How to Grow Our Economy and Revive *the American Dream*

The ROAD to PROSPERITY

PATRICK TOOMEY

with Nachama Soloveichik

Foreword by Larry Kudlow

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To my wife Kris, whose love, encouragement and confidence
inspire me to dream great dreams;
and to the sunshine of our lives,
Bridget and Patrick, who have waited patiently for Daddy
to have more time to play with them

Contents

Foreword

Barack Obama is moving American economic policy firmly away from democratic capitalism toward a big-government command-and-control philosophy. Obama is seeking nothing less than to undo the principles of the Reagan Revolution, which unleashed the private economy from the shackles of stagflation and malaise and created enormous wealth for a generation of Americans.

As I write this in May 2009, the Republican Party is searching for both a coherent message and a central spokesperson to counter Obama and the Democratic Congress. Polls indicate that the United States remains a center-right country and both the financial industry bailout and the economic stimulus package are unpopular with voters. Republicans have an opportunity to capitalize on public unease and articulate a strong, commonsense alternative to Obama's government-driven, budget-busting policies.

The Road to Prosperity by Pat Toomey is an important salvo in the fight for traditional American free-market economics against the Obama-led, European-style collectivist policies. In a clear, eloquent fashion, Toomey explains the core principles undergirding prosperity and shows how those principles are systematically being ignored or violated by the Obama administration.

Ultimately, democratic capitalism is about ideas—simple, profound ideas about creating an economy that rewards hard work, investment, imagination, and risk taking. History proves that policies of low taxes, currency stability, free trade, and respect for property rights ignite individual ambition and creativity, stimulate economic growth, and increase overall prosperity.

Toomey rightly points out that the Obama administration's policies threaten a repeat of Franklin Roosevelt's New Deal, which unnecessarily prolonged the Great Depression. The massive government spending, along with the punitive, antibusiness rhetoric and protectionist trade measures promulgated by the Obama administration echo back to the 1930s. Those types of actions did not lead to a strong, sustained economic recovery in the 1930s; and they will not today.

We are witnessing more spending, deficits, and debt creation than anyone ever imagined. Bailout Nation has run amok. While this started under Bush, Obama has raised the stakes exponentially.

The latest federal budget would double the debt in 5 years and triple it in 10. For some perspective, that debt level is higher than the combined debt levels generated under every president from George Washington to George W. Bush. According to the Congressional Budget Office, federal debt held by the public as a percentage of gross domestic product (GDP) under Obama is projected to rise to 82 percent in 10 years. The budget deficit itself never drops below $670 billion and closes the period at $1.2 trillion. That's nearly a 6 percent share of the economy.

All of this will certainly lead to large tax-rate hikes that will rob incentive power from entrepreneurs, investors, and small-business owners. Just look at Great Britain, where the top tax rate has been raised to 50 percent from 40 percent. The Thatcher revolution is being repealed over there. Unless current trends are reversed, the Reagan revolution will be repealed in the United States.

This is the wrong direction for economic growth. Instead, business tax rates should be slashed—which, by the way, would repatriate corporate earnings for domestic investment. We need a capital gains tax holiday. We should be flattening individual tax rates across the board. And all manner of loopholes and special-interest deductions should be repealed to broaden the taxable income base.

Nowhere is the Obama vision of government interference more evident than on the banking front. The White House and Treasury are using the Troubled Asset Relief Program (TARP) as a bullying club to force government control on the country's financial institutions. Exactly how it will end is unclear, although it is near certain that major banks and corporations will remain subject to government control. This reminds one of François Mitterrand, the former socialist president of France. It's way outside the American economic tradition.

According to Special Inspector General Neil Barofsky, the $700 billion TARP program—which has ballooned to more than $3 trillion in spending, loans, and loan guarantees—is "inherently vulnerable to fraud, waste and abuse." Barofsky already has opened 20 separate TARP-related criminal investigations and six audits into whether taxpayer dollars are being stolen or wasted. Rest assured that they are.

In short, Obama is seeking to change the whole relationship between the government and the free-enterprise private sector. It looks very much like a war against investors, businesses, and entrepreneurs. Shareholder rights are being eviscerated. Political decisions are replacing the rule of law, the rule of bankruptcy courts, and free-market principles.

The Road to Prosperity is a much-needed reminder of the principles of prosperity and a warning against the dangerous course that we have embarked upon. It is hoped that people will listen before it's too late.

—Larry Kudlow

Preface

It is ironic that economics is so widely seen as an obscure, complex, highly technical field best left to academics and financial experts. In fact, the most important truths of economics are easily grasped by most people, in part because they are repeatedly demonstrated in daily life. We all know intuitively, from a very early age, that, all else being equal, a shortage of something makes it more precious and an excess makes it less so. We understand without questioning that people respond to economic incentives because, as consumers, we are bombarded with and often take advantage of clearance sales, coupons, volume discounts, and the like. Even an esoteric-sounding idea such as the "time value" of money is universally understood, if not always by that name. We all prefer to be paid promptly for a service rendered rather than made to wait. Conversely, most of us take advantage of zero-percent financing when it is offered.

Despite the commonsense understanding of economics most of us demonstrate through our mundane, daily behavior, many myths and misconceptions are widely disseminated and too often believed. Special-interest groups and the politicians they support tell us that government subsidies of select industries are good for taxpayers, that wage controls are good for workers, that fewer imported products are good for consumers, that higher taxes won't slow down economic growth. They peddle these and other pernicious myths by cloaking them in half-truths and populist rhetoric. These economic fallacies are believed by people who have not been guided to see through the smoke and mirrors obscuring the economic truth. The fallacies are promoted by policy makers who seek to ingratiate themselves with the special-interest groups who are seeking their own narrow gains at the cost of the general taxpayer or consumer.

The result is a muddled set of laws and regulations that restrain the American economy. We have the biggest, strongest economy in the world by far. But we still have fewer jobs, slower growth, and less prosperity than we could have if our policies better reflected the economic truths that, upon reflection, most of us know to be true.

This book does not present any new economic theories or novel mathematical proofs. Its purpose is to remind us of the simple economic truths and the corresponding policies that lead to prosperity. The ideas that underpin prosperity can be understood by noneconomists today just as they have been understood in the past. They were discovered centuries ago and have been thoroughly explained since at least the eighteenth century. They have been successfully demonstrated throughout the twentieth century. They are available to us today and, if pursued, would usher in an unprecedented era of economic growth and prosperity in the United States.

Patrick J. Toomey
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Chapter 1

Principles of Prosperity

Our Economy: The Sum of Many Voluntary Transactions

On my way to the office each morning, I stop to buy a cup of coffee. The coffee costs me $1.49. I buy it for one reason: The cup of coffee is worth more to me than the $1.49 in my pocket. If this were not the case, I'd keep the $1.49 and forgo the coffee. The owner of the coffee shop has the opposite view. To him, the $1.49 is worth more than the cup of coffee, so he sells me the cup. The two of us have exactly opposite views regarding the value of the cup of coffee and therein lies the opportunity for our mutual gain from a single transaction. I gain the coffee that I value more, he gains the cash that he values more, and, most importantly, we are both better off for having made the trade.

This example may seem too ordinary to be noteworthy. In fact, it is exemplary of the most important principle of economics. That is, both parties to any voluntary exchange gain from the transaction. That is why they enter into it. No one is able to determine the value of a transaction better than the people engaged in it. No one knows better than I do how much I value the cup of coffee I buy each morning. No one knows better than the coffee shop owner how much he values producing and selling that cup of coffee in the morning. We each know our own self interest better than anyone else possibly could.

Thus, in a free society in which transactions are honest, purely voluntary, and absent fraud, every transaction is an economically good one[1]—benefiting both parties to it. Buying or selling a cup of coffee, a sweater, a stock, a movie ticket, or a life insurance policy; renting a car or a vacation home; or placing a deposit with a bank—every voluntary transaction between people, businesses, or any combination thereof, is an economically good transaction in that it benefits all parties involved. Otherwise they would choose not to be a party to it.

