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The Great (and Continuing) Economic Debate of the 20th Century

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The following is adapted from a speech delivered at Hillsdale College on January 29, 2006, during a five-day seminar co-sponsored by the Center for Constructive Alternatives and the Ludwig von Mises Lecture Series on the topic, "Great Economists of the Twentieth Century."

The great economic debate of the twentieth century was between collectivists and free-marketers. In one sense, the free-marketers won: When the Berlin Wall fell in 1989, it was widely acknowledged that Soviet socialism had been a catastrophic, not to say murderous, failure. But in another sense, the debate continues. Democratic capitalism still has not vanquished the idea of collectivism. Far from it.

At the beginning of the last century, free markets seemed to be on the ascendancy everywhere. But two events gave collectivism its lease on life. The first was World War I. In addition to the slaughter—and to breeding the ideologies of communism, state fascism, Nazism, and even the Islamic fascism we are battling today—World War I served as an intoxicating drug to those in the West who believed that a handful of people in government could manage affairs better than the messy way in which free peoples tend to do so. Massive increases in government powers, coupled with massive increases in taxation, gave many the idea that you can achieve massive increases in production by commandeering the financial resources of society.

The second event that served as a boon to collectivism was the Great Depression, which was widely seen as a free-market failure. This view was false. Misguided government policies were at fault—the Smoot-Hawley Tariff, for instance, which dried up the flow of capital in and out of the country. If you track the stock market crash of 1929, it parallels the course of this tariff bill through

Congress. When Smoot-Hawley arose in the fall of 1929, the markets fell; when it looked like the tariff bill was sidetracked in late 1929, the markets revived (the Dow Jones went up 50 percent from its lows in November); in the spring of 1930 it was signed into law, and the rest is history. There were other factors at work in the Great Depression, of course, such as President Hoover's gigantic tax increases of 1931. But despite the fact that these also involved bad policies, the lesson taken away by many was that economies will implode unless the government manages them. John Maynard Keynes, the intellectual guiding light behind New Deal economics, believed that an economy was like a machine: If you put doses of money into it or pull money out at the right times, he thought, you can achieve an equilibrium. This idea that government can drive an economy as if it were an automobile has had baleful consequences.

Other leading economists at the time, such as Joseph Schumpeter, recognized that an economy is an aggregate of disparate activities—thus that the idea of achieving equilibrium, while it makes for a neat theory, is nonsense in the real world. A vibrant economy is full of constant *dis*equilibria: New enterprises rise up, old ones decline, etc. Snapshots of such economies mean very little. In the real world, therefore, free markets operate rationally and efficiently in a way that government regulators simply can't. Here in America we came to this realization at the end of the 1970s. Following World War II, we largely bought into the idea that government must play an active role to prevent the economy from going off the cliff. But in the late 1970s, the devastation of inflation and high taxes brought about a reassessment. With the election of Ronald Reagan, the U.S. took a step back from Keynesian economics. Since then, as Western Europe has stagnated—creating, for instance, only a fraction of the private sector jobs that the U.S. has created—our country has undergone an economic revival.

Nonetheless, democratic capitalism often still seems on the defensive. Why?

Is Democratic Capitalism *Good*?

One of the great vulnerabilities of capitalism is the perception that it is somehow less than moral, if not positively amoral. A common view of business was depicted in the movie *Wall Street*, in which Michael Douglas's character made famous the phrase, "Greed is good." Capitalism is widely seen as promoting selfishness. We tolerate it because it gives us jobs and prosperity, but many look on this as a Faustian bargain. Charity and capitalism are seen as polar opposites. Thus there's a phrase that's often used today—I myself use it from time to time without thinking—which is "giving back." If you've succeeded in business, it's counted a good thing if you "give back" to the community. And charity is, of course, a good thing. The problem with this phrase is its implication that by succeeding, we have taken something that wasn't ours. The same idea is summed up in the cynical saying, "Behind every great fortune lies a great crime." This way of thinking about democratic capitalism is wrong.

In fact, philanthropy and capitalism are two sides of the same coin. To succeed in business in a free-market economy, one must meet the needs and wants of others. Even someone who makes babies cry is not going to succeed unless he or she provides a product or a service that people want. This system weaves intricate webs of cooperation that we don't even think about. Take a restaurant: Someone who opens a restaurant assumes that farmers will provide the food and that someone else will process and package it and that someone else will deliver it, having been supplied the fuel to do so by yet someone else, etc. These marvelous webs of cooperation happen every day throughout a free economy. No one is commanding it. It occurs spontaneously in a way that economists like Schumpeter understood.

Free markets also force people to look to the future and take risks. Misers do not found companies like Microsoft. Nor should we look on it as immoral for people to work for the betterment of themselves and their families. We are all born with God-given talents, and it is right to develop them to the fullest. The great virtue of democratic capitalism is that it guarantees that as we develop our talents, we're contributing to the public good. Statistics show that the U.S. is both the most commercial nation and the most philanthropic nation in human history. And this is no paradox. The two go hand-in-hand.

