empowerment of individuals to protect those environmental resources that they value (via a creative extension of property rights). This path has been relatively unexplored. It is complex; it is controversial; and obviously, in a short space I can only outline this alternative environmental policy approach. I only *hope* that I can persuade you that FME warrants further study as a way to complement, substitute, or perhaps even replace, the dominant political approach to environmental issues.

Chickens and Pigeons

When Europeans colonized this continent, there were billions of passenger pigeons in America. When these birds flew over Philadelphia, the skies would darken. While pigeons were ubiquitous, there were no chickens in North America. Today, the reverse is true. There are billions

Private stewardship arrangements may offer a superior way of addressing environmental concerns.

of chickens, yet there are no passenger pigeons. What accounts for this massive shift in bird demographics?

We understand why there are so many chickens: Chickens had owners who were interested in protecting them. Chickens were valued by their owners for meat and egg production, so their owners learned how to protect their investments. First they stood watch outside the henhouse door to guard against foxes and other predators; later they developed improved chicken-protection techniques. Chicken farmers have researched chickens to the point that we even know what kind of music chickens like. As amazing as it might sound, people have even developed contact lenses for chickens. People have spent so much time learning about chickens because ownership integrates the welfare of chickens with the welfare of people. As a result, chickens have done very well.

The passenger pigeon, however, was the "common heritage of all mankind." It had no protectors or nurturers. Nobody was empowered to protect it, either for profit (as with chickens), or for its own sake. The passenger pigeon is now extinct.

This story suggests that private stewardship arrangements may offer a superior way—at least in some cases—of addressing environmental concerns. And, if one does not like the chicken example, because they are used for food, consider other animals, from goldfish to butterflies to the scimitar-horned oryx, all of which have private protectors in this

Private institutions and private property effectively harness man's self-interest to advance the public interest.

country. Through the institution of private property, few private owners are able to protect many species merely because individuals place a value on those species' existence.[1] This fact suggests that linking human concerns about the environment via private ownership can be a very effective strategy for environmental conservation.

Framing the Question

Sustainable development is not an artifact of the physical world but of human arrangements. Environmental resources will be protected or endangered depending upon the type of institutional framework we create, or allow to evolve, to address these concerns. The institutions that encouraged the protection of chickens could have saved passenger pigeons. How environmental issues are framed has everything to do with how they are solved, and whether they are addressed at all. Private institutions and private property effectively harness man's self-interest to advance the public interest. Sustainable development requires that we explore the same options for dealing with environmental problems that we use for other important matters such as food and housing. There is no reason to believe that environmental matters must be handled in a substantively different manner than anything else.

Unfortunately, most people do not see it that way. For most people, the sustainable development problem is the "terrible toos" problem. Sustainability is threatened by *too* much unnecessary consumption, *too* rapid an introduction of untested technological innovations, *too* many unwanted children, and existing wealth that is far *too* poorly distributed. The United Nations Earth Summit in June 1992, which I attended, adopted this dominant intellectual motif. If implemented, both economic and environmental values will be the worse for it.

Countering Malthus

"Carrying capacity" is exceeded, the argument goes, when the demand for resources exceeds the supply. When carrying capacities are exceeded, populations precipitously decline. From the Reverend Malthus to today, intellectuals have warned that human beings would exceed the carrying capacity of the planet. Hence, the call for "sustainable" development—a form of development that ensures that carrying capacity is never exceeded.

Recall the definition put forward by the World Commission on Environment and Development, chaired by Gro Harlem Brundtland: "Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs."[2] In this sense, sustainability requires that, as resources are consumed, one of several things must occur: a) new resources must be discovered or developed; b) demand must be shifted to more plentiful resources; or c) the demand must be met in another manner. In sum, the Brundtland thesis is that as resources are used, they must be renewed or replaced.

Malthusians believe that this generalized replenishment cannot continue indefinitely. Reverend Robert Malthus asserted that "population, when unchecked, increases in a geometrical ratio. Subsistence increases in only an arithmetical ratio." This, Malthus argued, would result in mass starvation.

In his later revisions to his work on population, Malthus began to suggest that such outcomes were not inevitable. And, in fact, increases in food production have generally outpaced increases in population. Historically, except in those regions where political turmoil reigns, per capita consumption of food has improved steadily for decades. Moreover, it is likely to improve equally dramatically in the future, as the shift of formerly communist nations toward market economies will further expand world food supplies.[3] After all, it will be very difficult to produce less in those regions than was produced under communist regimes.

A second era of concern occurred in the area of energy supplies, such as coal. Based on "scientific calculations," Lord Jevons worried that the world was running out of coal. Jevons would have been shocked to realize that although we have used far more coal than he dreamed possible, proven reserves have expanded even more rapidly. As a result, coal reserves are now measured in centuries, not years. Similar trends can be observed with other resources. World proven oil reserves have grown rapidly, reaching all-time highs, despite major increases in consumption. Whereas a decade ago politicians fretted about exhaustion of the world's oil resources, few give credence to such fears today.

For yet another example, consider the state of America's forests. A century ago, Gifford Pinchot warned that "The United States has already crossed the verge of a timber famine so severe that its blighting effects will be felt by every household in the land." At that time, Americans were clearing almost 9,000 acres a day, a rate that continued for 50 years. America needed wood to build homes, fuel furnaces, and lay rail lines. Despite these trends, today there are more trees in America's forests than at any point in this century. This forest regrowth has been led not by the U.S. Forest Service—whose lands are chronically mismanaged—but rather by private landowners. Some, like the railroad companies, engaged in replanting solely to meet their own demands; others planted either for speculative purposes or for the simple reason that they could.[4] Gains in agricultural productivity have allowed the conversion of farm lands to forests. In fact, several eastern wilderness areas include lands once cleared for agricultural or other uses. The market system, founded on a system of transferable property rights, worked. The rebirth of America's forests is a testament to that fact. This system would also work in many other areas—if we let it!

Necessity Is the Mother of Invention

In the United States, about every 10 to 20 years, Malthusian fears sweep the nation. However, whenever the facts are examined, it becomes fairly clear that we are not going to run out of resources after all. Something is constantly going on to replenish resources and ensure sustainability. What's "going on" is that when available resources run low, prices increase and market incentives encourage people to produce more. If the material in question is truly limited, then there is an incentive to discover new approaches or sources. Hence, scientists and technologists discovered how to replace tons of copper wire with sand. Sand, in the form of silicon fiber optics, has vastly reduced the need for copper wire.

Sustainable development depends upon an institutional framework that relates demand and supply through the market.

The demand for more communication was the necessity that created this miraculous invention.

Sustainable development, however, is not a function of demand alone. Sustainable development depends upon an institutional framework that relates demand and supply through the market. In a free-market system based upon private property, entrepreneurs and innovators are encouraged to innovate to ensure that we have more tomorrow than we do today. But there is nothing cornucopian or "inevitable" about such improvements. Positive trends are assured only if we create the proper institutional framework. Still, the empirical evidence is clear: Resources integrated into a private property system do, in fact, achieve "sustainability."

Ensuring Sustainability: Private Protection of Commercial Resources

Can this observed sustainability be extended to the full range of environmental resources? Yes, although not without some difficulty. Ecological resources are already integrated into the marketplace through property rights in many areas. The task ahead is to extend these institutional arrangements to those environmental resources heretofore excluded from the private property rights system.

Consider the beaver in pre-colonial Canada.[5] Originally, there were many beavers and relatively few Native Americans. The result? Small demand, stable situation, and little danger of beaver extinction. Then the French arrived and created a market for furs. Moreover, the French provided guns and traps, which made it easier to hunt beavers. As a result, the cost of acquiring beavers dropped precipitously and Indian settlers sought to take advantage of the situation. The beaver population was very quickly in danger of extinction.

Property rights have a tremendous potential of protecting ecological resources.

Native Americans in that region recognized what was happening. With increased demand pressures, the traditional common property approach was no longer working. In the past, beavers were hunted anywhere by anyone, but now they were disappearing. This is the proverbial "tragedy of the commons."

To respond to the beaver decline, the Native Americans in the region elected to divide the area such that each indigenous community had responsibility—essentially ownership—of the beavers in its area. Each group was given the ability to manage its beavers as it saw fit. Under that new allocation of property rights the beaver population quickly stabilized. Each community managed its local beaver population in a sustainable fashion.

This system prevailed until the English arrived approximately 100 years later. The English did not respect the Native Americans' property rights in beavers—or anything else. As a result, the private protection regime broke down and the beavers were quickly hunted to the verge of extinction. This story suggests that property rights have a tremendous potential of protecting ecological resources, but only if such private property rights are actually honored and defended by the political system.

Ensuring Sustainability: Private Protection of Non-Commercial Resources

The example of the beaver in colonial Canada is an economic one. The economic value of the beaver to the outside world and to the indigenous population led institutions to evolve that made sustainability achievable. Yet non-economic examples—examples where there was little commercial value—also exist. For instance, in the early part of the 20th century, the United States had a policy about hawks. The policy was very clear: Kill them! Hawks were predators; they preyed on chickens and other valued animals. The government paid bounties to kill chicken hawks. At the time, shooting birds was considered good practice for young men who might soon serve in the military.

Not everyone was pleased with this policy. One individual, Rosalie Edge, argued that hawks were worthy of protection. She valued hawks for their own sake and wanted to protect them. The Audubon Society, which already maintained a growing network of wildlife sanctuaries, declined to help her effort, arguing that protecting birds of plumage, game birds, and songbirds exhausted its resources. Given the political views of that era, a legislative solution was impossible. Most voters wanted to exterminate hawks, not save them. As a result, Edge sought to protect hawks privately.

Edge purchased a mountain ridge in Pennsylvania known as Hawk Mountain—called that because the ridge provides a useful updraft and had always attracted large numbers of hawks. The ridge was also a favorite spot for hawk hunting. Thousands of hawks were killed at this site until she bought the mountain ridge and posted the land against hunting. Gradually, she educated the public on the value of a species, not initially popular. Hawk Mountain is now one of the leading raptor research centers in the world. Such a solution was possible only via the institution of private property rights.

Property rights are a means of empowering individuals to act as environmental stewards.

In a world where property rights can be privately acquired, people have the opportunity to create safe havens or refuges. Individuals who value ecological amenities can then play a critical role. A handful of people can make a difference. In politics, when the prevailing majority is not interested, the minority has few options. Property rights, then, are a means of empowering individuals to act as environmental stewards. They allow us to integrate environmental concerns into our general value system.

Private Property Encourages Cooperative Solutions

Environmental policies are generally discussed in the framework of market failures: Markets fail to account for environmental values. Pollution, for example, is considered an "externality" that the market fails to resolve. But there is something wrong with that argument about pollution. If it were true that pollution is a function of markets, then one would expect that the less market-oriented economies of the world would have cleaner ecologies. In fact, the reverse is true. Market economies not only produce more high-quality goods and services, they do so in a more efficient and environmentally sound manner.

Moreover, policy makers often talk about market failures. However, there is little discussion about the failures of government. The reality is that political management has not done very well at protecting environmental resources. The creativity of a decentralized private approach is not readily achieved within a political bureaucracy. Moreover, political institutions do not foster accountability. The individuals who make resource-use decisions in a bureaucracy are rarely those who bear the costs or receive the benefits of such decisions.

Take the contentious issue of oil drilling in the Arctic National Wildlife Refuge (ANWR) and compare it to the reality of oil development in the Audubon Society's Paul J. Rainey wildlife sanctuary in Louisiana. Both of these areas are valued by environmentalists. Both also sit above oil deposits. In the case of ANWR, we have witnessed political gridlock. To put it very simply: The environmentalists want it preserved, and the oil companies want to drill. ANWR is a political football in the congressional debates over environmental and energy policy.