The economy is nothing more than the sum total of all of these transactions. The more economic activity, the larger the economy, and the more people improve their lives. The most important and constructive thing the government can do in the economic realm is to ensure that people are free to engage in these mutually beneficial transactions and to resist policies that hamper these transactions. There are several ways in which governments can facilitate exchange. Unfortunately, there are an almost unlimited number of ways in which governments can impede exchange.

Four fundamental principles, if adhered to, maximize the opportunity for voluntary exchange and thus for prosperity. Whether we are talking about complex exchanges like a major corporate merger, or simple ones like my daily cup of coffee, these four principles of prosperity provide the indispensible preconditions for the vibrant exchanges that enable economic growth. They are: private property rights; a relatively unfettered free market; low tax burden and government spending levels; and a stable currency.

When governments follow these four principles, people spontaneously cooperate, innovate, and elevate their individual and collective well-being. Prosperity is inevitable. Conversely, without these principles, a free and vibrant economy as we know it would cease to exist. There have been plenty of communist and socialist countries that demonstrate just how true this is. The extent to which governments adhere to these principles generally determines the level of prosperity countries achieve.

Because America has observed these principles more consistently and to a greater extent than most other countries, we have become one of the most prosperous countries in the world. But there is plenty of room for improvement in America's commitment to these principles. Because our government often strays from them, America is not as prosperous as it could and should be. For reasons political, ideological, and intellectual, government policies sometimes run diametrically opposed to these principles, and we pay the price for these mistakes with less prosperity. We will discuss a number of these policy errors at length in later chapters because these flaws can be remedied. When government policy encourages and ensures private property rights, a free market, low tax burden and government spending levels, and a stable currency, the result is stronger economic growth, more opportunities, higher wages, and a better living standard for our society. This goal is well worth striving for.

The First Principle: Property Rights—Ownership Is the Foundation of Markets

Private ownership of property is the foundation upon which a free economy is built. Because most economic transactions involve the exchange of property, clearly defined ownership and relatively unfettered rights attached to ownership are necessary preconditions to a free and vibrant economy.

Property takes many forms. The word first brings to mind real estate—land, buildings, houses—also called real property. But it also includes personal property, sometimes called chattel in the common law tradition. Personal property is, generally speaking, things that are not permanently affixed to land and thus movable. Goods, clothes, money, and my morning cup of coffee are all considered personal property. Finally, intellectual property refers to the result of personal creative effort, like songs, books, and the design of a commercial product, machine, software, or logo.

In all its forms, the ownership of property must be clearly established in order to maximize its availability for use or exchange. There is not much doubt that the coffee shop owner owns the cup of coffee he sells to me each morning just as he is confident that the $1.49 I give him belongs to me. If either of us is wrong, the consequences are not very significant. After all, it is only $1.49, and the coffee ceases to exist as such within fifteen minutes of my buying it.

But it is a very different matter if the property in question is a substantial piece of land. A buyer with plans to build on the land will not make the purchase if he cannot be sure the seller is the rightful owner. If ownership were in doubt, the buyer risks substantial loss should the legitimate title holder one day demand the return of the property. The same is true of a car, a plane, jewelry, or anything else of value. In order to facilitate the voluntary exchange of property, a prudent government must establish clearly defined rules regarding private property ownership. These rules vary depending on the nature of the property and the manner in which it is acquired.

For instance, real property ownership is usually registered in public documents kept by local governments. Ownership of cars, planes, and boats is typically documented by state governments, which issue titles, while securities ownership is registered by federal government agencies. These are examples of the constructive role governments can play in establishing and documenting the unambiguous ownership of private property, thereby facilitating their use and exchange.

Government helps to establish rightful ownership of property in another way. Since property can be acquired or transferred in many ways, it is helpful to have clear, universally accepted rules for establishing legitimate transfers. Property can be legitimately acquired when it is purchased, traded for, inherited, found, invented, created, or received as a gift. It can be obtained illegitimately by theft or fraud. It can be taken in bankruptcy or seized by the state for a number of reasons. In all of these examples, well-defined laws, especially laws that protect owners from illegitimate loss of property through theft or fraud, are conducive to economic growth.

Finally, it should be noted that property can be privately owned through many different vehicles. People often chose to own and deploy property jointly with others through partnerships, corporations, or trusts. It is very important that these forms of ownership receive the same government recognition and protection as individual ownership. As long as the property is acquired legitimately, there is no reason why they should not.

Without the protected right to own private property and engage in the exchange of property, we would have no real economy to speak of. To see just how true that is, consider the alternative. The opposite of privately owned property is communally, or collectively, owned property. One ideal of every communist state is to restrict the ownership of all property to all people jointly, with the government controlling its usage. Many states have attempted this system to varying degrees. All such experiments have resulted in impoverishment and often tyranny.

The Rights of Ownership

Just as important as establishing lawful ownership of private property is respecting the rights of property ownership. Here government's record is much less constructive. Real ownership means the exclusive right to do as one wishes with one's property, provided one is not harming another person or another person's property. This includes the rights to use, alter, exchange, give away, or destroy one's own property. Unfortunately, governments too often succumb to the temptation to restrict the rights of property owners. When they do, they invariably diminish prosperity by impeding the voluntary exchanges that enhance wealth.

The New Jersey Highlands Water Protection and Planning Act is a perfect example of the harm government can do when it unduly restricts an owner's use of his property. Passed by the New Jersey Legislature on June 10, 2004, the Highlands act set strict restrictions on the development of land in Northwest New Jersey with the alleged goal of protecting the state's fresh water drinking supply.[2] Whether this goal was sincere is a legitimate question, but even the well-intentioned goal of protecting the state's water supply should have been accompanied by appropriate compensation. Landowners sued but court decisions have so far denied landowners their due compensation.[3]

Covering 88 towns and an 850,000-acre region, the result of the Highlands act was that thousands of landowners suddenly found themselves unable to use their private property as they wished. Developers are unable to build homes; even some farmers are unable to farm; and many wishing to sell their property have found the value of their land decreased significantly.[4]

The ripple effects of these losses are huge. Farmers and developers whose livelihoods depended on the development of their land are essentially prohibited from earning a living. Jobs are lost when the farmers and developers no longer need to employ the workers they would have used on the now-restricted land. The homes they would have built and the produce they would have grown will never reach the marketplace.

Consider Andy Drysdale, a dairy farmer in Chester Township, who planned on subdividing his 16 acres of land and retiring on the earnings. Drysdale, then 70, saw the Highlands Act squash those plans, leaving him without a retirement nest egg.[5] Or consider all the people who would have purchased homes in the Highlands area but were forced to go elsewhere. During the first half of 2005, new-home construction grew by 8 percent in New Jersey; in the seven counties affected by the Highlands Act, new-home construction decreased by 28 percent.[6] A whole range of economic transactions that would have created wealth and enriched ordinary New Jerseyans will never take place. And we have the New Jersey government to thank for that.

Unfortunately, the New Jersey Highlands Act is just one of many ways in which governments restrict the legitimate use of private property and thereby restrict economic growth. A recent Supreme Court decision (*Kelo v. New London*) determined that a local government can forcibly acquire a person's property for the purpose of transferring it to another private owner. Governments force banks to make certain loans that the banks believe may be imprudent. They prevent sports fans from selling their baseball tickets to the highest bidder by forbidding what they pejoratively call scalping. They deny restaurant owners the right to sell a glass of wine with dinner unless they acquire expensive licenses. The list goes on and on from the seemingly trivial to the very significant.

These and other restrictions on the use of private property are justified with the highly dubious notion that governments make better decisions about how people should use their property than the individual property owners themselves. When governments limit their involvement with private property to defining and protecting ownership, they facilitate the exchanges that contribute to prosperity. When they restrict the rights of people to decide for themselves what to do with their property, they inhibit those exchanges and diminish prosperity.

The Second Principle: Markets Work—Let Them!

The free market economy has been one of the greatest human inventions ever. No other economic system has ever come close to matching its ability to generate prosperity, eliminate poverty, and foster opportunity. Yet so many political figures fall victim to what Fredrik Hayek called "the fatal conceit"—the belief that they can improve upon the outcomes of the marketplace by manipulating it in ways they deem appropriate.