Another vulnerability of democratic capitalism is that although it leads to progress and to an increase in our societal standard of living, progress is usually disruptive. This allows collectivists to play on people's natural fear of change. We saw this with the rise of industrialism in the 19th century. We had paintings and writings depicting a pastoral agricultural past. Then railroads came along to disrupt the canals, and cars came along to disrupt

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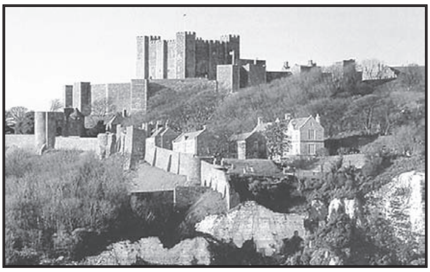

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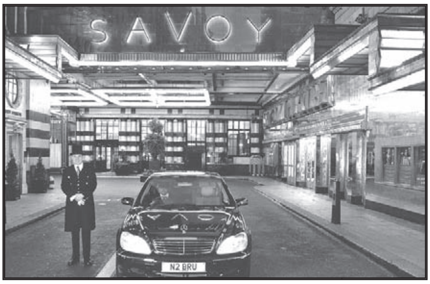

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the railroads. Buggy-whip makers and blacksmiths were done for. One can imagine what *60 Minutes* would have been investigating 100 years ago: the poor blacksmiths being put out of work by Henry Ford. Likewise, when TV came along in the late 1940s and early 1950s, most movie theaters in the country went broke. Now the Internet is disrupting newspapers and Craig's List is disrupting classified advertising. Disruptions are inevitable in a free-market system. The political challenge is to allow these disruptions to take place—they are ultimately constructive, after all—rather than reacting in a way that stymies progress.

In recent decades, collectivists have also hijacked the cause of environmentalism to promote their agenda. I'm not talking about the desire to have clean water; we're all in favor of that. Or clean air; one of the great things we've done in the last century is getting lead out of the air. Saving tigers and elephants is also a good thing. I'm talking about those who use the mantra of environmentalism to try to control the economy the way the old-time socialists wanted to, breathing hellfire and damnation on those who don't subscribe to their new, post-Christian religion. The fact is, if our goal is to improve the environment, increasing government regulation and destroying manufacturing is counterproductive. Affluence is the friend, not the enemy, of the environment. As people become better off, they want a higher quality of life, including environmental improvements. And new technology drives such improvements. Consider the east coast of the U.S. Even though its population has more than doubled—in some areas, it's tripled—and even though there are more developments, malls, and urban sprawl, there are more trees today than there were 80 years ago. Why? Because of technology that allows us to grow more food on less land. Technology is a friend of the environment.

Additional Collectivist Myths

Let me mention three additional myths that are used to promote collectivism. One is the idea that demand is the key to economic growth. Collectivist economists often talk about means to increase "aggregate demand," as if that would ensure that the economy will grow. Following Keynes, they assume that the economy is like a machine. But again, the economy is an aggregate of tens of millions of people, millions of businesses, millions of technologies. We don't know how it interacts on a day-to-day basis. We don't know what's going to work or not work. Who could have conceived of eBay ten to twelve years ago? But today, 400,000 people make their livings on eBay. When Google was launched, there were ten other search engines. Who would have thought another one was needed? Isn't that how you get so-called "bubbles"? But Google found a way to do it better and ended up on top. Innovation is the key. Whether it's railroads, cars, computers, the Internet, or iPods, risk-taking is messy. It is often irrational, and seemingly wasteful. But it's the only way to determine what works best and what doesn't.

Another collectivist myth concerns trade. If I were dictator of the world—even though I believe in the First Amendment—I would ban trade numbers, especially merchandise trade numbers. They just lead to mischief. We are given the impression that a trade surplus is like a profit and a trade deficit is like a loss. But trade is not a transaction between countries. It takes place between parties. For example, *Forbes* magazine buys paper. For all of the 88 years that we've been in existence, we've run a trade deficit with our paper suppliers. If you look just at that trade deficit, you might think we are doing poorly. But if you look at the two parties involved, that turns out to be an illusion. The paper supplier thinks he's going to make money selling his paper. We think we're going to make money by taking the paper and putting print on it, with value added. So it's a mutually profitable transaction, even if it looks like a trade deficit. Or consider a book printed in Taiwan. Looking at the trade number alone, it appears there is a two dollar trade deficit with Taiwan. Yet the book comes back here and retails for $24.95. The value added is in the U.S. The author gets a cut, the publisher gets a cut, booksellers get a cut, distributors get a cut, and remainder stores get a cut. Something similar happened with iPods: A lot of its parts are made overseas, but where is most of the value added? Here in the United States. North America has had a merchandise trade deficit for 350 out of the last 400 years, and we have done very well, thank you.