Rainey is different. This refuge is owned privately by the Audubon Society, rather than by the federal government. At this site, Audubon has the ability to exclude all visitors and activities that could damage the refuge or threaten the animals that live and breed there. Audubon could have prevented all oil development at Rainey. They chose not to do so. Preventing oil development would have required foregoing the economic benefits of that development—economic benefits that could fund other environmental efforts. As a private owner, Audubon had an incentive to reconcile the very same interests that are in conflict in the case of ANWR. Audubon developed an oil extraction plan that would allow drilling but also protect Rainey's ecological values. They did so by making accommodations: no drilling during the breeding season, a smaller oil platform, spill prevention and containment plans to prevent contamination, and the like. Oil production has been occurring under these conditions at Rainey for over 20 years with little problem.

Politics too often encourages conflict and a zero-sum game.

Because of Audubon's private ownership, it was possible to integrate the human economic and ecological concerns. Private ownership encouraged people to work toward this type of win-win solution. Politics too often encourages conflict and a zero-sum game. Where politics has been dominant—as in the case of ANWR—conflict, not accommodation, has been the rule.

Private Property: An Alternative to Eco-Imperialism

Some of you may be familiar with the remarks of Mostafa Tolba, executive director of the U.N. Environment Program, who complained that "the rich are more interested in making the Third World into a natural history museum than they are in filling the bellies of its people."[6] Environmental paternalism is not likely to prevail in a world where people count, too.

The U.S. spotted owl situation has created great tension between economic and ecological interest groups. Cutting restrictions aimed at protecting the owl threaten the economic livelihood of whole regions. This tension is unnecessary, as an earlier example of a bird endangered by exactly the same situation, the wood duck, illustrates. Unlike most ducks, the wood duck nests in trees. The forest nesting habitat for these ducks was disappearing. There was no Endangered Species Act or political protection program; therefore, people concerned about the wood duck survival found a way of creating a new habitat for it—an artificial nesting box.

Many of us would rather live in colonial mansions, but if worse comes to worst, we can live in one-bedroom apartments. It turned out that the wood duck could modify its living habit as well and was quite able to live in the new artificial habitat. Wood ducks are now so plentiful that in recent years the Fish and Wildlife Service has recommended that hunters kill this duck first. It is important that in the zeal for environmental protection, environmentalists do not preclude alternative efforts. Unfortunately, current laws discourage such action by reducing the private value of lands in which endangered species are found.

Empowering Private Environmentalism

How do we get there from here? Initially, we should require government to take an Ecological Hippocratic Oath: First, do no harm. As many have pointed out, governments are doing vast ecological harm through their many programs, some based on fostering environmental protection. The United States is not a place where sugar should be grown, yet farm subsidies encourage this. No profit maximizing individual would harvest timber on the eastern slopes of the Rockies, yet such practices are fostered by the U.S. Forest Service.

Capitalists may cause ecological damage, but at least they try to make money doing it. The same cannot be said of many government programs. Too often the political process tries to create concentrated benefits through the imposition of generalized costs, such as environmental damage. This makes for disastrous public policy.

Outside the U.S., property rights approaches are even more important. In much of the world, property rights exist, but these rights are restricted to a "use it or lose it" role. One can own the property, but only if used for a specified purpose. Thus, land in the Brazilian rainforest or grazing allotments on federal lands, must be developed or be lost. Such property rights are too limited. Without authority over how the property is to be used, the owner does not have sufficient incentive to act as a responsible steward. Environmentalists constantly fret over whether private property will be used in undesirable ways, but rarely consider whether policies discourage the use of property for conservation purposes. Without rethinking the role of private property, encouraging further private conservation activities will be very difficult.

Without authority over how the property is to be used, the owner does not have sufficient incentive to act as a responsible steward.

Global Issues

Rather than encourage property rights and free markets abroad, the conventional wisdom in environmental circles is to grant foreign aid to developing countries, while requiring environmental safeguards enforced via trade agreements. Such efforts are folly. Foreign aid too often is aid from governments, to governments, for governments. It rarely gets to the people who need it, and even more rarely fosters broad-based environmentally friendly economic development. I attended the Rio Earth Summit. A Brazilian friend was driving me around. As we were going through downtown Rio, he pointed to several large buildings and said, "We call that the Brazilian Triangle." "You mean the Bermuda Triangle?" I asked. "No, no," he responded, "the Brazilian Triangle. Those are all government investment agencies. Billions of dollars have gone in and never been seen since." As environmental organizations such as Probe International in Canada have documented, foreign aid has largely created environmental destruction and expanding Swiss bank accounts, not sustainable economic development.

As for trade, let me focus on the Convention on International Trade in Endangered Species, known as CITES. As documented in a recent *New York Times Magazine* article, "Crying Wolf Over Elephants" by Raymond Bonner,[7] and the book from which it was adapted, *At the Hand of Man*, too many in the environmental movement have decided to sacrifice elephants in favor of effective fundraising.[8] By preventing international trade in ivory, we deprive Africans the use of an extremely valuable commodity. Yet, if development is to occur, resources must be utilized—even resources with such emotional appeal as African elephants. Eventually the CITES decision to ban international trade in elephant products will be reversed, but not before it adversely impacts thousands, if not millions, of Africans. Wealthy Americans may well believe that four-legged Africans are important, but they must never forget that two-legged Africans are, as well.

We also need to recognize and honor the diversity of values around the world. American environmental priorities are not shared by much of the world. Our obsession with cancer risks in the Third World could result in policies negatively impacting the rest of the world. In Brazil, concern over water pollution is not focused on parts per billion of theoretically carcinogenic chemicals, but rather on the very real risks of bacterial and other contaminants that kill people throughout the developing world. In these countries, few live long enough to fear cancer.

Conclusion

Sustainable development in an integrated world requires that we explore the full range of policy proposals. I have suggested that the U.S. political control strategy is failing and should not—indeed cannot—be extended to the developing world. In the United States, we spend hundreds of billions of dollars on environmental issues (over 2 percent of GNP according to 1990 EPA estimates).[9] We rely on an army of highly skilled technocrats, both within government and within the affected industries; we also depend on a civil service largely immune from bribery and corruption. The rest of the world does not have those billions of dollars, those unemployed technicians, and an unimpeachable civil service. If we are going to protect Spaceship Earth, we need to develop more robust institutional arrangements than politics provides.

If we are going to protect Spaceship Earth, we need to develop more robust institutional arrangements than politics provides.

Eco-privatization, the extension of private rights to the vast range of resources that have been left outside the marketplace, provides such a robust alternative. Trees cannot have standing in a court of law, but behind every tree—as well as behind every whale, aquifer, forest, and stream—can stand a private group or individual empowered to protect that resource. Such stewards, by protecting their resources, would protect the planet for the rest of us.

Consider the protection of biodiversity. Some argue that there are as many as 10 million to 100 million species of flora and fauna that

Environmental resources are too important to leave to politicians.

deserve protection. There are in the world today fewer than 200 governments, most of which are doing a dismal job of protecting their human populations. Do we really think a few hundred governments are going to protect 10 to 100 million anything? Yet, there are five and a half billion people on the face of the Earth. If people play a stewardship role, our odds of protecting the environment are vastly improved. Not all people will care about conservation, but certainly far more will than under the current political arrangement.

The challenge we face is how to integrate the human valuation of economic and ecological welfare. To date, political approaches have been relied upon almost exclusively to achieve this goal. As a result, environmental resources today depend on politicians for their protection. I believe this has been a mistake. Environmental resources are too important to leave to politicians. At the least, the private alternatives I have suggested warrant greater attention.

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AUTONOMY: THE LIBERATING BENEFITS OF A SAFER, CLEANER, AND MORE MOBILE SOCIETY

America's love affair with the automobile has become a cliché, often a snide one. But in the early days, there was real passion. "You know, Henry, your car lifted us out of the mud," a farmer's wife living near Rome, Georgia, wrote to Henry Ford in 1918. "It brought joy into our lives. We loved every rattle in its bones."

Even American reformers and intellectuals were favorably inclined. In his 1916 book, *The Romance of the Auto Industry*, James Rood Doolittle expressed the belief that the car would "increase personal efficiency … make happier the lot of people who have led isolated lives in the country and congested lives in the cities; [and] … serve as an equalizer and a balance." Conservationists saw the automobile as a great advance—no longer would vast quantities of fertile farmland be lost feeding horses. And, with mobility, rural youth might even stay on the farm, rather than rushing away to the big city.

But those early positions have long vanished. Today's intellectuals and reformers have little respect for the automobile—or for automobile culture. The car's very convenience seems an indulgence, a waste of resources and money. "The Soviet Union's greatest contribution to world peace was the fact that it did not put a car in every Soviet citizen's garage," says Ralph Nader.

Political activists such as Nader have no monopoly on hostility to the automobile. Among the well-educated and well-to-do, nostalgia for train travel and paeans to subways are as common as complaints about traffic congestion. But those who prescribe subways for America's cities rarely hold the jam-packed trains of Tokyo up as a paragon; the Washington Metro, whose modern cars often travel all but empty, is a more appealing model. And those who sing the praises of mass transit are the first to complain about crowded airplanes. One begins to suspect that the problem with automobiles is that they're too democratic: They let too many people on the road.

The specific charges levied against the only truly democratic form of transportation are many: the destruction of traditional urban America, condemning Americans to the sterility of suburbia; the deaths of over 40,000 people annually; the consumption of vast quantities of "nonrenewable resources;" the fouling of our air and our climate; congestion that has made a mockery of the car's promised mobility. Critics assert that Americans must renounce this faithless machine and accept the virtues of collectivist transportation. Schemes ranging from doubling the gasoline tax to odd/even rationing plans to outright bans of automobile ownership are eagerly proposed.

But the charges lodged against the automobile are largely incorrect, and the accompanying prescriptions are flawed. The coming of the automobile not only brought mobility, but also relieved pollution and improved safety. And many of the problems associated with automobiles are the result of too much, not too little, political control.

The coming of the automobile not only brought mobility, but also relieved pollution and improved safety.

The reformers' rejection of the automobile reflects, in part, their distaste for capitalism and its main beneficiaries. Intellectuals have particular contempt for the self-expressive gaucherie of American car culture—tail fins, hot rods, drag racing, and, worst of all, the Pink Cadillac. To a large degree, their hostility to the automobile is simply a manifestation of their larger hostility toward unfettered American individualism.

The automobile offers not only personal mobility but personal space. Ensconced within their cars, drivers may sing along with the radio, avoid panhandlers, hang fuzzy dice on their rearview mirrors, put on makeup, and otherwise behave as if they were in their own homes. Early car proponents noted that automobiles, as opposed to public transit, preserved women's modesty, protecting them from pawing or unsavory gazes from strangers. Of course, automobiles from the beginning also provided convenient sites for lovemaking.

By giving individuals control over when and where they go, automobiles render impossible the planned world so desired by the coercive utopians—those well-meaning despots who seek to stifle human nature and thereby save humanity. As Brock Yates, former author of "The Dream Machine" column in *The Washington Post*, has noted: "The ownership [of cars] is discouraged in totalitarian societies. A mobile population is a population essentially out of control of centralized government."

When *The Grapes of Wrath*, the powerful film depicting the plight of the Depression-era rural poor, was shown in the Soviet Union, audiences were struck less by the pitiable condition of the Joad family than by their mobility. "I will never forget the American film made from Steinbeck's *Grapes of Wrath*," wrote Lev Navrozov in his 1975 book, *The Education of Lev Navrozov*.

> The author and the filmmakers wanted to show the life of the poor in the thirties. The poor rode about in trucks. The Russian audience stared. Even a small dingy car 30 years old is a status symbol here perhaps as high as a yacht in the United States. But the ownership of a truck is something as would, in the United States, be the ownership of, say, a fleet of dirigibles. The audience perceived Steinbeck's wrathful message of poverty as a futuristic fantasy about extraterrestrials riding about in their fleets of dirigibles.