There are two major reasons why governments should generally leave markets alone to work their wonders without excessive interference. The first is that free markets enable the individual pursuit of self-interest to result in broad, general well-being far better than governments can. The second is that government interference in the markets is often counterproductive. Government regulations are defended as necessary to protect some segment of the public, and regulations that ensure public safety, help to reduce the risk of fraudulent transactions, or address the effects on nonparticipants to an exchange, such as pollution, all have their place. But excess regulations often fail to achieve their intended goal and carry a cost that outweighs their intended benefit.

Self-Interest Serves the General Interest

We have already seen that a voluntary exchange occurs between people only when both parties perceive themselves to benefit from the exchange. If not for each individual pursuing his self-interest, the exchange would not occur. Equally important is the fact that an economic system based on voluntary exchange inevitably elevates the well-being of the general population. Perhaps the greatest genius of a free-market economic system is the mutual benefit that arises spontaneously from the pursuit of individual self-interest.

The brilliant eighteenth-century Scottish economist Adam Smith was the first to systematically describe this remarkable mechanism in his seminal work *An Inquiry into the Nature and Causes of the Wealth of Nations,* commonly referred to as *The Wealth of Nations*:

> It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self-interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.[7]

Like all of us, the butcher, the brewer, and the baker sell their products in order to improve their own circumstances, but they can't make a sale unless they simultaneously improve the circumstances of the buyer. Their own self-interest drives them to offer the prospective consumer sufficient value to make the sale.

Furthermore, in a free-market economic system, there will always be another butcher, another brewer, and another baker competing for the same sale. Therefore, each must strive to provide as much value as possible to consumers—not out of generosity but out of self-interest. The competition inherent in a free-market system inevitably leads to innovation in products, services, and business methods that continually improve the range, quality, and value being offered to consumers.

A free-market system of voluntary exchange also serves to increase the general economic health of a society by directing goods and services to those who value them most and can be most productive with them. Coffee beans are of little use to a home builder but my coffee shop owner needs them in large quantities. Similarly, my coffee shop owner would not know what to do with a backhoe but the home builder needs one every time he starts a new home. The value of these items is simply what someone is willing to pay for them. By directing them to those who value them most, the free-market system maximizes their value and puts them to their most productive use.

Another way in which free markets dramatically enhance the level of prosperity is by allowing both specialization and a division of labor to maximize productivity.

Specializing enables people to develop their talents and skills and produce goods and services far more efficiently than others could produce them themselves. We take it for granted that we would neither want to live in a home built by my coffee shop owner, nor consume the coffee and Danishes produced by the home builder. The free-market system allows them both to specialize, and all of us benefit from the superior products that result.

Similarly, dividing the production of a complex item into a series of discrete steps, each carried out by a different person operating cooperatively with all the others, dramatically increases the output of the group. A single person would be hard-pressed to assemble an automobile by himself even if given a considerable period of time. That same person, however, could easily master one part of the assembly process while other workers could master the remaining tasks. Together, they could assemble several cars each day.

Market competition, directing goods and services to where they are most valued and useful, and specialization and a division of labor are all made possible by the voluntary exchanges of a free market. All of these individual exchanges increase the wealth of each individual partner to each exchange and, collectively, the process enhances the quality of life for everyone.

Once again, Adam Smith made this case so well over 230 years ago in perhaps the most famous of all passages from *The Wealth of Nations*:

> Every individual … intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that

> it was not part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.[8]

Excessive Regulation Always Has Unintended, Negative Consequences

Regulations by their nature restrict or raise the cost of exchanges. Some are worth the cost. For example, the public health benefits of safely disposing toxic, industrial waste justify the higher cost this imposes on consumers. But excessive, unnecessary regulations, some of which we will consider next, inhibit productive exchanges, thereby diminishing the individual and collective wealth of society.

There are as many noble reasons for government to interfere in markets as there are cynical ones. Often it is special interests that stand to benefit at the expense of the general public that push a particular regulation. Just as often, politicians honestly think they can provide for the general public better than the free market can. But whatever the motivation or complaint, the result is almost always the same. Government regulations raise costs and produce adverse side effects that inhibit the voluntary transactions that are so integral to the growth of our economy.

Government-set prices, meant to lower costs for consumers, create scarcity when set too low as they were for gasoline during the energy crisis of the 1970s. They create windfall profits when set too high as with certain agricultural products in recent decades. Licensing requirements, intended to protect consumers, often drive up costs and limit job opportunities by needlessly restricting the number of people allowed to engage in a given trade or profession such as haircutting or taxi driving. Mandated coverage requirements for health insurance, justified as necessary to ensure access to health care, drive up the costs of insurance policies, thus leaving more people without any health insurance at all. Excessively high minimum wages, sold as protections against worker exploitation, prevent some people from earning any wages. Tariffs and quotas on imported products, promoted as a means to protect American jobs, limit choices and raise prices for consumers while destroying the jobs of American exporters who suffer from retaliatory measures.

These are just a few examples, but there are innumerable ways in which governments interfere with the operations of free markets. Whether the motivation is noble or ignoble, political or philosophical, regulations always have at least one effect in common: They hamper voluntary exchanges by forbidding them, restricting them, or raising their costs. Thus, any regulation proposed by government should be scrutinized with a very skeptical eye. And policy makers should always bear in mind that, when left alone, markets will allocate resources and facilitate the exchanges needed to elevate the general level of prosperity.

The Third Principle: Taxes and Spending—The Lower the Better

Chief Justice John Marshall famously said, "The power to tax involves the power to destroy."[9] He was right. This quote embodies one of the irrefutable laws of economics: If you tax something, you get less of it. If you tax it enough, you can destroy it altogether. This law applies to any product or service taxed directly, and it applies to the economy as a whole.

Taxes and government spending are two sides of the same coin—the coin of private wealth creation that is taken by government. Ultimately, taxes are needed to pay for all government spending—that which is legitimate and necessary and that which is illegitimate and wasteful. Governments can borrow to fund the shortfall between tax revenue and expenditures, but large borrowings over long periods of time are unsustainable.

In the long run, the level of government spending drives the level of taxes.

Unfortunately, governments are naturally biased in favor of ever more spending. In order to fund the largesse, taxpayers are burdened with high taxes and a corresponding decrease in economic growth. Maximizing prosperity requires overcoming this bias and minimizing government spending. Only then can we enjoy the low tax rates and expanded prosperity that would result.

Death by Taxes

A tax on a product is a cost not intrinsic to the production of the product but imposed arbitrarily by government. Since a producer must recover all of his costs in order to make a profit and stay in business, he generally has to pass on the full cost of any tax to potential consumers in the form of higher prices. This tax creates a wedge between the provider of a product and its consumer, raising the cost to the consumer without enhancing the value of the product. This wedge separates consumers from producers—that is, it prevents voluntary exchanges—in proportion to its size.

Even a very small tax will prevent some sales. I am willing to exchange the $1.49 in my pocket for my morning cup of coffee. But if the government raises the sales tax, even by just a few pennies, I may decide to brew my morning cup in the office instead of buying it at the shop. Or I may forgo buying a second cup later in the morning. Some coffee drinkers will inevitably cut back on their consumption even if the tax hike is just a penny. The greater the tax increase, the fewer cups of coffee sold. The relationship between the tax rate and the decline in sales may not be linear—it may vary over time and from product to product—but the basic effect is always the same: Higher taxes result in fewer transactions and lower sales.

And taxes can take many forms. In some ways the sales tax just described is one of the less objectionable forms. At least it is transparent—the consumer/taxpayer sees exactly what the government is taking from him on every transaction. Many other forms of taxation are much less transparent, but they are at least as damaging to an economy. Corporations are subject to all kinds of taxes: income taxes, windfall profit taxes, and user fees, which are taxes by another name. In my home state of Pennsylvania, corporations are even required to pay a tax on their accumulated capital regardless of whether or not they are profitable! But all of these taxes get passed on to consumers in the form of higher prices for the goods and services produced. In this sense, corporations do not really pay any taxes—instead they collect them from their customers and pass them on to the government while making fewer sales as a result.

People pay the taxes that governments force businesses to collect, but people also pay a wide range of taxes directly. Sales taxes, payroll taxes, income taxes, capital gains taxes, and property taxes are just a few of the kinds of taxes that creative politicians have imposed on people. While all of these inhibit economic growth, some are more damaging than others.