The final myth I'll mention concerns budget deficits. Milton Friedman said several years ago that if he had a choice between a federal budget of $1 trillion that was in the red and a federal budget of $2 trillion that was balanced, he would take the former. Deficits, in and of themselves, are not evil. Deficits must be put in context, because Washington's inability to curb spending is often used as an excuse to raise taxes.

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2005 Henry Salvatori Prize
for Excellence in Teaching

Hillsdale President Larry Arnn (l) and Hillsdale Academy Headmaster Ken Calvert (r) present this year's annual $25,000 Henry Salvatori Prize to History Teacher Kjersti Keen of Cheyenne Mountain Charter School in Colorado Springs, accompanied by Cheyenne Mountain Principal Colin Mullaney, on February 22, 2006, at a Hillsdale College National Leadership Seminar in Palm Beach, Florida. Winners of this prestigious award are selected from the hundreds of teachers nationwide making use of the Hillsdale Academy Reference Guide, *a comprehensive liberal arts resource designed by Hillsdale College faculty for teaching grades K-12. For information, see www.hillsdale.edu/academy or call 1-800-989-7323.*

Principles of Prosperity

Now let me turn to five basic principles of economic growth. First and foremost is the rule of law: Without individual equality before the law, entrepreneurs cannot challenge already existing businesses. Alliances between the latter and government regulators who place barriers before entrepreneurs must be guarded against.

The second essential principle is property rights. We take it for granted in this country that if you buy a piece of property, everyone acknowledges that you own it. Most countries don't have that kind of uniform property system. A few years ago, Hernando DeSoto, a great economist from Peru, saw that in countries like his, although there is entrepreneurial activity, there isn't the corresponding prosperity found in the U.S. And he wondered why. In his recent book—*The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*—one of the key factors he cites is the absence in so many other countries of a legal foundation for property rights. In Brazil's shanty towns, an individual may know that he owns the house in which he lives, and his neighbors may know it, but the fact is not recognized elsewhere.

Mr. DeSoto was asked by the Egyptian government a few years ago to determine who owns the businesses and residences in Egypt. His finding was that 88 percent of the businesses in Egypt are illegal. Why is that? Here in the U.S., it is possible to set up a business legally in a matter of days. In Egypt, it takes a couple of years. It requires going through numerous bureaucracies, doling out numerous bribes, etc. So it makes sense to proceed "informally." On the other hand, running a business outside the law limits its growth. Most "informal" enterprises never grow beyond the level of family enterprises, because if they get too big, they might attract the attention of the tax collector. DeSoto's group also reported that 92 percent of Egyptian housing is illegal. People living in residences may have deeds; but only a few miles away, those deeds are not recognized. In Egypt, as in so many other places, there is no uniform system of establishing and protecting property rights. As a result, four billion people around the world own $9 trillion of assets that amount to dead capital.

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What do I mean by "dead capital"? Remember that here in the U.S., the most important source of capital for new ventures is not Wall Street, the local banker or the venture capitalist. It is the mortgage market. People either increase their mortgage or take out a second mortgage in order to start businesses. This is not possible in countries like Egypt. Understanding this was the key to Japan's post-World War II economic boom. General MacArthur reformed a feudalistic property system, in which the peasants had only an informal system of property exchange, into a system with formalized property rights. Immediately, the Japanese economy took off. The importance of property rights is not sufficiently recognized by those of us who take them for granted.

The third principle of economic prosperity is low taxes. Taxes are not just a means of raising revenue for the government. They are also a price. Income taxes are a price paid for working; taxes on profits are the price paid for being successful in business; taxes on capital gains are the price paid for taking risks. In light of this, the importance of low taxes is easy to see: When you lower the price of good things—things like work, success and risk-taking—you tend to get more of them. Raise the price of these good things and you get less. In 2003, we lowered tax rates in the U.S. and the economy started to grow again. As we've seen time and again, tax cuts do not mean a loss of tax revenue. By increasing incentives, the government comes out ahead. Washington's revenues in the last fiscal year were up 15 percent—$100 billion above expectations. Washington's problem is not revenue, but spending.

The fourth principle I would mention is making it simpler to launch legal businesses. Getting bureaucracy out of the way will inject a new vibrancy into the economy. The fifth and final principle is free trade. Expanding markets and creating greater opportunity for trade benefits us all.

In closing, I will remind you of a point I made earlier: The reason that the great economic debate continues into the 21st century, despite the proven superiority of free markets in terms of delivering prosperity, is because of the misperceptions that keep democratic capitalism from capturing the moral high ground. Dispelling these misperceptions should be our priority as we carry on that debate in the years ahead.

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