Although the automobile was not invented in America, it was here that mobility was first democratized.

Although the automobile was not invented in America, it was here that mobility was first democratized. In the late 19th century, cars were the toys of the rich—beautiful handcrafted items requiring vast effort to build and maintain. The automobile, Woodrow Wilson feared, would stimulate socialism by "inciting the poor to envy the possessions of the rich." And in Europe, cars did remain unavailable to all but the wealthiest until after World War II.

But in America, Henry Ford's populist vision and capitalist genius put the world on wheels. His pioneering assembly-line production methods could produce a car in 70 man-days; in Europe, where carriage-trade practices still held sway, 3,000 man-days were required. When the Model T was discontinued in 1927, over 15 million had been sold.

European governments saw cars as luxury items and adopted policies early on that kept them in that class until after World War II. From the beginning, very high horsepower and fuel taxes priced automobiles out of the range of moderate-income Europeans. (In the British Parliament, Herbert Asquith argued in 1907 that a tax on cars was "almost an ideal tax because it is a luxury which is apt to degenerate into a nuisance.") No such restrictions hampered American industry, which responded by producing inexpensive autos that quickly increased in quality and performance.

American manufacturers also had the benefit of a more promising customer base than Europeans. The flat terrain of the Midwest was more suitable for early, poorly powered automobiles than mountainous Europe, and the large and relatively prosperous rural population was already familiar with steam- and gasoline-powered farm machinery. In 1908, when Ford introduced the Model T, half the U.S. population lived on farms or in towns of less than 2,500. Farmers eagerly adopted the automobile, and it dramatically changed rural life. In 1909, *Collier's* reported that in Iowa one out of every 34 farmers owned an automobile, versus one family out of 190 in New York City.

Entrepreneurs reinforced this demand by pioneering rational consumer financing arrangements. General Motors Acceptance Corporation was launched in 1919. Within two years there were more than 100 car-financing companies in the United States. Buying on time made it possible for most employed Americans to gain automobility.

Consequently, the growth in car ownership in America was explosive. In 1910, there was one car for every 44 households; by 1930, it was one for every 1.3 households. England didn't reach that level until 1966. In 1929, the U.S. companies manufactured 5.3 million motorcars—10 times the total of the combined output of all the rest of the nations of the world.

Eight thousand vehicles were registered in America by 1900; by 1940, the number had reached 32 million.

Before the coming of the car, many Americans relied on the sort of fixed-schedule mass transit prescribed by today's auto critics—trains, subways, and trolleys. Trains, in particular, were vital to rural life. But depending on a combination of horses and fixed transportation rendered the rural population essentially immobile.

Although we associate the car with urban sprawl, it also created new metropolitan areas by bringing small towns together.

The speed of the horse was only about six to eight miles per hour, and a horse could only go about 25 miles without extensive rest. To travel the 25 miles from Oregon, Illinois, to the neighboring town of Rockford, for example, took about four hours by horse. Most people, however, took the train, confronting a fixed schedule that made one-day round trips nearly impossible. (Norman T. Moline's study of Oregon, *Mobility and the Small Town, 1900–1930*, provides a detailed look at the automobile's effect on life in rural communities.)

Before the automobile, Oregon residents made understandably few trips to Rockford. A diary kept by Oregon resident Hugh Ray records three trips to Rockford from 1901 to 1903; 10 years later, the Ray family could travel with auto-owning friends and made eight trips from 1911 to 1913. After the Rays bought their own car in 1916, they began to visit Rockford every three or four weeks.

The automobile, which traveled more slowly than a train but adhered to its owner's personal schedule, knit Oregon, Rockford, and surrounding communities together. Although we associate the car with urban sprawl—

cities spreading out from their centers into the suburbs—it also created new metropolitan areas by bringing small towns together.

For city dwellers, mobility began to improve prior to the automobile. Both the bicycle and street railroads created swifter means of travel about urban areas. The "safety bicycle" was first popularized in 1885 and laid the basis for the industrial structure that would soon be converted to automobiles.

By 1900, there were some 850 electric trolley systems operating over 10,000 miles of track. Today, anti-car intellectuals look back on the trolleys as Edenic carriages overthrown by the automobile serpent. Trolleys did provide clean, reasonably priced service, but they were inflexible and there was no easy way to bypass a disabled vehicle. The costs of building and maintaining the rail infrastructure were very high.

Nor were trolleys immune to public criticism. By 1918, the Los Angeles streetcar system's five-cent fare could no longer cover its costs, but public resentment made increases politically impossible. Riders complained bitterly about being forced to stand in crowded cars. "Is it not about time you took steps to ascertain just why the Pacific Electric [the famous Red Cars] gets by with the putrid brand of transportation they are dishing out?" a Venice citizen complained to the local board of trustees in 1920. "Is there no redress for the hundreds of citizens in this community who are forced to pay high fares—to be handled like cattle?"

Long before the freeways, Angelenos were escaping public transit and buying private automobiles at a far greater rate than other Americans. In 1915, Los Angeles had one car for every eight residents, compared to a national average of a car for every 43 people. These cars caused downtown traffic jams—less when they were moving than when they were parked.

Then, as now, many drivers expected to park at the curb for free, as they had in the days of horses. The city briefly tried to ban curbside parking from a congested area of downtown, only to face a political rebellion. Eventually, the city backed down, the streets remained crowded, and paid parking lots began to appear. More importantly, stores moved out of downtown to less crowded areas where they could provide private parking lots for their customers. Contrary to the claims of automobile critics, such “free” parking does not constitute a subsidy, since it is included in the store’s cost of doing business and passed along to customers in the prices they pay. The same cannot be said, however, for free curbside parking.

Los Angeles also pioneered a common Progressive-Era policy: squelching the private jitney services that sprang up to offer commuters group transportation via automobile. Some jitneys were full-blown businesses, running regular routes or offering door-to-door service. In other cases, commuters simply stuck signs in their car windows announcing their destinations and charged a nickel to any passenger going their way. The jitneys cost the same as streetcars but carried passengers at speeds 150 percent to 200 percent faster.

Said Atlanta jitney proponent and auto dealer George Hanson:

> Jitneys mean convenience in transportation to the public never dreamed of before by those who have ridden on badly heated and badly lighted streetcars which have dumped them off at street corners, in the middle of the street, probably in a mud

As car ownership increased, people began to demand better roads.

puddle. Not so with the "jitney." The ladies will not have to get their feet soaked with rain and mud. The "jitney" will drive you to the curbstone in front of your residence.

Naturally, such service posed a grave threat to the financially troubled streetcar monopolies, and cities from Los Angeles to Atlanta quickly moved to outlaw or severely restrict jitney service—depriving urban dwellers of an inexpensive form of "public" transportation that offered much of the automobile's comfort and flexibility.

Politics also intervened in road building. As car ownership increased, people began to demand better roads. The first American limited-access highway exclusively for automobiles was a 45-mile, privately built toll road linking Great Neck, New York, to Lake Ronkonkoma—the Long Island Motor Parkway, begun in 1908. However, toll roads were opposed by the highway establishment, and politicians rushed to preempt private solutions.

One spokesman noted that a toll road would generate only 30 percent new traffic, while a "free" road might generate twice that amount. The concept that traffic volume, rather than willingness to pay, was the appropriate measure for determining highway decisions introduced a major bias into highway investment and operating decisions. Roads were justified on the basis of proposed usage levels, not on the basis of the value of that usage. (The value of roads need not only have been measured by tolls; traditionally, many roads had been paid for and maintained by the adjacent property owners, who wanted access to their homes, farms, or businesses.)

To finance road construction, state governments elected to focus on more-diffuse tax approaches rather than tolls. The early preference was for the gasoline tax. Oregon, New Mexico, and Colorado were the first states to impose this "user fee," beginning in 1919. By 1929, every state and the District of Columbia had imposed such taxes, generally at about three cents a gallon.

Unlike Europeans, Americans have tended to restrict gasoline taxes to road-related projects. But that principle has gradually eroded, as other political constituencies—including anti-car groups—have gained power. In 1982, for the first time, Congress diverted one cent per gallon of the increased federal gasoline tax to mass transit. Later, politically preferred fuels (ethanol and methanol) were exempted from the federal user-tax system.

The automobile's critics often note the irony of a technology that promises mobility ending in gridlock. But, of course, most drivers make most trips without ending up stuck in traffic. And congested highways are not inevitable. The very concept of "congestion" is an artifact of political control. Early on, we opted for a financing system that severed the relationship between the price paid for access and value to the user. Drivers who use uncongested roads or who travel at less popular times of day pay the same gas taxes as people who clog the freeways at rush hours. And there is no incentive, other than political pressure, to add capacity to overcrowded roads.

Pre-car America bore less resemblance to the spotless museum world of Colonial Williamsburg than to a stockyard.

Can one imagine a private provider viewing a situation in which too many people wish to use his services at current prices as a "problem"? Yet in the absence of a rational pricing policy, the only rationing system available is based on the willingness to sit still on the freeway. Although it creates a vibrant market for car phones and books on tape, this is not the way a reasonable system allocates resources.

Cars create pollution. This most common indictment of the automobile is, of course, true. But it's also true that cars may well have dramatically decreased overall pollution.

Pre-car America bore less resemblance to the spotless museum world of Colonial Williamsburg than to a stockyard. A horse produces approximately 45 pounds of manure each day. In high-density urban environments, massive tonnages accumulated, requiring constant collection and disposal. Flies, dried dung dust, and the smell of urine filled the air, spreading disease and irritating the lungs. On rainy days, one walked through puddles of liquid wastes. Occupational diseases in horse-related industries were common.

In this day of animal rights, it is hard to imagine a world of dray horses dying in harness, but that world is less than a century behind us. New York City in the 1880s removed 15,000 dead horses annually. Like the car carcasses of today, they were not always disposed of in a timely fashion. And an abandoned horse is a far more troublesome nuisance than its modern equivalent.

The Club of Rome did not pioneer predictions of doom that ignore technological innovations. In 1885, A British writer described the future of London:

> It is a vast stagnant swamp, which no man dare enter, since death would be his inevitable fate. There exhales from this oozy mass so fatal a vapour that no animal can endure it. The black water bears a greenish-brown floating scum, which forever bubbles up from the putrid mud of the bottom. … It is dead.

From this we were saved by the automobile.

The automobile also encouraged developments that reduced air pollution. Before the automobile, most urban homes and businesses were heated with coal, an extremely dirty source of energy that spewed sulfur dioxide, particulates, and toxic ash into the air. As the demand for gasoline stimulated oil exploration, heating oil and natural gas became cheaper and more readily available.

Of course, as other sources of air pollution were reduced, the automobile became a significant residual source of various air pollutants, particularly carbon monoxide, hydrocarbons, and nitrogen oxides. Even today, however, these emissions pose neither health nor visibility problems in most places. But under selected climatic conditions, in dense urban areas, these pollutants can cause a level of discomfort that the inhabitants find unacceptable. This happens regularly in a very few cities (notably Los Angeles and Houston) and a few times a year in some other cities. Rural areas are not troubled by poor air quality.

New risks are always weighed more heavily than are older, more-accepted risks, and the automobile is no exception.

A rational society seeking to ensure wise management of airsheds would devise institutional arrangements that harnessed pollution-mitigation technologies to the incentives of those causing the polluting—charging specific polluters for the specific harms they do. Instead, we have instituted a moral crusade against the sin of emission (and against the automobile). By failing to recognize that emissions can create more or less damage depending upon whether they occur in rural Missouri or downtown Los Angeles on a summer day, we spend most of our resources controlling emissions in areas where no pollution occurs.