Most harmful to prosperity are those taxes that discourage productive activity. Income taxes and capital gains taxes discourage work and investment, respectively. The higher the tax one has to pay on the last dollar earned, the less it pays to work—literally. Less pay for work makes alternative activities like leisure, recreation, or simple inactivity relatively more attractive. The equation is simple: The higher we tax people's incomes, the less they work.

Capital gains are the economic rewards for successfully taking financial risk. Investments that generate rewards generally contribute to economic growth—hence the reward. When governments impose a tax on capital gains, they create an asymmetry in risk-reward calculations that discourages risk taking. A dollar lost on an investment often means the investor loses 100 cents. In other words, he bears the loss in its entirety. If the government imposes a 20 percent tax on capital gains, then a dollar reward on an investment yields the investor only 80 cents after taxes. Any investment in which an investor must fully absorb any loss but can keep only a portion of the gain is less attractive than one in which gains and losses are treated equally.

While some taxes do more economic harm than others, all taxes do less harm as the tax rate decreases. For any kind of tax and any given level of tax revenue sought, economic growth is inhibited least when taxes are applied on the broadest possible base and at the lowest possible rates. If a retail sales tax, for example, is meant to produce a particular amount of revenue, exempting certain categories of goods from the tax requires that other goods be subject to a higher rate than if all items were taxed equally. This unequal treatment leads to excessive allocations of resources to the untaxed items, and results in suboptimal economic growth.

The Problem with Government Spending

Of course, over time, taxes can only be as low as government spending permits. Unfortunately, the natural tendency of governments is always to increase spending. There are several reasons for this economically unhelpful proclivity, but they generally boil down to two. The first is the law of concentrated benefits outweighing dispersed burdens. The second is the fact that people naturally tend to focus on observable benefits and ignore invisible costs.

Concentrated Benefits Beat Dispersed Burdens Spending money ingratiates politicians to the beneficiaries of the spending. Whether it is money for education, subsidies for heating oil, or funds for bridge building, there are usually two broad categories of people who want the government to increase any particular spending: the people meant to receive the benefit—the student, the home owner, the traveler—and the people who are paid to deliver the benefit—the teachers, the oil distributors, the construction companies. Both groups always demand that the government spend more on them. The concentrated benefits they stand to receive make it worthwhile for them to lobby government aggressively, either directly or through surrogates.

The taxpayers forced to pay for these benefits, on the other hand, can hardly afford to fight each government spending program, which, individually, adds only a tiny amount to their overall tax burden. Those seeking more government spending lobby aggressively for it while those paying for it are relatively silent. The path of least resistance for Congress is always to agree to more spending.

I will never forget my first days as a newly minted member of Congress when I witnessed this asymmetry in pressure for more government spending versus less. Having never served in any legislative body, I was naïve enough to be shocked by the number of people, mostly lobbyists, who wanted to meet with me immediately after being sworn into office. Much to my disappointment, the vast majority of them wanted to impress upon me how vitally important it was for the federal government to spend more money on the program from which they, or the people they represented, benefited. No one came to my office to lobby me to vote for less government spending and lower taxes.

The Seen Trumps the Unseen

It is not just a lack of resources that prevents voters from protesting. Often the general public is lulled into supporting higher spending because it cannot see the harm caused. Henry Hazlitt describes this phenomenon as:

> The persistent tendency of men to see only the immediate effects of a given policy, or its effects only on a special group, and to neglect to inquire what the long-run effects of that policy will be not only on that special

group but also on all groups. It is the fallacy of overlooking secondary consequences.[10]

The unseen, secondary effect of government spending is all the economically beneficial private sector spending that government spending prevents. As we have seen, government spending is generally paid for either by taxes or borrowing. In either case, the government is taking money out of the private sector—money that otherwise would have been spent or invested—and spending it on some politically motivated project.

When a government decides to build a bridge, the politicians responsible are usually quick to tout the number of jobs that will be created to complete the design, financing, construction, and eventual management and maintenance of the bridge. These folks become very visible as the project progresses and people tend to associate the bridge with the creation of jobs.

But this view presents only half the picture. All the money spent on the bridge project had to come from the private sector—whether taxed or borrowed. That money would have been spent on something else had the government not taken it for the bridge. So while it is true that the government creates many jobs when it undertakes such a project, it destroys at least an equal number of jobs by reducing spending elsewhere in the economy by the same amount as is spent on the bridge.

If the project in question is truly needed and would have been undertaken privately absent the government's involvement, like a strategically located bridge, then the net effect on job creation and economic output is probably only slightly negative since governments usually overpay for things.

However, governments routinely spend money on projects that no private individual or business would ever consider. A "Bridge to Nowhere,"[11] an indoor tropical rainforest in Iowa,[12] and the Cowgirl Hall of Fame[13] are just a few of the tens of thousands of ridiculous projects the U.S. federal government funds each year. These egregiously wasteful expenditures could never be justified by anyone risking their own money and are funded at the expense of productive alternatives in the private sector.

Governments also spend vast amounts of money simply redistributing income from one group of people to another through major entitlement programs. Social Security and Medicare are the two biggest programs by far and, as I explain in subsequent chapters, are completely unsustainable. Absent reform, they will lead to crippling tax increases.

The net effect of government spending is not the visible economic growth and jobs created directly, but those activities minus the economic growth and job creation that would have been created had the government left the money in the private sector. Unfortunately, this net sum is very often a negative number since private spending and investment tend to generate more productive economic activity than government spending. Thus, the unseen losses frequently cost more than the visible gains. The more governments spend, the more economic growth is diminished.

The Fourth Principle: Stable Money

We all use money almost every day. In its various forms of cash and coin, checks and deposits, it is almost as ubiquitous as air and water. While most of us intuitively know how to prudently manage our own money, the management of our country's monetary policy often elicits confusion, contradiction, bewilderment, even despair. And that's just among members of Congress!

Understanding good monetary policy need not be daunting. There are just two things to remember about money that should guide all monetary policy. First, money serves three distinct purposes that enable our economy to function efficiently. Second, money serves those three purposes best when its value is stable.

Therefore, the most important responsibility of a country's monetary authority, in our case the Federal Reserve, ought to be maintaining a stable monetary unit. To see why this is so, let us first consider the three functions of money.

The first purpose to which we put money is as a unit of measure. Much like the foot is a unit for measuring length and the pound is a unit for measuring weight, a dollar is a unit for measuring value. Since the value of all goods and services can be measured in dollars, it provides us with a very convenient way to compare the values of different things.

As a unit of measure, money also enables us to keep accounts. A person, household, or business may have thousands or millions of transactions in a given period of time. A unit of measure allows us to know, among other things, whether the net effect of these transactions is positive or negative. If my favorite coffee shop owner one day adds to his stocks of coffee cups, sugar, and muffins while selling a high volume of coffee, tea, and scones, in the absence of a single, standard unit to measure the value of all of these items, it would be pretty hard for the shop owner to know whether he made progress or lost ground that day. Money provides him with that unit of measure.

The second purpose for which money is almost indispensible is as a medium of exchange. I say almost indispensible because it is possible for an economy to run on barter, in which different goods and services are traded directly. It is just that barter is so cumbersome and inefficient that relying on it as a payment system precludes having a modern, advanced economy. Imagine a shoemaker going into the coffee shop for a cup of coffee. What if the shop owner has no need for shoes and refuses to accept them in exchange for his coffee? The shoemaker would have to find someone willing to accept his shoes in exchange for something the coffee shop owner will accept. Determining the respective quantities would vastly complicate this already onerous arrangement. Clearly, a universally accepted medium of exchange is a precondition of a strong economy.

Finally, money serves as a store of value over time. Though we take this role for granted, money's function as a store of value is really amazing, especially since paper money has no real, intrinsic value at all. A $100 bill and a $1 bill differ only in the images printed on otherwise identical, nearly worthless pieces of paper. Yet we will exchange 100 times the quantity of real goods for the former as for the latter. We do this because we have confidence that others, in turn, will accept these dollars when we want to purchase something.

One of the great virtues of money's ability to store value is that it enables us to separate our consumption from our production. Ultimately, we all produce goods and services so that, in exchange, we can consume other goods and services. But the timing of our production and consumption can vary widely. A small home builder, for instance, might build just a few homes each year and get paid once every few months when he sells a home. This builder, however, certainly needs to consume many goods—foods, clothing, shelter certainly—almost continuously. It is the fact that the money he periodically receives holds its value that enables him to live comfortably between paydays. If our money were just a medium of exchange but could not store value over time, we would have to immediately spend what we get paid. Savings would be impossible and so would a modern economy.

In all three of its vital functions—as a unit of measure, a medium of exchange, and a store of value—money only performs well when its value is stable, predictable, and perceived with confidence. It is easy to see how the voluntary exchanges that comprise any economy are impeded when this is not the case.

The whole point of a unit of measure is that it is agreed upon and constant, thereby providing a common understanding of that which is being measured. There is nothing magic about a pound consisting of 16 ounces. We have all just agreed that it does. If instead we had decided that a pound consisted of 12 ounces, the actual weights of things would not be any different; we would just count those weights differently. If, however the number of ounces to a pound varied constantly and unpredictably, then we would not know the real weight of something measured in pounds. The pound would be a useless unit of measure.

The same is true of money. As long as it is stable, whether a dollar's value is equal to 100 Yen or 1,000 Yen, 1/1,000 of an ounce of gold or a full ounce, a quart of gasoline or a gallon, it can be a perfectly good unit of measure. Problems arise when the dollar's value fluctuates. Like the previous example, if the dollar's value varied unpredictably, then we would not know the real value of things measured in dollars. Confusion would reign. Financial accounts would lose their meaning, and perhaps most importantly, vital information about scarcity and abundance, as reflected in prices, would be obscured by unreliable measurements. Money's effectiveness as a unit of measure depends on its stability.

Similarly, when the value of money is unstable, money loses its effectiveness as a medium of exchange. My favorite coffee shop owner would not know how many dollars to charge for his coffee if he did not know what a dollar was worth. If people did not know the real value of things expressed in dollars, then they would not want to use dollars as their medium of exchange. Economic activity would be severely hampered.

In addition, as we saw in the example of the home builder, money is an effective medium of exchange when it is a reliable store of value over time. If the aforementioned home builder worried that the money he received for the sale of a house might lose its value, he would inevitably seek an alternative, less risky medium of exchange. One of the biggest reasons people accept paper money in exchange for the goods and services they produce is their confidence that it will allow them to buy as much tomorrow as they can today. If a monetary unit is unstable, then it cannot play this role of storing value. The risk that one's money will lose value increases the incentive to spend it quickly before it does. It is for this reason that volatility in a currency's value in general discourages savings. Conversely, if money is expected to gain value, there is an incentive to hoard it. In all of these cases, unstable money leads to distorted economic decisions and misallocated resources. These, in turn, mean less economic growth.

Since all of money's vital functions depend on its value remaining stable, one would expect a long-standing, overwhelming consensus for monetary stability among policy makers. One would be wrong. From ancient days through today, history is replete with examples of governments that have destabilized their currencies, almost always by intentionally devaluing it. This always leads to inflation, and inflation is always harmful to an economy.

Since the Federal Reserve Act of 1913 all power to control the supply of money in America has rested with the Federal Reserve Bank (the Fed). Placing so much power in the hands of unelected, and essentially unaccountable, officials would normally give great offense to my generally democratic instincts. But I have served in Congress and I am convinced that we would be in far worse shape if we let those folks run the money machines. It is hard enough to keep the Fed from inflating; we wouldn't stand a chance against Congress.

In fact, part of the reason Fed policy tends toward inflation is the fault of Congress. It is Congress, through the Federal Reserve Act, that mandates that the Fed should seek "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."[14] While all of these are worthy goals for our economy, the Fed is ill-suited for achieving the first and need not worry about the third. In attempting to actively achieve the goal of maximum employment, the Fed can easily undermine the second, and most important, goal of price stability. When the Fed maintains stable prices, the markets keep long-term interest rates in sensible ranges.

The mandated goal of maximum employment puts pressure on the Fed to add to the money supply (or "ease," in monetary parlance) whenever the economy is at less than full employment. This easing is widely believed to stimulate consumer and business demand, thereby expanding economic growth and increasing employment. But if this kind of easing begins too soon, goes too far, or lasts too long, as it did from 2002 through 2005, it can have negative, unintended consequences, including credit bubbles, devaluation, and especially inflation.

And inflation is always bad news for an economy. Inflation reduces economic growth by destabilizing money and thereby undermining all three of the key functions that money serves (as discussed previously). It also harms people and economies in other, major ways, including the inequity of punishing savers and providing a windfall to borrowers; its interference with the price mechanism; and the unproductive speculation it encourages.

Since inflation is always caused by mismanaged monetary policy, when it occurs in America, it is always the fault of the Fed. Congress should narrow the Fed's mandate to do the one thing it can and ought to do: maintain a stable currency. This, in the long run, is the best way to moderate long-term interest rates and maximize employment since this is the way to enable the dollar to perform its three vital functions well.

Where We Go From Here

The four foundational principles of prosperity already described—private property rights; relatively unfettered markets; limited government spending and low taxes; and stable money—certainly do not represent any new discoveries in the field of economics. The importance of these ideas in promoting economic growth has been well understood as classical liberal economics for hundreds of years. I think of them as the cornerstones of economic freedom. It is hard to deny how successful they have been when consistently applied.

One of the great lessons of the last century is the spectacular improvements in the human condition that have resulted from the wealth that comes with economic growth. Life spans, child survival, health care, scientific knowledge, sanitation, living conditions, opportunities to pursue interests and leisure, the state of our environment, and all forms of material well-being have improved dramatically for virtually everyone in all societies that generally follow these principles. Those that have generally neglected them, however, remain mired in the misery and deprivation of poverty.

Yet very often policy makers violate these foundational principles. Sometimes these errant policies result from ignorance. More often they are a response to political pressure applied by a narrow special interest group. In still other cases, proponents of compromising these principles are willing to sacrifice economic growth in favor of some other priority such as greater uniformity in income or diminished pollution.

But it is economic growth that makes dramatic improvement of the human condition possible. When these foundational principles are followed, free markets drive these improvements rapidly and spontaneously. On the other hand, when governments neglect these principles, the unseen and unintended consequences typically do more harm than good.

In the following chapters I consider a number of policy challenges facing the United States and the solutions that follow from observing these proven principles of prosperity.

Chapter 2

Lessons from History

The Great Depression, the Reagan Revolution, and the Celtic Tiger

The contrast between the popular mythology surrounding the causes and cures of the Great Depression and the understanding of most economic historians on the topic is stark. Most Americans have been taught—either formally in school or informally through our popular culture—that the Great Depression was the result of unbridled capitalism and excessive speculation. The underlying assumption is that unfettered free markets inevitably go through cycles, some of which include cataclysmic troughs. According to this orthodoxy, the absence of governmental safety nets left swaths of American society destitute when the bottom fell out from under our economy during the 1930s.

FDR's response to the calamity he inherited upon taking office in 1933 was swift, dramatic, and unprecedented. He transformed the federal government from a modest enterprise with constitutional boundaries into a behemoth with virtually unlimited powers. He created a network of social safety nets meant to protect Americans from the deprivation of the current downturn and all future downturns—as it was presumed that capitalism would fail again and again and continually leave Americans economically vulnerable. He is commonly credited with using the enormous powers he had assumed to end the Depression to reignite economic growth and ensure broad-based prosperity.

There is just one problem with this popular understanding: It could not be farther from the truth.

How ironic that the very federal government credited with saving us from the Depression actually triggered the stock market crash of 1929, and then turned what probably would have been a brief and ordinary recession into the worst economic contraction in American history. Eminent economists and historians, including Irving Fisher, Milton Friedman, Anna Schwartz, Ben Bernanke, and Amity Shlaes, among many others, have amply documented the grievous policy errors committed by Herbert Hoover, FDR, the United States Congress, and the Federal Reserve. As we will see, these leaders managed, collectively, to violate all four of the fundamental principles of prosperity outlined in the first chapter of this book. And they did so repeatedly and to devastating effect.