In *Rebel Without a Cause*, James Dean competes in a suicidal drag race. The film fate of his challenger foreshadows Dean's own death in the California desert at the wheel of a Porsche Spyder bearing racing stripes and the legend "Little Bastard" on the tail. The automobile as animistic evil force is later explored in Stephen King's *Christine*, which features a blood-red 1957 Plymouth Fury as the automobile equivalent of Dr. Frankenstein's monster.

These are extreme expressions of a widely held view that automobiles are inherently dangerous. The belief that the automobile has made the world less safe is natural for a conservative people. A new technology introduces new risks, even when it makes the world much safer. Safety can only be increased by prudent risk taking. Fire introduces the risks of burns and asphyxiation; this is outweighed by the reduced risks of exposure, starvation, and wild animal attacks. But new risks are always weighed more heavily than are older, more-accepted risks, and the automobile is no exception.

Indeed, early cars were by all accounts unsafe. A turn-of-the-century postcard depicts a motorist leaning out of his car to ask a hunter in the field, "Killed anything yet?" He receives the reply, "No, have you?" Early cars combined relatively high power with an absence of reliable braking, steering, suspension, and other safety features.

The roads were little more than cleared paths, and the experimental vehicles of the day were often shaken apart.

But even the early cars were seen as much safer than horses. Rene Bache, writing in *The Saturday Evening Post*, reported that some three-quarters of a million people were injured by horses in 1900. In 1899, *Harper's Weekly* said, "a great many folks to whom every horse is a wild beast feel much safer on a machine than behind a quadruped, who has a mind of his own, and emotions which may not always be forestalled or controlled." Women and the elderly, in particular, could not always control a horse team. And the brakes and other controls of the early cars were already superior to those of horses.

The automotive industry began to introduce safety features almost immediately. Typically, a new feature would be introduced on a luxury brand and then over the next four years would become standard equipment on most cars. Four-wheel hydraulic brakes, balloon tires, and laminated glass windshields were all widely available by 1927. Unlike horses, cars could and did rapidly increase in safety over time. In 1921, there were 25.3 highway fatalities per 100 million miles of travel; in 1941, there were 12.0, and in 1947, 8.8. The figure had dropped to 5.2 by 1966 and to 2.2 by 1989.

We should also recognize the risks of an immobile society, and the advantages of rapid and flexible transportation, particularly in emergencies.

We should also recognize the risks of an immobile society, and the advantages of rapid and flexible transportation, particularly in emergencies. After the wealthy, the first group to purchase automobiles was physicians. Urban doctors initially accounted for more vehicles than all commercial uses, and the country doctor was the first rural inhabitant to adopt the automobile. The November 1905 edition of *The Horseless Age*, a magazine promoting automobiles, printed 89 articles written by doctors describing their experiences with cars. Automobiles could travel more quickly than horse-drawn vehicles and often withstood blizzards and heat waves better than horses.

Automobiles have done much to improve the world. They have increased mobility, reduced pollution, and improved safety. But the success of the automobile, paralleling the success of capitalism in general, has enraged rather than appeased its enemies. That is why efforts to make the system work more effectively (privatization, tolling, targeted pollution-control strategies, deregulating insurance) are vehemently opposed by the automobile haters.

The unfettered, unstructured, private nature of automobile travel offends them. Their goal is not to rationalize transportation resources, but to force people out of their cars. But people won't leave their cars easily. As Richard Smith, a Lexington, Kentucky, resident, told researcher Priscilla Lee Denby, "The normal person would not squawk as much, numerically speaking, to have to give up freedom of the press, etc., as freedom to travel. This freedom is his privacy. I think if you took individual cars away, the psychological stress would be incredible."

Economist Kenneth Boulding, quoted in *The Green Lifestyle Handbook*, describes the automobile as a "suit of armor with two hundred horses inside, big enough to make love in." He notes, "Once having tasted the delights of a society in which almost everyone can be a knight, it is hard to go back to being a peasant."

But, the anti-car groups realize, if America won't rush into this masochistic policy, how can we ask the rest of the world to forgo economic growth? This won't be easy. "Trouble is," notes auto critic Michael Walsh, writing for the World Watch Institute, "we don't have the political mechanisms to impose pain on citizens in a democratic society." Not yet, anyway. Individual autonomy irritates those who long to mold society to their own tastes. It's not surprising that this paternalistic Daddy wants to take the T-Bird away, for good.

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Civilization can be seen as the gradual evolution of ever more creative risk management.

COWBOYS VERSUS CATTLE THIEVES

The Role of Innovative Institutions in Managing Risks along the Frontier

Civilization can be seen as the gradual evolution of ever more creative risk management—from the family and private property to derivatives and structured financing arrangements. The goal is to permit an ever-greater scope for the prudent assumption of risk. Because knowledge is dispersed, only that expanded scope offers any hope of fully using the varied skills of all the peoples of this planet. Civilization is the story of the advances and retreats of such prudent risk management expansions.

Civilization makes it possible to better manage risks in the financial, technological, and social fields. Indeed, a reasonable metric for assessing the level of civilization is mankind's success in evolving institutions that permit an ever-larger scope of prudent risk taking. Prudence is best defined as a careful calculation of the risks of change versus the risks of stagnation—and the development of institutions that encourage that careful balancing.

Risk management is most important and least developed at the frontier of civilization. There, not only do new risks emerge, but also old risks are encountered in new guises. Moreover, innovation on the frontier is undertaken by individuals who are self-selected risk takers. Finally, the institutional arrangements for managing risks in these areas are often embryonic. Note that the cowboys of the Old West were often portrayed as renegades and misfits, yet they played a critical role in policing borderless boundaries—reducing the risks to the cattle herds from wandering and rustling. Indeed, until the advent of barbed wire, the cowboy was the central feature of the risk management landscape, as well as perhaps the most often misunderstood.

A thin line separates the cowboy from the rustler.

Most individuals attracted to the frontier share similar goals—love of adventure, the spirit of competition, the thrill of innovation and discovery, and the willingness to take chances. It is not always easy to distinguish legitimate entrepreneurs and risk managers from frauds and miscreants. A thin line separates the cowboy from the rustler—in some cases, cowboys succumb to the weak monitoring of their activities and themselves become the cattle thieves.

Of course, all organizations face this traditional principal/agency risk—the risk that an employee will take advantage of his localized knowledge and power to advance his personal agenda at the expense of the organization. The confusion that characterizes activity on the frontier makes this all the more likely. And the focus on the novel risks present along the frontier too often leads to weakened scrutiny of traditional risks. Often old errors occur in these new settings, largely because they are not recognized as such and the older risk management strategies are less effective in the new setting.

And, when the inevitable errors do occur and potential risks become real losses, the instinctive response is often to retreat, to restrict the innovation. Rarely do policy makers consider whether existing policies might have made such losses more likely or whether modifying or strengthening some element of the competitive process might have reduced them. Too often, the inevitable losses associated with the trial and error process lead to quixotic attempts to seek a trial without error approach.

The Enron story follows this scenario. That Enron was staffed with cowboy entrepreneurs is not disputed. The real question is: When, where, how, and why did some of these legitimate risk-managing cowboys stray and become rustlers? And, more important, why did the traditional safeguards that had prevented such straying in earlier years fail? Why did the institutions—both private and political—designed to detect and prevent such a migration from legitimate entrepreneurship to abusive corporate malfeasance cease to discipline Enron management?

Many critics seem to believe that it was the company's involvement with novel financial products such as derivatives and structured finance that led to its financial losses. Had Enron avoided such complex and poorly understood innovations, it would have escaped its subsequent fraud and deception problems. Wrong, wrong, wrong! … Enron's problems arose from more traditional business mistakes—paying too much for acquisitions, acquiring companies that required management skills that Enron did not possess, and failing to put in place internal checks and monitoring requirements to ensure that employees were adhering to corporate policy. Enron's failures largely reflected the mismanagement of the traditional risks faced in any corporation—the "old cloudy wine in new but equally cloudy bottles" problem.

Enron did operate at the frontier. Its corporate financial policy, specifically its innovative ways of raising funds for its often-creative energy market activities, were pathbreaking. Some of Enron's corporate financing innovations … have been adopted by most global energy market participants as legitimate financing methods. Enron's derivative operations were actually largely profitable; they reduced rather than increased the overall riskiness of its operations. Enron's financial market maker role allowed other firms to reduce their commodity price and inventory risks. In brief, Enron's frontier-area activities in financial markets appear to have reduced overall societal risk. It is true that Enron's operations at the corporate finance frontier did leave it somewhat exposed. Still, Enron's problems arose less from the innovative nature of its financing strategies than from its failure to adequately monitor the use of these innovative financial instruments.

Doing so, of course, was not easy. Traditional accounting and tax reporting rules proved inadequate to clarify the riskiness of the special purpose entities, stock options, and other innovations implicated in the Enron fall. The procedures developed to ensure prudent business practices in the tangible asset-based sectors of the economy failed to keep pace with Enron's increasingly complex—sometimes overly complex—financial activities.

Enron's problems, it should be noted, emerged only after the firm had shifted from a traditional energy firm focused on the distribution of oil and natural gas to a new economy firm dealing with the financial aspects of these physical energy transactions. After the partial deregulation of the 1990s, Enron's management began to see its comparative advantage as managing the virtual rather than the physical aspects of energy production and distribution. Enron pioneered the now famous asset lite strategy … . In this brave new world, Enron would allow others to manage the physical flows; it would focus on managing the financial risks associated with these flows. Enron's background as an energy services firm gave it the knowledge needed to address these risk issues, *Human nature has changed little over recorded history.*

to design new financial instruments and strategies to help manage these energy-related financial risks. Enron also provided liquidity to make these emerging markets possible. Despite later monitoring failures, Enron's innovations in these areas were beneficial.

Enron's losses reflected the misuse of its creative innovations. It was its failure to prevent dishonesty and misrepresentation in this new setting that triggered the disaster.

The outrage over the Enron experience reflects in part the egalitarian concern that such innovative financial practices—even when honest—generate excessive profits. Yet, as Joseph Schumpeter noted long ago, extraordinary profits are "the baits that lure capital on untried trails" (Schumpeter, 1942, pp. 89-90). This confusion at the frontier, coupled with year after year of continued high profits, led many in corporate management to fall asleep at the switch. The errors and crimes now uncovered would have been less likely had Enron been operating in the "interior" of the economy. Still, Enron's innovations remain valuable; its failures demonstrate the nature of man, the fallen angel, rather than man the manipulative genius. Enron demonstrates that trial and error can be extremely costly. Yet, it remains the only viable path to the future. Trial without error is a utopian fantasy.

Risks and Culture: Values and Attitudes Toward Risk

Human nature has changed little over recorded history. Humans value the immediate more highly than the more distant—both in time and space.

We emphasize those things that affect us rather than others, and we continually face conflicts of interest between competing goals—for example, more food today versus the potential tightening of our belts tomorrow. And all this occurs in an environment where mistakes have consequences, often very painful consequences. Effective risk management institutions, therefore, create incentives relevant to man as he is—not man as we would have him be.

Douglas and Wildavsky suggested that cultural factors determine the way in which various societies respond and adapt to risk (or, more exactly, those risks that are not directly relevant to that individual). Attitudes toward such risks, they argued, are best viewed as "selected" to reinforce the legitimacy of the values they hold. Risks, in effect, aren't "out there" but rather are "internal constructs" useful for structuring a complex world. Douglas and Wildavsky (1982) defined four cultural values that they believed captured much of the varied views various peoples and societies hold toward risk and how best to manage it: fatalism, hierarchy, individualism, and egalitarianism.

Fatalism

The fatalist believes that risk is random. The appropriate response is to resign oneself to whatever fate the capricious gods might dole out. Progress is an illusion; whatever one person gains, another has certainly lost. Wealth creation and the prudent risk-taking activities necessary for its advance have little traction in such cultures. In fatalist cultures, prudence is irrelevant since risk is random. Fatalists aren't political—there's no use fighting city hall!

There are few risk takers in societies where the potential of action is viewed as nil.