It was tragic enough that the federal government, through well-intentioned but profoundly misguided policies, caused so much unnecessary misery in the 1930s. This tragedy, however, has been compounded many times over by our popular misunderstanding of our own history. The widespread misperception that the newly empowered federal government saved us from the Depression forged a political consensus for a vastly larger and more powerful federal government. After thriving for a century and a half under a government of limited powers, Americans overwhelmingly accepted FDR's riding roughshod over the

Constitution and assuming unprecedented powers. Our continuing misunderstanding of the Depression underpins popular support for, as Ben Bernanke describes it, the "consensus that the government bears the important responsibility of trying to stabilize the economy and the financial system."[1] Correctly understanding our history is essential to forging a new consensus on the proper role of the federal government in our economy.

It must have taken an event of seismic proportions to so profoundly change the role of government in our society, and it is hard to overstate the magnitude of the crisis that was the Great Depression. From 1929 to 1933, the American economy—the actual output of goods and services in America—declined by a staggering 30 percent. During that time, the percentage of unemployed Americans grew from about 3 to nearly 25 percent. And many Americans could only find part-time work. Thousands of banks, businesses, and individuals became bankrupt; the stock market crashed and then declined further; and prices for goods, services, and assets generally declined by about 10 percent each year.[2] The economy improved significantly from 1934 through 1936 only to collapse again. It was the longest, deepest economic disaster in American history by far.

For decades after the Great Depression, economists argued about its causes until, in 1963, Milton Friedman and Anna Schwartz published their seminal work: *A Monetary History of the United States, 1867–1960*. Friedman and Schwartz forged a new consensus among economic historians that the proximate cause of the Great Depression, and a major contributing factor to its duration and severity, was the mismanagement of monetary policy by the Federal Reserve Bank.

The Federal Reserve's Great Deflation

Although inflation is by far history's more common monetary policy sin, deflation can be every bit as devastating, as 1930s America proved. Deflation is a decline in the general level of prices for goods and services caused by an increase in the value of the currency. A currency increasing in value, relative to the general price level, can be just as destabilizing to an economy as a currency losing its value. In either case, the instability undermines the currency's ability to serve the three key functions outlined in the first chapter—as a unit of measure, a medium of exchange, and a store of value. Like inflation, deflation is always fundamentally a monetary phenomenon. It can only be caused by a contraction in the supply of money relative to the overall volume of goods and services. Since the Federal Reserve controls the supply of American money, deflation, like inflation, is always the fault of the Fed.

Motivated by a misguided desire to curb speculation in the stock market, the Federal Reserve Bank needlessly raised short term interest rates in the spring of 1928, making monetary policy more restrictive than economic activity justified. A little over a year later, the excessive monetary contraction induced a recession. According to Ben Bernanke, the recession "together with high interest rates, was in all likelihood the most important source of the stock market crash that followed in October."[3]

Two years later, the Federal Reserve made a bad situation worse. Speculators succeeded in driving the British government off the gold standard in September 1931. Sensing weakness, they turned their attack to the United States, draining the Federal Reserve's gold reserves and helping to create a run on deposits at many American banks. The classic Central Bank response to the circumstances of the fall of 1931—a shrinking economy, declining prices, and a drop in money supply caused by the banking crisis—would be to stabilize the money supply by injecting funds into the banking system. But as Friedman and Schwartz point out, the Fed did the opposite—raising interest rates again in order to stem the decline of the dollar against gold.[4] They succeeded, but in the process, increased the value of the dollar against prices of goods and services generally. This deflation accelerated the economic collapse.

Throughout the 1930s, the Federal Reserve failed to recognize that their monetary policy was far too restrictive. By allowing the money supply to contract dramatically, they caused an unprecedented decline in prices and contributed to a devastating wave of bank failures. Because the issuance of loans by banks multiplies the supply of money, the bank failures themselves accelerated the decline in the money supply. As prices continued to fall, people withdrew their money from banks. It was rational for people to hoard their money instead of spending it in anticipation of lower future prices. In the process, they reinforced the downward economic spiral.

Clearly a vicious, self-perpetuating cycle had taken hold, driven largely by the failure of the Federal Reserve to maintain a stable dollar. Unfortunately, the elected branches of the federal government were, at the same time, wreaking havoc of their own.

Herbert Hoover Intervenes

It was not President Hoover's refusal to act that contributed significantly to the Great Depression—as conventional wisdom has it. On the contrary, it was his refusal to leave the economy alone.

Only a couple of weeks after the market's crash in October 1929, Hoover held a series of meetings and conversations with the country's most prominent business, labor, and political leaders. He urged mayors and governors to continue spending money on public works projects, while Hoover did the same at the federal level.[5] He also convinced business leaders to keep wages up, believing that higher or steady wages would increase purchasing power, thereby increasing production and stabilizing the markets.[6] Hoover apparently did not understand that higher wages could only be sustained by higher labor productivity and a stable dollar—not government fiat or arm twisting.

Hoover pressured businesses to maintain wage and employment rates when they needed to cut costs. Steady wages helped workers who actually held jobs, but declining prices and sales meant businesses simply could not maintain both the wage level and their own viability. With prices declining by about 10 percent per year, comparable wage reductions would have helped businesses survive without reducing the purchasing power of workers. Instead, maintaining nominal wage rates meant unaffordable real wage increases and, eventually, these contributed to massive layoffs, an inability to hire new workers, and in many cases, the collapse of the business itself.[7] The unemployment rate went from an average of 3.2 percent in 1929 to a crippling 16.3 percent in 1931.[8] Hoover's well-intentioned efforts to help workers did more harm than good, and the persistently high unemployment rate he helped create delayed an economic recovery.

One of Hoover's most harmful actions was his signing of the Smoot-Hawley Tariff Act on June 17, 1930 despite widespread protest from economists across the country. The bill raised import tariffs an average of 59 percent on more than 25,000 products.[9] As we will see, free international trade is a prerequisite for maximizing economic growth.

The naysayers proved prescient. Countries around the world retaliated with tariffs of their own, in effect, closing their doors to American exports.[10] The stock market nose-dived. Those who thought the Smoot-Hawley Act would be their salvation saw exports to Europe drop from $2.3 billion in 1929 to $784 million in 1932.[11]

Still, Hoover was not done. The same man who spoke rhapsodically about the "freedom of initiative and enterprise" in the waning days of his 1928 campaign,[12] turned on Wall Street with a vengeance. Congress followed his lead, subjecting short sellers and speculators to investigation and harassment.[13] Then he went even further. Only five months before the 1932 elections, Hoover pushed Congress to pass the Revenue Act of 1932, raising the top marginal tax rate from 25 percent to a whopping 63 percent and imposing new and increased excise taxes on a slew of items.[14]

Raising income taxes by 252 percent is equivalent to reducing take-home pay by 51 percent (from 75 percent of income to 37 percent). This draconian tax hike could only serve to dramatically diminish the incentive to work, save, invest, and take financial risks precisely when the economy needed more of those activities.

This "anti-wealth gesture" was, Amity Shlaes writes, "a sort of symbol of Republican capitulation to a coming Democratic moment." Already, FDR was sweeping across the nation, arguing for the "distribution of national wealth" and blaming the Depression on "profits of speculation."[15] The country was drifting leftward. Former President Calvin Coolidge's sudden death shortly after FDR's 1932 victory was a symbolic closing of the book on small-government capitalism.[16]

Roosevelt's Role in Prolonging the Depression

The Heavy Hand of Government Regulation

Roosevelt entered office in March of 1933 as an experimenter.[17] These experiments were not a gentle testing of the water but a full-fledged dive into a legislative ocean of new, onerous, and job-crushing regulations. One of his first undertakings was the National Industrial Recovery Act, which created the National Recovery Administration, a massive conglomeration that set rules and regulations for 22 million American workers.[18] These regulations included price controls; minimum wage rules; health requirements; child labor laws; and production quotas.[19] Some of these specifications bordered on the absurd. The NRA, for example, dictated the acceptable composition of macaroni and prohibited shoppers from choosing their own chickens at the butcher shop.[20] Just when businesses needed maximum flexibility to discover how to survive, innovation and cost-cutting were stifled and many businesses failed as a result.