Such extremely risk-averse societies were characteristic of man's early history—when our powers were weak compared to nature and our understanding of the world was rudimentary. Even today, many non-developing nations and some minorities within developing nations adhere to this dead-end cultural value. There are few risk takers in societies where the potential of action is viewed as nil and where the successful individual is seen as harming others. The fatalist culture gives way to more change-oriented cultures only when forced to do so by external circumstances or by internal collapse.

Hierarchy

Hierarchists believe that society should be ordered—that those most expert, most capable of leading society should be granted power and authority. Risk taking is necessary, even valuable, but the risks must be carefully monitored and supervised by the wise. Prudence is best ensured by leaving the decision as to which risks can be taken in the hands of those most qualified to decide for all.

Traditional societies and much of modern society have long been organized along hierarchic lines. The tribe or hunting band looks to the headman or chief to decide which risky actions should be banned and which encouraged. Today, similar faith and power are given to bureaucrats manning the various centralized political risk management institutions—the Securities and Exchange Commission (SEC) Environmental Protection Agency, Commodity Futures Trading Commission, Food and Drug Administration—and a host of other risk management agencies.

Hierarchic regulators realize that risk taking is essential. However, they are the sole arbiter of what constitutes "prudent" risk. Note that hierarchic regulators do not capture the full gains of prudent risk taking (regulators are rarely residual claimants). However, they will face heavy criticism if their approval leads to some mishap. As a result, hierarchic agencies tend to adopt some variant of the Precautionary Principle—the policy that the risks of innovation should generally be weighed more heavily than the risks of stasis.

In practice, hierarchical risk managers seek trial without error.

In practice, hierarchical risk managers seek trial without error and thus, in practice, tend to slow or even ban institutional and technological change. Hierarchic risk managers operate at some distance from the actual risk-taking activity, which makes it very difficult for them to incorporate the specialized knowledge that is dispersed widely. Further, the costs incurred in gaining approval to take some specific risk discourage some innovations.

Hierarchic societies can be very stable—there are few internal tensions to encourage reform.

Regulators typically liberalize their anti-change rules only when faced by external competitive pressures from less restrictive risk management regimes (other political jurisdictions, for example). National hierarchic cultures are even more stable. For example, Japan, after its civil war, moved to create a stable world and largely succeeded. Change did not occur until the Europeans entered Asia in force in the 19th century.

By opening the frontier to entrepreneurial risk takers, individualist cultures have greatly accelerated economic and technological growth.

Individualism

Individualist societies view risk as largely a personal matter—especially in areas where institutions are believed adequate to contain and target the impacts of risk taking. Society's role is to develop generalized rules to assign responsibility and to ensure that the consequences of individual actions are isolated. (Individualists tend to believe that this separation has largely been achieved.) Individualist societies arise both as risk-targeting institutions allow the risks associated with an individual decision to be localized and as external pressures on hierarchic societies force liberalization. Individualist cultures enlist a greater fraction of the citizenry in the critical task of exploring the economic frontier. Because risk taking is individualized, each person is able to use the information that he or she alone possesses—thus society benefits from dispersed information unavailable in hierarchic risk management systems.

Individual risk taking requires, of course, a wide array of institutional arrangements to ensure that the well-being of the society isn't endangered by the careless acts of a few aberrant members. Modern society … has evolved a wide array of institutions—private property, contracts, and the rule of law—to advance that objective. These generalized rules make decentralized risk taking more palatable to the society's more risk-averse members. Moreover, as risks are incurred and sometimes disasters result—that is, when the potential risks of the trial and error approach become reality—individualist societies respond by seeking out new institutional arrangements to reduce the likelihood of a reoccurrence of such disasters. By opening the frontier to entrepreneurial risk takers, individualist cultures have greatly accelerated economic and technological growth.

Egalitarianism

In modern societies, the major struggle is between hierarchic and individual risk management. Yet, the policy debate often focuses on another cultural value—the egalitarian concern over whether risk taking is compatible with fairness. In a society already characterized by vastly different rewards and status, egalitarians worry that entrepreneurial risk taking, if successful, will worsen existing inequities. Initially, new technologies will be available only to the powerful; thus, any wealth or life quality improvements that might result will accrue only to the few. Besides, egalitarians argue, while the innovator will gain the benefits, the risks are too likely to fall largely on the downtrodden. For such reasons, modern egalitarians increasingly view change negatively. The world is too fragile and change too likely to prove destructive to allow hierarchic—much less individual—risk taking. We should not expend time or energy in the impossible search for ever-greater economic and technological growth; rather, we should seek fairness by finding ways to equate wealth and power in the current world.

In many ways, the modern egalitarian has returned to the negativism of the fatalist. Unlike the fatalists, however, egalitarians do have a political agenda. Believing that change makes the world a less fair place, they view our planet and our societies as extremely fragile—one misstep and disaster is ensured. Thus, they oppose all novel risks: biotechnology, *How can any central authority understand in a timely fashion the ever-changing local situation?*

global warming, and derivatives. In a world that has become freer (satisfying those seeking greater individual freedom) and wealthier (reassuring those seeking a well-ordered society), the egalitarian perspective has become more significant. And, because total opposition to all change would render them politically irrelevant, egalitarians seek instead ever-stricter hierarchic regulation, seeing in that approach their best hope of blocking, or at least delaying, change.

The Evolution of Risk and Culture

The hierarchic enterprise-wide approach to risk management has many virtues for individual firms. Indeed, the firm itself is best seen as an institutional arrangement for managing and coordinating the various risks associated with the production and marketing of goods and services. The managers of the firm can more readily consolidate positions and exposures for integrated risk measurement, can more easily monitor the evolving risks, can more readily address those risks as they are revealed, and can adjust the overall risk profile of the firm to that desired by its shareholders.

In contrast, socially centralized and hierarchical risk management (e.g., SEC regulation) is far less adaptable to tailored risk management. Neither the SEC nor any other centralized political risk manager is able to make full use of the knowledge dispersed across the numerous market participants. Those localized individuals who will benefit or lose based on the wisdom of specific investment decisions are far more knowledgeable about the prudence of a specific financial risk, yet their knowledge is inaccessible to the bureaucrats. The complexity and tempo of modern financial markets, moreover, makes them extremely difficult to monitor. How can any central authority understand in a timely fashion the ever-changing local situation? How can they ensure that their policies are being implemented? Individuals with the wisdom and foresight to accomplish that task may exist but they are unlikely to be found in governmental agencies.

As noted earlier, the fact that the gains from innovation accrue to the innovator and not the regulator creates a residual claimant problem—the regulator bears the risks of approval but does not gain the economic rewards that might accompany that approval. These difficulties encourage political regulators to move slowly, to shy away from approving any novel technology. It also makes them susceptible to any information suggesting reasons for delay or denial. Because successful innovations threaten existing economic interests, the centralized regulator will be lobbied fiercely by competitors providing many reasons why the innovation is too risky for approval. An interesting example of this special interest effort to block technology was Edison's efforts to frighten America away from alternating current; that ban would have made direct current—his entry into the electricity sweepstakes—a winner.

Political agencies also are influenced by *realpolitik*. They will consider more carefully the impact of their decisions on the powerful—and those relying on current technology and arrangements will generally be more powerful today than the innovators representing tomorrow. Powerful groups may be allowed risk-taking privileges denied to those perhaps better prepared to incur such risks. Again, the evidence on the riskiness of the innovation will be weighed more heavily. And if such preferred

Market prices guide firms toward prudent risk taking.

firms or individuals incur losses, they may find themselves reimbursed from taxpayer funds.

That passive fatalistic societies would gradually be replaced by limited risk-accepting hierarchic cultures is understandable, as is the fact that competitive pressures would gradually liberalize centralized hierarchic regulatory systems. In time, individualistic risk-taking schemes would gain greater sway. However, we should not be surprised that egalitarians, distrustful of both individualism and hierarchy, would urge retreat from innovative risk taking whenever errors—inevitable in a system of trial and error—occur. The history of mankind's gradual effort to manage risk … is a tale of slow advances and many retreats, sometimes for centuries. Even today, most financial risks are heavily regulated by a host of political risk managers. And, as the response of the administration and Congress to the Enron crisis demonstrates, this progress is fragile, all too easily reversed when disasters occur.

History suggests that civilization is never secure. The innovative entrepreneurial society has no deep roots, and few passionate defenders. Yet, hierarchic regulatory bureaucracies are poorly designed to balance the risks of innovation against the risks of stagnation. In contrast, the competitive marketplace encourages that balancing very well. A business would always prefer to play it safe; yet, in competitive markets, the firm that spends nothing on R&D will soon be outflanked by firms that do make such productivity and quality-enhancing investments. Market prices guide firms toward prudent risk taking (rising prices suggest the value of investments in that area). If their intuition is correct and their innovation proves viable, they may well profit handsomely, attracting other resources to this new field. Prices signal the risks for which prudent investment is warranted; profits determine which investments are appropriate. Together, these competitive market forces guide risk taking at the economic frontier.

However, both fatalist and egalitarian values are biased against such competitive risk management. Fatalists lack any confidence that risks can be managed. Egalitarians fear the inequities that reliance on prices and profits might create. Moreover, the hierarchic view that centralized risk management offers greater security does have deep roots. Current society is influenced by the fact that for many millennia we obeyed the autocratic leadership of tribal priests and chiefs. Taboos blocked risk taking on all sides to protect the tribe against the risks of the wayward individualist. Given the fact that early societies operated close to the edge—even minor setbacks might well lead to the destruction of the tribe—these anti-innovation rules had some validity. Moreover, for much of mankind's prehistory, the risk-management institutions that today help to isolate risks, targeting their impact on those directly involved, were weak or nonexistent. In that era, competitive regulation of risks was often unfeasible. This prehistory has left society with a profound bias toward "priestly" control over risk taking. Even today, many believe that "objective" experts freed from any economic motive are far more likely to choose wisely for society than would economically motivated individuals disciplined by competitive markets.

That instinctive preference for hierarchic control over change often leads—in times of crisis— to the imposition, or reimposition, of centralized regulation. This weakens the evolving competitive forces that promise to make such disasters less likely in the future. Indeed, political intervention in response to economic mishaps often increases risk from moral hazard—the tendency of individuals to act in a riskier fashion if they believe any costs of such risks will be borne by others. In America, for example, the bank collapses of the 1930s led to federal deposit insurance, the "hostile" takeover battles of the past half century led to state and federal rules strengthening traditional management against outsiders (and weakening the incentive of outsiders to monitor errant performance by corporate managers), and failing corporations (airlines most recently) were granted access to federal loan guarantees. These interventions undermine competitive pressures for prudent risk taking.

Institutions that alleviate the pain when risks become reality and socialize the losses associated with those adverse events misdirect resources and energies toward imprudent risks. We spend too little in areas where prudent risk taking would be beneficial; we spend too much on imprudent risks in areas that have been socialized. Also, we weaken the incentives of the parties most knowledgeable about risks to innovate, to explore improved ways of focusing the gains and losses associated with such risks.

This is an excerpt from a chapter in Corporate Aftershock: The Public Policy Lessons from the Collapse of Enron and other Major Corporations*, ed. Chris Culp and William A. Niskanen (Hoboken, NJ: John Wiley & Sons, 2003).*

WHY NOT ABOLISH ANTITRUST?

Many actions once banned by antitrust enforcers, and many others still banned, are now recognized as enhancing efficiency.

Deregulators appear to be of two minds about antitrust. They denounce the actual practice of its enforcement. Yet, almost without exception, they endorse it in principle. Most want to continue to ban "excessive" horizontal mergers, price fixing, and other "anti-competitive" business practices. And most want to extend antitrust regulation to sectors of the economy that have heretofore been partially exempt, such as trucking, shipping, and airlines.