The NRA's counterpart in the world of agriculture was the newly created Agriculture Adjustment Administration (AAA). Under the leadership of Secretary of Agriculture Henry Wallace, the AAA sought to raise farm prices by paying farmers to produce fewer crops and overseeing the widespread destruction of crops and slaughtering of animals.[21]

These regulations were like a vise on economic growth. Much like Hoover's wage controls, many businesses—especially small businesses—could not afford the NRA's mandates. The mandatory wages and work hours for instance, made some labor too costly and thereby increased the ranks of the unemployed.[22] Some economists so disliked the meddlesome NRA that Irving Fisher called it the "National Retardation Affair."[23] The Agriculture Adjustment Administration provided subsidies to larger, wealthier farmers, to the detriment of small farmers who couldn't compete against their subsidized competitors. Roosevelt and Wallace apparently did not understand that falling agricultural commodity prices resulted from a deflationary monetary policy—not from excess supply. Worse, they could not see the obvious folly of destroying crops and animals when millions of American were going hungry.[24]

A Government Spending Spree

In addition to increasing regulations, Roosevelt did not waste any time in accelerating government spending. Barely in office a couple of weeks, he created the Civilian Conservation Corp., which sought to put otherwise unemployed Americans to work on conservation projects throughout the country. The program cost over $2 billion between 1933 and 1939.[25]

Similar programs abounded. In June of 1933, the National Industrial Recovery Act created the Public Works Administration (PWA) to distribute new federal spending across the country. New bridges, dams, schools, and roads were built at the hands of Roosevelt's PWA.[26] The Federal Emergency

Relief Act gave matching grants to states. The Civil Works Administration was another attempt at putting the unemployed to work.[27] Dozens of agencies, administrations, and whole new government-owned corporations were created and money was lavished on all of them.

FDR's public works and employment programs were an understandable reaction to persistently and devastatingly high unemployment. His programs put millions to work and certainly alleviated much misery. But this visible help had an invisible cost. These programs were funded with new taxes or borrowed money that siphoned money out of the private sector that otherwise would have been invested, at least in part, in job creating enterprises. While people saw the new jobs created by the government, they did not see the corresponding jobs whose creation was prevented by the allocation of funds away from the private sector. Roosevelt's massive shift of capital away from the accountable private sector to the unaccountable public sector reduced and delayed the inventions, discoveries, and innovations that would otherwise have occurred. While seeming to spur an ailing economy, his huge spending programs may have actually slowed the pace of economic recovery.

The Attack on the "Rich"

Since Roosevelt believed greedy corporate men were the cause of the Depression, hunting them down was a natural recourse. Major corporate figures were harassed and dragged to court on charges of tax evasion and antitrust violations. These included utility giant Samuel Insull; Andrew Mellon, treasury secretary under Harding, Coolidge, and Hoover; and T. S. Lamont of J.P. Morgan. Many of these giants were eventually cleared: A Pittsburgh grand jury balked at indicting Mellon, and a Chicago jury declared Insull not guilty. But for Roosevelt and his henchmen, this was not about individual infractions, but a war against an entire class of Americans. As Roosevelt's treasury secretary

Henry Morgenthau put it: "I consider that Mr. Mellon is not on trial but Democracy and the privileged rich and I want to see who will win."[28] Roosevelt and Morganthau in fact had put free enterprise on trial. Even where they could not obtain convictions in court, they managed to have a chilling effect on entrepreneurs and investors everywhere.

Tax increases were in keeping with this philosophy. FDR's Revenue Act of 1934 raised taxes on income, capital gains, and undistributed earnings of personal holding companies, and increased the estate tax to 60 percent.[29] In 1935, a second Revenue Act raised taxes further on personal income, estates, gifts, corporate incomes, and corporation excess profits.[30] When businesses responded with a reluctance to invest their capital, Roosevelt imposed yet another tax increase package, the Revenue Act of 1936. The most debilitating part was the undistributed profits tax that sought to squeeze revenue out of businesses by taxing corporate savings.[31] The total tax burden under FDR almost doubled as a percentage of GDP from 1933 to 1940, going from 4.6 percent to 8.4 percent.[32]

The ferocious attacks on business and wealth, both in word and deed, spread fear and uncertainty throughout Wall Street.[33] Roosevelt blamed the wealthy for the downturn, but it was America's wealthy who would normally be in a position to take risks and make investments crucial to the country's recovery. Roosevelt's 1935 taxes meant that three-fourths of the profits from a new venture would be seized by the government. Before considering a new business venture, one must weigh the risks and rewards. Under FDR's taxes, all losses would be borne by the businessman, and most of the profit would be confiscated by the government.[34] A risk-to-reward ratio so skewed against reward heavily discouraged risk taking. Businessmen decided to hold on to their capital and wait out the Roosevelt frenzy, keeping sorely needed capital out of a starved economy.[35] The new Social Security tax also hurt, cutting into the income of employees and employers everywhere.[36] The disincentive created by Roosevelt's taxes was aptly summed up by David Lawrence, the founder of *U.S. News & World Report*:

> Confiscation of wealth may satisfy the vengeful in us. It may soothe a retaliatory spirit. But it is the path of national suicide. . . . There must always be the reward motive. To many people it is but another way to set goals of human ambition. . . . When government kills the opportunity to earn, it sounds the death knell of the opportunity to serve.[37]

Even Roosevelt's own tax adviser, Ralph E. Paul, admitted that these tax increases "intensified the depression they were seeking to correct."[38]

A Depression within the Depression

Over the course of his first term, the country perceived Roosevelt as a veritable savior. For starters, many were grateful that Roosevelt was simply doing *something.* And it was easier for Americans to appreciate the visible local park Roosevelt built with federal money than to envision the jobs never created because so much money was drained from the private sector. One cartoon painted an image of a muscled Roosevelt with sleeves rolled up, trudging through the water, pulling America's ships to "port prosperity." The caption reads: "What a man!"[39] Roosevelt coasted to an easy reelection in November 1936 with 523 electoral votes.

But this rosy picture did not last for long. The mid 1930s saw spurts of relief despite Roosevelt's interventionist policies, but these spurts were temporary and never approached the prosperity of the pre-crash days.[40] As Roosevelt's attitude toward business grew increasingly hostile and his policies increasingly onerous, the country sank into another depression in 1937 and 1938, a "depression within the Depression." The Dow dropped from 190 in August of 1937 to 114 that

November, a loss of 40 percent.[41] By April of 1938, unemployment was back up to 20 percent.[42] "Whatever it was," David M. Kennedy writes in his book *Freedom from Fear*, "the New Deal was not a recovery program, or at any rate, not an effective one."[43]

If Roosevelt was the great savior history has made him out to be, if his policies were the right ones to drive an economic recovery, then why did the Depression last so long? Shlaes hits upon this point exactly when she writes: "The big question about the American Depression is not whether war with Germany and Japan ended it. It is why the Depression lasted until the war." Her answer is exactly the opposite of the traditional and widely accepted narrative: "From 1929 to 1940, from Hoover to Roosevelt, government intervention helped to make the Depression Great."[44] The Federal Reserve precipitated the Depression. Roosevelt's New Deal dragged it out over ten years. Consider this: In 1929, the Dow hit a high of 386. It would be twenty-five long years before the market recovered its 1929 peak.[45]

Considering all that it did, it is hard to imagine how the federal government could have done more harm to the American economy from 1929 through the late 1930s. The Federal Reserve precipitated the stock market crash; caused a massive deflation; and contributed to several waves of bank failures. Herbert Hoover's above-market wages forced people out of jobs; his tariffs launched a market-closing trade war; and his tax hike stifled risk taking. FDR virtually declared war on job-creating business; imposed countless exorbitant regulations; launched massive new spending programs that deprived the private sector of resources; and foisted his own tax hike on productive Americans. Yet despite the horrendous impact of federal government intervention during this period, the general consensus, as observed by Ben Bernanke, is "that the government bears the important responsibility of trying to stabilize the economy and the financial system."[46]

The Greatest Story Never Told

If the Roosevelt years teach us about the dangerous consequences of an expansive government, the Reagan years offer the opposite story. Starting with Ronald Reagan's first presidential term, the ensuing two and a half decades are the story of the greatest period of prosperity in the history of the world. It is a lesson of what is possible when government abides by the principles of prosperity we discussed in the previous chapter. Over those 25 years, massive wealth was created; millions of people were lifted out of poverty; standards of living were elevated dramatically; and the quality and length of life has improved like never before. This is an extraordinary story but, as economist and TV business news show host Larry Kudlow famously repeats, it is the greatest story never told. We need to tell this story. Only then can we learn from its lessons.