In other areas of regulation, economists have discovered that the market is far more robust in protecting consumer welfare than was once thought and that, conversely, government is highly prone to failings once thought reserved for the market (along with having some special failings of its own). Thus, economic reformers have not only criticized the administration of regulatory statutes, but called for deregulation. But although they want to get rid of the Interstate Commerce Commission (ICC) and the Civil Aeronautics Board, they almost never apply the same analysis to the Federal Trade Commission (FTC) or the Antitrust Division of the Department of Justice. Antitrust may be the last refuge of the notion of "enlightened" regulation: It is thought of as a target for regulatory reform, not deregulation.

The continued scholarly support for antitrust in principle is all the more surprising because of the tremendous erosion in support for its particular applications. Many actions once banned by antitrust enforcers, and many others still banned, are now recognized as enhancing efficiency. "Big" is no longer invariably seen as "bad," and the notion that collusive arrangements occur every day in the business world has been discredited. Antitrust is beginning to receive the same type of empirical scrutiny that George Stigler, a recent Nobel Prize winner in economics, and others have applied to consumer regulation. Yet few perceive that these waves of revisionist thinking will manage to wash away the remaining pillars of antitrust theory.

My purpose here is not to explain this inconsistency, but to review the case against antitrust and to explain why the call for complete antitrust deregulation deserves more attention than it has received. Most of my illustrations will be taken from the one area, price fixing, where nearly all economists still believe antitrust should be retained.

Economists' suspicion of the efforts of businessmen to restrain trade dates back at least as far as Adam Smith's oft-quoted comment: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices" (*The Wealth of Nations*). But Smith doubted both the efficacy and the morality of enacting any laws on the matter: "It is impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice." And then he concluded: "[T]hough the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies; much less to render them necessary."

Smith's view—the view that prevailed through most of the 19th century—was that the dangerous sort of market power was the monopoly power that emerged from government-granted protection. Most economists, accordingly, were cool to the new idea of antitrust legislation at the time the Sherman Act passed. They did not come to endorse it with any enthusiasm until the second decade of this century, by which time the notion we all absorb from childhood—that business rapaciousness is curbed only by antitrust laws—had been popularized by the Muckrakers. And it was not until the 1960s that support for adventurist antitrust enforcement became widespread in the profession. Politically, antitrust was peaking around this time, too. In 1968 a White House task force on antitrust policy (the Neal task force) recommended laws to break up leading firms in concentrated industries, and the FTC and Department of Justice reached a zenith of enforcement activity.

That enthusiasm, however, was short lived. Before long, economic scholarship began to reveal that all sorts of antitrust policies once applauded by economists were harmful to consumer welfare. Now the critics range, among economists, from Lester Thurow on the left ("The costs [antitrust] imposes far exceed any benefits it brings," *The Zero-Sum Society*) to Milton Friedman on the right ("I am inclined to urge that the least of the evils is private, unregulated monopoly," *Capitalism and Freedom*). The leading critics in recent years have been members of the Chicago School—in particular, Yale Brozen, Richard Posner, Harold Demsetz, and Robert Bork. Bork's conclusions in *The Antitrust Paradox* are reasonably representative:

> [M]odern antitrust has so decayed that the policy is no longer intellectually respectable. Some of it is not respectable as law; more of it is not respectable as economics; and ... a great deal of antitrust is not even respectable as politics.

Bork presents cogent justifications for a whole range of practices questioned by conventional antitrust theory: small horizontal mergers, all vertical and conglomerate mergers, vertical price maintenance and market division agreements, tying arrangements, exclusive dealings and requirements contracts, "predatory" price cutting and price "discrimination." He would also ignore firm size if it came about through internal growth or acceptable mergers. Moreover, he defends agreements between competitors on prices, territories, refusals to deal, and other "suppressions of rivalry" that are "ancillary" to some economic efficiency. All of these practices, Bork finds, can enhance the competitive process and have foolishly been discouraged by antitrust regulation in the past.

Since it is only lately that these bastions of orthodoxy have fallen, one might expect experts to maintain a seemly humility in the case of the few remaining policies that have not yet been—but may in the future be—discredited. After all, a full repudiation of the antitrust concept itself would represent only a moderate change compared to the shifts in intellectual opinion that have already occurred.

Yet Bork wishes not to abolish antitrust, but only to reform it so that it "advances rather than retards competition and consumer welfare." He would still ban horizontal mergers that are "too" large and arrangements to fix prices or divide markets that do not contribute to efficiency. Similarly, Richard Posner and George Stigler advised the incoming Reagan administration to "throttle back" on antitrust, but to retain the "healthy core of federal antitrust policy ... the prohibition of horizontal price fixing (collusion) and large horizontal mergers." These core policies, they said, enjoy the support of "a consensus of economists of all political persuasions." Stigler's views come especially oddly from an economist who once pointed out that most economic reforms go wrong because "we don't know how to get there" (*The Citizen and the State*), who is noted for looking at the results of regulation—not its intent—and who has observed that "regulation and competition are rhetorical friends and deadly enemies" (*Can Government Protect the Consumer?*).

Liberty is a neglected aspect of antitrust discussion.

The Case against Antitrust

The full case against antitrust can only be sketched in a brief essay. It has at least five versions. In reverse order of their general acceptance, they are: (1) the libertarian view that the right to fix prices is part of a general and inviolable right to dispose of one's property as one sees fit; (2) the Austrian view that the neoclassical economic rationale for antitrust, based on the equilibrium perfect-competition model, is flawed; (3) the historical argument that efforts to fix prices have in practice generally been futile and are always likely to prove so; (4) the view of some neoclassical economists that price agreements help coordinate the plans of buyers and sellers (that is, provide offsetting efficiency gains); and (5) the public choice argument that antitrust, like other forms of regulation, gives private parties a way to cripple their competition through political influence, rather than market superiority.

Individuals Have the Right to Use Their Property as They Wish. Liberty is a neglected aspect of antitrust discussion. Why should a businessman not be free to restrain his own trade if he wishes, alone or in combination with others? The activities prohibited under antitrust laws are invariably peaceable activities—whatever their merit under an efficiency standard—and thus should be allowed in a free society. In Adam Smith's view, and in the view of many others, an individual rights or justice standard is at least as compelling as an efficiency standard in judging policy.

Bork, too, notes that "when no affirmative case for intervention is shown, the general preference for freedom should bar legal coercion" (*The Antitrust Paradox*). Still, in general, the Chicago School's case for antitrust policy—and its opposition to price fixing in particular—rests solely on economic efficiency, as if rights had nothing to do with the matter—as if business had no right in principle to dispose of its property as it sees fit, but only a conditional freedom so long as it helps maximize some social utility function. That is to say, no business is entitled to its property if that property can be redeployed so as to expand output. With "conservative," "pro-business" economists taking this view, who needs social democrats?

Antitrust threatens basic rights in other ways, too, because of the unavoidable ambiguities and uncertainties in determining what behavior is efficient. These uncertainties lead to government arbitrariness and favoritism in enforcement, as well as a breakdown of the predictability that is necessary if citizens are to know when they are acting legally.

The Flawed Theoretical Basis of Antitrust. Antitrust was treated most skeptically by the illustrious economist Joseph Schumpeter, who saw the market not as some efficient state of static equilibrium, but as a dynamic process of "creative destruction." Schumpeter pointed out the artificial nature of the conventional neoclassical model of "perfect competition," in which markets are open, firms tiny, products homogeneous, buyers and sellers gifted with full information. Such a perfect world is always in equilibrium, and price equals marginal cost, which in turn equals average cost. If any firm raises its prices above the market level, its sales disappear entirely. Otherwise the market is not perfectly competitive, and the firm is said to have "monopoly power," which reduces output and consumer welfare.

Whatever the educational value of this equilibrium model, it does not describe the processes by which equilibrium is approached. These processes are, indeed, the characteristic activities and features of real competition: product differentiation, price competition, advertising and other sales techniques, variation in the size and profitability of firms, technological innovation, and aggressive efforts to increase market share. When these elements of the competitive process do show up, the logic of the "perfect competition" model identifies them as "elements of monopoly."

In a true competitive economy, all firms have some degree of "control" over their prices and all seek to maximize profits by restricting output to some degree. But any "profit" that may result should be viewed, not as social waste, but rather as the dynamic incentive needed to move the economy toward more efficient production technologies and a closer match to consumer preferences. As Schumpeter explains in *Monopolistic Practices*:

> [E]nterprise would, in most cases, be impossible if it were not known from the outset that exceptionally favorable situations are likely to arise which exploited by price, quality, and quantity

> manipulations will produce profits adequate to tide over exceptionally unfavorable situations provided these are similarly managed. Again, this requires strategy that, in the short run, is often restrictive. In the majority of successful cases, this strategy just manages to serve its purpose. In some cases, however, it is so successful as to yield profits far above what is necessary in order to induce the corresponding investment. These cases then provide the baits that lure capital on untried trails.

Thus, a finding that prices exceed marginal cost may well indicate only that the market is not in equilibrium—and in most sectors we would be very surprised if it were. In fact, these temporary high profit and restricted output levels increase competitiveness. As Schumpeter noted: “There is no more of a paradox in this than there is in saying that motorcars are traveling faster than they otherwise would because they are provided with brakes.”

Although Schumpeter did not oppose all antitrust regulation, he wanted industry to have the flexibility to organize its own “advances” and “retreats”:

> Rational as distinguished from vindictive regulation by public authority turns out to be an extremely delicate problem which not every government agency, particularly when in full cry against big business, can be trusted to solve.

Dominick T. Armentano has, in *The Myths of Antitrust* and more recently in *Antitrust and Monopoly*, elaborated on the Schumpeter tradition in a way that provides the basis for rejecting even the remnants of antitrust regulation still favored by the Chicago School.

Price Fixing Rarely Succeeds. In the competitive process, said Adam Smith:

> The real and effectual discipline which is exercised over a workman is not that of his corporation [guild], but that of his consumers. It is the fear of losing their employment which restrains his frauds and corrects his negligence.

As Armentano has shown, the historical record indicates that, unless the government enforces rate agreements or erects barriers to entry, price-fixing agreements are rarely effective—except where the government itself is the purchaser. Government seems to lack both the internal profit incentives and the external goad of competition to encourage efficient purchasing behavior.

A would-be price-fixer faces numerous and formidable theoretical difficulties: the availability of substitutes, product differentiation, changes in demand, supply, production technology and costs, the difficulty of policing the agreement, resale among buyers, and market power among buyers. And the major legal cases seem to indicate that price fixing is in fact rarely successful. Thus, *Addyston Pipe* (1899), *Trenton Potteries* (1927), and the great electrical equipment conspiracy (1961) all resulted in convictions, but in each case the cartels did not in fact succeed in fixing prices. Armentano notes that the customers testified on behalf of the *Addyston* conspirators, and analysis of the price data by Almarin Phillips suggests that the prices the conspirators charged were reasonable.

In his new book, *Concentration, Mergers and Public Policy*, Yale Brozen cites evidence that the *Trenton Potteries* defendants also failed in their attempt to fix prices: "the prices offered by low bidders were not those fixed by the cartel." Official cartel prices no more dictate what consumers pay than list price dictates what you pay for a car. Yet even Bork approvingly quotes *Addyston Pipe* and *Trenton Potteries* as well-founded applications of the antitrust rules against cartels: the "contributions [of the rule against price fixing] to consumer welfare over the decades have been enormous." This is mysterious: Consumers are not damaged by ineffective cartels, and Bork cites no effective cartels.

An antitrust case against a New Jersey trucking rate bureau, recently analyzed by Bruce Allen of the University of Pennsylvania, illustrates some of these questions. The case, on the surface, would seem to support antitrust theory. The carriers in the rate bureau published official rates that averaged 10 to 20 percent higher than those of independent carriers. Whether they succeeded in wielding market power, however, is questionable. A number of important shippers were not among the "cartel's" customers, and some independent carriers heavily advertised their lower rates in a bid for market share. There are also several reasons why rate bureaus may provide better service and thus command a higher price: They may lower the information costs of small shippers or pay better attention to their shipments (which may be why some large shippers used the large independent carriers). Most crucial, perhaps, the official bureau prices may not have been the prices actually charged by the member carriers. Unfortunately, data were not available on what shippers actually paid or how much traffic was actually carried at the higher rates.

If there is little empirical evidence that price fixing harms consumers even in such suspicious circumstances, it is no wonder that it cannot be proved significant in ordinary business settings.

Price Coordination Enhances Efficiency. Why might restrictive arrangements serve efficiency goals? One reason is that they provide firms with information that allows them to plan their production and marketing more efficiently. Friedrich Hayek and Thomas Sowell, for their part, say that the market's most vital and misunderstood role is that of creating information. Price discussions are one way to reduce the costs of information exchange. Truckers often claim that mutual discussions and common tariffs facilitate some discounts, product quality differentiation, and new services by providing a universally understood basis for bargaining and informing competitors of the state of the market. Such information might be supplied to the industry in other ways, by outsiders such as trade associations, consulting firms, or the trade press. But the market may be trying to tell us that the firms in the industry are best equipped to develop this information. To bar them from doing so does not deprive them of the market information, but merely increases needlessly the cost of providing it.

Most economists have come to perceive important efficiency gains in many vertical price maintenance agreements, but in the case of horizontal agreements they credit gains only where the collaborators actually integrate their economic activities and achieve cost reductions (an exception is Richard Posner's testimony on railroad rate bureaus and economic efficiency before the ICC on July 16, 1980). Bork discusses a number of ways, long ignored by antitrust scholars, in which rate fixing that is "ancillary" to the integration of economic activity can lead to important economic gains. Thus, he concedes that rate cartels may reduce the costs of obtaining market information; but "the possible savings seem minuscule compared to the certainty of output

No one can be sure what business arrangements will efficiently serve consumers even 10 minutes from now.

restrictions"—although, as we have already seen, cartels do not always reduce output. Since there is no way to know beforehand how much the coordination of information is worth, how can we be sure that the efficiencies will be trivial? Bork does not tell us.

Outside observers find it hard to verify that "efficiency" has or has not improved in any instance, and harder to quantify its extent. Bork admits that this is a very subjective and subtle area, but he is willing to condemn price fixing anyway because he believes its only significant efficiency advantages are associated with some integration of other economic activities. But the survival of cartel arrangements in some open markets for long periods, despite open entry, suggests they must be providing efficiencies to shippers important enough to justify the higher rates.

No one can be sure what business arrangements will efficiently serve consumers even 10 minutes from now, let alone in the year 2135. Antitrust laws, in their static way, typically ban activities for which officials and scholars have not yet discovered the rationale; markets are more dynamic than that. The Justice Department and FTC now say that their antitrust policy has changed, and that in future they will allow most efficiency-enhancing arrangements—except for those that encourage price fixing.

Aside from the inherent difficulty of making the latter judgment, it must be noted that in the past trustbusters have seen price fixing almost everywhere, so that it is doubtful that they will allow many new arrangements.

Antitrust Encourages Business to Look to Government. As Bork and others have shown, antitrust has often protected inefficient producers. These producers invoke government help to squelch their low-cost competition—much as truckers file ICC complaints against rate discounters. From July 1976 to July 1977, private parties filed 1,600 antitrust suits in federal courts, while government filed only 78. Antitrust encourages firms to win their competitive fights by relying on Washington lawyers and lobbyists instead of engineers, scientists, and computer experts.

William Breit and Kenneth Elzinga, two commentators relatively sympathetic to antitrust, note nonetheless that it "affords inducements to customers to behave perversely in hopes of collecting greater damages." Part of the problem is that buyers "can view the antitrust laws as a type of insurance policy against 'poor purchasing' and will at the minimum reduce their precautionary purchasing efforts." Breit and Elzinga cite a 1951 case in which an Arkansas canner refused to accept a shipment of cans because of a minor dispute over freight pricing, and then sued the can maker for triple damages "for losses incurred partly because the canning company had no cans." (A lower court ruled for the plaintiff, but was reversed on appeal.) Since 1951, Breit and Elzinga add, it has become much harder for defendants to escape by citing this sort of "antitrust entrapment"—which further encourages customers to try to strike it rich in the treble-damage sweepstakes.

Changing the Law

Any effort to challenge antitrust in principle will have to move beyond the coalition politics of trucking and airline deregulation. Libertarians—

Getting rid of antitrust would focus reformers' energies on the true enemy of competition and consumer welfare— state-created privileges.

who hold that the right to reach voluntary price agreements is part of companies' general right to economic freedom, not a special privilege—are perhaps the natural core of a coalition for antitrust deregulation. Liberals and populists, on the other hand, seem to have supported past deregulatory moves because they view price floors and entry restraints as "pro-business"—which they do not believe, at least at present, is true of antitrust. Even liberal reformers who are no fans of trustbusting want special measures to deal with big firms; though Galbraith, for example, says that bigness is here to stay, he favors federal chartering of large firms. Many populists also view antitrust as a tool to force industry into various sorts of "cooperative" arrangements with government, as by allowing mergers when firms make concessions on plant closings. It will take a big educational effort to convince liberals that business itself uses antitrust in an anticompetitive manner.

Getting rid of antitrust would also focus reformers' energies on the true enemy of competition and consumer welfare—state-created privileges. In his recent book, Brozen notes that those structuralists who once saw low concentration and a large number of firms in a market as the essence of competition have largely changed their views: "[E]ntry barriers are the appropriate arena for antitrust action. The most significant barriers are those administered by regulatory agencies and licensing authorities." Armentano carries the point further:

> The critics of American business are right to be concerned about the manifestation of political power in society, but they are wrong to argue that monopoly power is to be associated with product differentiation or with concentration and market share. Nader, Green, and others, despite some promising early work, have continued to blur the essential differences between private persuasion and government coercion, between efficiency as a barrier to entry and pernicious legal barriers, between power and production, and between economic and political accountability. Large corporations in open markets—regardless of their size—must earn their market positions each day through voluntary exchange [*Antitrust and Monopoly*].

The stakes are high, as Bork points out:

> Antitrust goes to the heart of capitalist theology, and since the laws' fate will have much to do with the fate of that ideology, one may be forgiven for thinking the outcome of the debate is of more than legal interest.

The most immediate ramifications of that debate are the controversies over whether to extend antitrust to previously exempt industries that are being deregulated. The trucking industry, by and large, wants to retain its antitrust exemption—no doubt because it hopes that exemption will prevent competition. Since this industry now enjoys more political than intellectual support, it may be able to win continued antitrust immunity without mounting any intellectual case at all. This would be unfortunate; such a victory would be widely perceived as just another instance in which industry power prevailed over the interests of the consumer.

It would therefore be a step forward if the truckers and other industries facing antitrust assault came to see that they have a more principled case for their position. To accept antitrust liability as the natural corollary of deregulation would mean the effective reregulation of every firm's price (and, in some cases, its entry) decisions. So, it is only natural for the industry to resist. Which means that when truckers, travel agents, or others ask for exemption from antitrust regulation, they are not necessarily itching to organize a cartel the moment the public's back is turned. They may simply and understandably be trying to avoid a burdensome, unfair, and unproductive layer of regulation. And they may just have been reading the economic literature of the past decade.

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SUPPLEMENTAL REMARKS TO THE HOUSE BANKING COMMITTEE ON THE FUTURE OF FANNIE MAE AND FREDDIE MAC, JUNE 21, 2000

I head the Competitive Enterprise Institute, a pro-market public interest group that has long been active in financial regulatory issues. I'm pleased to be invited to testify today on the "moral hazard" problems created by Freddie Mac and Fannie Mae. While these firms might once have merited some special assistance as "infant industries," they have now clearly matured. The continuance of special privileges creates a serious hazard to the market, to taxpayers, to the economy, and, perhaps most of all, to the poor, whose real need—economic opportunity—is given lower priority by pushing middle- and upper- class housing mortgages to the front of the capital queue.

A monograph by Peter Wallison and Bert Ely documenting the risk posed by the projected rapid growth of Fannie and Freddie was recently published by the American Enterprise Institute. I have requested copies of this monograph and would ask that these be made available to the Committee. For balance, I've also appended to my remarks a recent paper by the Senior Economist of Freddie Mac, Robert Van Order, just published in the Cato Institute's *Regulation* magazine. "A Microeconomic Analysis of Fannie Mae and Freddie Mac" presents a lukewarm case for these entities. Finally, I add the delightful "Dear Abby" editorial that appeared earlier this week in *The Wall Street Journal*. That editorial illustrates well that, although there are complexities in this issue, the core issues can be readily communicated to the American public.

Let me now summarize my testimony. First, let me note that Fannie and Freddie are strange organizations, neither private-sector fish nor

Monopoly money makes it easy to become a monopolist.

political-sector fowl. As a result, no one is quite clear how these entities should be evaluated or how they might be held accountable. They are largely immune to competitive market regulation—their access to low-cost money makes it impossible for truly private firms to compete. Yet, their charter grants them special subsidies and permits them to expose the taxpayer to unlimited risk without effective political scrutiny. As Mr. Nader noted last week, these GSEs [government-sponsored enterprises] operate under special rules: The management and shareholders keep any profits, but the taxpayer will bear the bailout burden if their policies go sour. This asymmetry is dangerous and evades the whole system of checks and balances that is the basis of the American political system.

Fannie and Freddie get subsidies, but no one ever votes for them. This is wrong. America fought a war to oppose "taxation without representation." Yet, today, in this situation we have seemingly endorsed "subsidization without representation." Did we really mean to define GSEs as government-subsidized enterprises?

The roots of this problem, as you've heard time and time again in these hearings, stem from Fannie's and Freddie's ability to obtain funds at a rate far lower than any private firm. Cheap money guarantees them high profits. Now, making a profit is normally a tough game, but when you're allowed to play with Monopoly money and everyone else has to use the real thing, you can buy up all the houses and hotels (or, at least, their mortgages) from Baltic Avenue to Park Place without passing Go (and, of course, without running the risk of going to jail). Monopoly money makes it easy to become a monopolist. And, as these hearings have indicated, Fannie and Freddie are well on their way to becoming the largest monopolists in history.

Fannie and Freddie, of course, argue that all this misses the point. As their ads have been telling us repeatedly for the last month or so, they simply want to help everyone realize the American Dream. Good rhetoric; not so good policy. First, note that some of the so-called housing subsidy is dissipated in higher housing costs. Just as subsidized student loans contributed to the rapid increase in college tuition costs, so also have the Fannie/Freddie subsidies made housing less affordable. I hope you will seek an estimate of the extent to which the problem of affordable housing may have been exacerbated by Fannie and Freddie. It would be especially important to examine this question for those lower-income groups not served by Fannie and Freddie.

Still, as their ads do point out, the interest rate, if not the cost of housing, is lower because of their involvement. Doesn't this make the American Dream more affordable—at least for those not priced out of the housing market? Perhaps, but there are many other American Dreams: getting a job, starting your own business, having a better school for your kids. And these dreams also require capital. Fannie and Freddie create no new capital—they simply move it around. For those pursuing other dreams, Fannie and Freddie may be more of a nightmare!

Some people—many of whom already share in the American Dream—gain a mortgage at somewhat lower rates. Others find themselves priced out of the housing market or, more frequently, find themselves unable to gain the funds needed to launch or expand their business or to expand their employment. Moreover, at least one-third of this taxpayer subsidy goes to management and shareholders—people who have already achieved the American Dream.

At least in the game of Monopoly people can buy something besides real estate.

Fannie and Freddie claim their success reflects skill. Perhaps. Certainly, there are some smart people at these agencies—at the salaries they offer, there certainly should be—but the success of Fannie/Freddie has less to do with their smarts than their subsidies. Had they purchased livestock, race tracks, movie theaters, car dealerships, railroads, or even aluminum siding, they still would have made money.

If you can buy low and sell high by using low-cost taxpayer-backed money, you do well. Indeed, give anyone in this room the right to issue their very own personalized Treasury bills, and I predict that they, too, will become very rich in very short order.

But all this weakens the stability of the American financial system. That's what "moral hazard" is all about. And it is those unintended consequences of helping one American Dream at the expense of all the other American Dreams. Those consequences should concern this Committee and this Congress.

And these risks threaten to get worse. The hearing last week illustrated that threat very well. Groups seeking more funds for lower-income housing were critical of Fannie and Freddie. However, they sought not the reform of these agencies, but more resources for lower-income housing. Such moves would do little to help the poor (luring families into debt does them no favor—as witnessed by concerns over "predatory lending") nor would it do much to address the affordable housing issue (a problem linked to anti-growth initiatives and other government regulations). Yet, it might well increase the likelihood of a Fannie/Freddie default and, thus, a taxpayer bailout.

Fannie and Freddie are already Too Big to Fail.

In effect, Fannie and Freddie are being urged to increase their riskier lending without incurring any additional risk! Not much chance of that happening in the real world but, as long as the taxpayer is forced to cover that additional risk, I suspect that Fannie/Freddie will soon move to do exactly that.

What can be done about this? Not much if we're not willing to rein them in. Political regulation has a very poor track record. Market discipline is far better at ensuring rational lending policies. If Fannie and Freddie are as necessary and as well-managed as they claim, then let them meet a market test rather than spend fortunes on newspaper advertisements.

The problem remains that in any real political calculus, Fannie and Freddie are already Too Big to Fail. Their stock is held in too-large blocks by too many important groups. Today, if a crisis were to occur, it is highly unlikely that anyone responsible would actually get a "haircut." The sad reality is that (when the smoke clears) we'd be more likely find that Freddie and Fannie had been given a perm.

Tinkering at the edges isn't likely to resolve the Fannie/Freddie instability. Rather, we should take advantage of the current good times to defuse this time bomb while we can. I recommend that this process begin by enacting the provisions of your bill. Specifically:

- Phase out the ability of regulated financial institutions to hold Fannie/Freddie stock as "Treasury Bill" equivalents;
- End the visible line-of-credit subsidy;
- End their exemption from state and local taxes (as a citizen of the District of Columbia, I was surprised that former D.C. Representative Walter Fauntroy neglected to recommend that reform last week);
- Eliminate their ability to use taxpayer-backed money to enter other sectors of the credit economy;
- Require increased capital reserves; and
- Create a liquidation plan that would plausibly avoid a bailout if and when the next economic crisis occurs.

Some have suggested we proceed carefully and I fully agree, but that does not mean delaying further action. The unintended consequences of past inaction are already very serious and the growth projections of Fannie and Freddie suggest that there is much worse in store. Delay is always the easiest course in the short term. Recall the prayer of the youthful Saint Augustine: "Oh God, make me chaste—but not yet!"

Still, even if you move expeditiously, I suspect it will not be enough. Fannie and Freddie have no real-world existence. They exist as artifacts of the special privileges they possess. Masquerading as market entities, they are better viewed as a costly and complex way of transferring capital from small businesses, consumer credit, high-tech startups, state and local governments, and schools to middle- and upper-income home purchasers. This is not wise. If America wants to nationalize its credit sector, wouldn't it be better to do it directly, rather than by using the ruse of GSEs?

Thus, as noted in my written testimony, I suggest that the Department of Justice be urged to develop a divestiture/breakup plan for Fannie/Freddie. They should be converted from Too Big to Fail institutions into normal market firms. I've noted that Fannie Mae's Ms. Gorelick comes from Justice and might well assist in the breakup. If government is willing to shatter a well-run truly private firm because it wasn't willing to bend a knee to Joel Klein and Judge Penfield Jackson, then it should certainly be willing to disassemble the artificial creations of Fannie and Freddie. Were these entities broken into four or so national firms, each assigned a diversified share of the holdings of the current monopolies, the privatization effort would be much less traumatic and far less risky politically.

Chairman, members of this Committee, these hearings cannot be very pleasant for you. You are finding that Fannie and Freddie have outlived their usefulness, have engaged in mission creep to a level never seen by any agency in history, have weakened the private housing finance markets, and now reject reform. Unfortunately, Freddie and Fannie are no paper tigers. They have massive resources and seem willing to use them without limit for lobbying, propaganda, political contributions, and attacking any opponents (including yourselves). Moreover, most people will see only the ads claiming disaster if Fannie and Freddie are ever reformed.

Yet, America has survived to date because we are a representative government; you were elected to represent the good of the American people, not the privileges of the powerful. Moreover, you have a bully pulpit to educate the American people on this issue. And it's not really very hard, as *The Wall Street Journal* editorial makes clear. Indeed, the

Freddie and Fannie get-rich-quick scheme would be laughed off the stage of any high school civics class in America. These hearings begin the educational process necessary for reform and I would like to commend you, Chairman Baker, and all those on this Committee for your willingness to explore how best to defuse this time bomb. I look forward to working with you toward advancing this most important work.

CHARLES DICKENS'S EBENEZER SCROOGE WAS THE ULTIMATE JOB CREATOR

There is probably no figure more emblematic of the greedy, penny-pinching capitalist than Ebenezer Scrooge in Charles Dickens's *A Christmas Carol*. Dickens is often seen as the chronicler of the injustices of the Industrial Revolution, including businessmen's cavalier attitude toward the welfare of their employees. Yet Scrooge, like many of Dickens's other archetypal characters, was a product of an earlier era, and in that context merits some defense.

By the tale's account, Scrooge was honest and frugal—perhaps excessively so. But there is something missing from Dickens's picture. The Scrooges of the world were the stewards of the scarce capital—the seed corn prosperity—of that earlier industrial age. Ensuring that it was used wisely and honestly was critical to the wealthier England in which Dickens lived.

In today's much wealthier age, Scrooges in the Dickensian sense are rare. Yet, some do persist in many of the world's poorer tribal enclaves. In fact, I knew one such "Scrooge" in my childhood home in Louisiana's St. Tammany Parish. The community, "Sixth Ward," was an isolated rural community some 50 miles north of New Orleans. It was a closely-knit community with a few major families and a small number of non-native residents. Like many "tribal" communities, Sixth Ward enjoyed a strong sense of egalitarianism based on kinship.

That communitarian spirit extended even to my family, even though we were "outsiders" with no local family connections. Moreover, we were Catholics in a community where everyone else was Evangelical

Christian. Still, our family quickly put down roots. My Daddy was the lockmaster at Lock # 1 on the Pearl River Corps of Engineers system, which brought him into contact with many of the locals. When my mother died, women from throughout the community brought us hot dishes and provided solace.

The comfort of community had a downside, however. Adam Smith's admonition that, "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" seems not to have gained many adherents in Sixth Ward, whose egalitarian and communitarian values made it hard for entrepreneurs to flourish and contribute to economic growth.

Every so often, a talented and enterprising individual would launch a new business, such as a sawmill, gravel pit, or butcher shop. Sometimes these endeavors would flourish, and the impoverished Sixth Ward (where many still lacked electricity and running water) would become a little less poor. But in this closely-knit community, success placed cultural demands on the entrepreneur. He would be expected to make place in his business for an out-of-luck Uncle Bill or Aunt Sally.

Often, that entrepreneur would give in to such cultural pressures and add these individuals to his payroll and the operation's efficiency would decline, often leading to its collapse. And with that collapse, the additional wealth that the entrepreneur had created would disappear, leaving the Sixth Ward a bit poorer and a little less prone to other entrepreneurial ventures. Some in the community would generally sympathize with that failure but still believe the entrepreneur had done "the right thing."

But there was one entrepreneur in Sixth Ward, "Old" Mr. Singletary, who resisted these cultural norms. He ran the local store and hired only those who worked hard and would accept the wages he offered. His store rarely offered credit and his prices were higher than those in the more remote city. Still, his store was one of the very few for miles, and thus essential to our community.

Not surprisingly, Mr. Singletary was widely regarded as selfish, as tight, a "mean" man. He was our local Scrooge, an individual who believed in the value of what he was doing and was willing to accept the social stigma of ignoring the cultural demands of others. He wasn't admired, but his enterprise survived when many of others who gained greater cultural approval failed.

Dickens, I believe, in *A Christmas Carol*, was reaching back to the small communities of an earlier England, where the guilds took care of tradesmen, nobles took care of their lands and serfs, and everybody had a station in life, even if not much in the way of freedom or riches. He seemed not to have understood how the breakthroughs made by the Scrooges of that earlier age had helped transform England from a stagnant feudal society into the industrial powerhouse of his day. Certainly, he found nothing heroic or admirable in such individuals.

That is understandable. Indeed, from a Victorian perspective, Scrooge's actions seem inexplicable. As F.A. Hayek recognized, our long tribal prehistory exerts a continuing influence on our views toward markets. The communitarian tribal mores "which are essential to the cohesion of the small group," Hayek noted, continue to hold greater emotional appeal than that of the market, even though they are "irreconcilable with the order, the productivity, and the peace of a great society of free men." Civilization's challenge, he believed, was to legitimize the morality of economic liberty, to move beyond the limited kinship-based exchanges of the past.

In that context, Scrooges may better be seen as symbolizing those transitional figures who were critical to the creation of a wealthier England—and a wealthier, fairer world. By demonstrating that markets better address the concerns of mankind than do the restrictive covenants of localized communities, these individuals paved the way to our modern world.

We have forgotten how much sweat, sacrifice, and painful cultural change occurred in our own history. The often painful steps out of poverty are more easily defended after the fact. We have come to realize that wealth cannot be given away until it is created, and that to criticize a practice because it falls short of what can be imagined gets us nowhere. Now, having escaped the poverty and cultural traps of Sixth Ward, I have much more sympathy for Mr. Singletary … and for Mr. Scrooge.

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Fred L. Smith, Jr. is the Founder and Chairman Emeritus of the Competitive Enterprise Institute (CEI), which he led from 1984 to 2013. His public policy research has covered a wide range of topics, including regulatory reform, free market environmentalism, antitrust law, international finance, and comparative economics. Throughout his career, Smith focused on bringing leaders in the business and academic worlds together to defend capitalism by highlighting the moral legitimacy of free markets.

His many published works include chapters in the books *Field Guide for Effective Communication* (2004), *Corporate Aftershock: The Public Policy Lessons from the Collapse of Enron and Other Major Corporations* (2003), *Ecology, Liberty, and Property: A Free Market Environmental Reader* (2000), *The Future of Financial Privacy: Private Choices versus Political Rules* (1999), *Environmental Politics: Public Costs, Private Rewards* (1992), and *Steering the Elephant: How Washington Works* (1987). His academic articles have appeared in journals such as the *Harvard Journal of Law and Economics* and *Knowledge, Technology, and Policy*.

Smith has also written widely for leading newspapers and magazines such as the *Wall Street Journal*, *Washington Post*, *USA Today*, *National Journal, Economic Affairs*, and *Forbes*. He has also made hundreds of television and radio appearances on networks such as ABC, CNBC, CNN, Fox News, National Public Radio, and Radio America, among others.

Before founding CEI, Smith served as Director of Government Relations for the Council for a Competitive Economy, as a senior economist for the Association of American Railroads, and for five years as a Senior Policy Analyst at the Environmental Protection Agency. He is currently a member of the Board of Directors of the Competitive Enterprise Institute.

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Smith. Extending to society. Goodwill. The immensity of the universe. These things fit together. They are like the elements of every good story we know.

- KENT LASSMAN