This story begins with a bleak picture. When Reagan moved into the White House in January of 1981 the consumer price index was rising at 12.4 percent.[47] Unemployment was at 7.5 percent, after hitting a high of 9 percent in 1975.[48] Real GDP growth the previous year was −.2 percent.[49] Jimmy Carter's last economic report of his presidency in January of 1980 offered little light at the end of the tunnel: It was the first economic report since the 1946 Employment Act mandated such reports in which the administration predicted a recession.[50]

Life Was Good and Getting Better

But the world changed in the 1980s. And for the next quarter of a century, America enjoyed the kind of economic prosperity many were wont to write off during the doldrums of the 70s. Average economic growth was not only positive for almost this entire period, but for much of it, the rate of growth accelerated, with only two brief, shallow downturns along the way.

In 1982—before the Reagan reforms took place—our nation's total economic output was $5.2 trillion. In 2006, it was $11.3 trillion (both in 2000 dollars).[51] Per capita economic output in 1982 was $22,346; in 2006, it was $37,798 (both in 2000 dollars).[52] The average unemployment rate in 1982 was 9.7 percent. It consistently declined over the next two decades.[53] The service sector of our economy was on fire, more than doubling from 1982 to 2006 in real terms.[54] Contrary to the claims of those who think American manufacturing peaked in the 1960s, 2007 marked an all-time record year in manufacturing output.[55]

An expanding economy, of course, resulted in huge gains in wealth. The Dow Jones Industrial Average began the 1980s at 838. By 2007, it reached 14,000 before declining precipitously in 2008.[56] And with the democratization of capital markets that has occurred through savings programs like IRAs and 401(k)s and investment vehicles like mutual funds, the average family's wealth grew dramatically too. In 1982, 11 percent of American households owned mutual funds; in 2006, nearly 50 percent were investors.[57] The median net worth nearly doubled from 1983 to 2004 in real dollars.[58]

What did all this growth mean for the average American? It meant plenty. These gains directly resulted in a better standard of living for virtually all Americans—including the poor. During the early 1980s, less than 60 percent of Americans living *below* the official poverty line owned a car. In 1984, about one-third of American living below the poverty line had air conditioning, and ownership of color televisions was below 70 percent.[59] Thirty-plus years later, the statistics had improved dramatically. In 2005, among Americans living *below* the poverty line, almost 75 percent owned a car (30 percent owned two or more); 98 percent had color televisions; 79 percent had air conditioning; and 82 percent owned a microwave.[60]

This prosperity generated a wave of new capital that was invested in new technology that is now increasingly accessible.

There were 29 million cable TV subscribers in 1984; there were 65 million in 1999.[61] There were 1.55 million personal computers sold in 1982; there were 24.4 million in 2006.[62] Our health has improved too. Infant mortality has dropped from 11.5 deaths per 1,000 people in 1982 to 6.4 deaths per 1,000 people in 2006.[63] In 1982, average American life expectancy was 74.50 years. In 2006, it was 77.85.[64]

This long period of virtually uninterrupted economic growth came to a screeching halt in mid-2008. Later, I will examine the principle causes of that recession. But the economic gains from 1983 though 2007 were remarkable, and they were real.

How Did This Happen?

This long period of sustained economic growth and the huge quality-of-life improvements did not just happen by accident. This amazing story was made possible by the specific policies adopted by the federal government beginning mostly in the 1980s. These policies conformed with the four principles of prosperity and led to predictable positive results: a stabilization of the dollar; a dramatic reduction in marginal tax rates; a series of major deregulations; and a broad, global expansion of free trade.

Volcker and Reagan to the Rescue

The double-digit inflation Ronald Reagan inherited upon taking office in 1981 was the worst America had experienced in over thirty years. Excessive growth in the supply of money had eroded the dollar's value against other currencies as well as goods and services generally throughout the economy. The dollar's instability undermined its ability to serve its three vital functions—a unit of measure, a medium of exchange, and a store of value. The dollar's weakness, in turn, contributed to the economy's slow growth and high unemployment rates.

Federal Reserve Chairman Paul Volker knew that he had to slow the growth of the money supply to wring inflation out of the economy. But he also knew that this cure for inflation would inflict considerable, albeit temporary, pain on the patient. Despite the Federal Reserve's legal independence, Volker would need at least the tacit support of the president to administer the necessary medicine. Understanding the significant political risk to himself, Reagan nevertheless let Volker get the job done, as Milton Friedman explained in a 2000 interview:

> The only way you could get the inflation down was by having the monetary contraction. There was no way you could do that without having a temporary recession. . . . after Reagan came into office, the Fed did step on money supply, did hold down its growth, and that did lead to a recession. At that point every other president would have immediately come in and tried to get the Federal Reserve to expand [the money supply growth]. . . . Reagan knew what was happening . . . and he supported Volker and did not try to intervene.[65]

Tightening the growth in the money supply had the desired effect. The Consumer Price Index steadily declined for the next seven years, reaching a mere 1.4 percent in 1987.[66] The dollar's value had been restored. It was, once again, a stable, well-functioning currency, and the economy was on the move.

A Supply-Side Revolution

After decades of top marginal tax rates in the 70s, 80s, and even over 90 percentiles, Ronald Reagan signed the Economic Recovery Act of 1981. The change was dramatic. The top marginal rate went from 70 percent to 50 percent, and by the time Reagan left office, it was down to 28 percent.[67] During President Reagan's two terms, the top corporate tax rate was reduced from 46 percent to 34 percent,[68] individual tax brackets were indexed for inflation,[69] and, although there were some tax increases, the devastatingly high top marginal tax rates that preceded Reagan were gone. And they have not come back yet.

George Herbert Walker Bush and Bill Clinton later raised some taxes too much but they lowered others. More importantly, it did not occur to anyone to return to the levels that had prevailed prior to Reagan. The days of 70 percent top marginal tax rates were over; Reaganomics had changed the nature of the tax debate. George W. Bush's presidency brought a further reduction in taxes in 2001 and 2003. The effect was to lower all marginal tax rates including, most importantly for stimulating economic growth, lowering the top marginal income tax rate to 33 percent, phasing out the inheritance tax, and lowering taxes on capital gains and dividends.

Regulatory Reform

Major deregulation was another part of the expansion of economic freedom that enabled strong growth. In fact, some of the burdensome regulatory schemes were leftovers from FDR's New Deal. While President Jimmy Carter was generally no friend of the free market, some of these crucial deregulatory measures began under his presidency.

In 1978, Carter signed the Airline Deregulation Act, lifting price and route controls that had forced higher prices and fewer choices on consumers. Without these controls, airlines could offer deals to fill otherwise half-empty planes and choose more efficient routes. The airline industry has since struggled for many reasons but consumers have won big: increased safety, more choices, and lower prices.[70]

In 1980, Carter also signed the Motor Carrier Act, deregulating an industry that had been closely controlled by the government since 1935. Government regulations had dictated what products truckers could transport and what routes they could travel by giving out licenses for these rights. These restrictions made it impossible for truckers to plan and make decisions in accordance with their business needs. Consider a motor carrier with a license to travel from Cleveland to Buffalo who purchased another carrier's right to go from Buffalo to Pittsburgh. Believe it or not, those two licenses did not give the trucker the authority to transport goods from Cleveland directly to Pittsburgh. He had to first travel to Buffalo; only then did he have the right to travel to Pittsburgh, adding an unnecessary and wasteful 279 miles to the trip.[71]

The Motor Carrier Act limited the Interstate Commerce Commission's authority over the trucking industry, and the results were tremendous. Between 1977 and 1982, prices for truckload-size shipments fell 25 percent, and the resulting efficiency gains and cost savings helped to make possible the just-in-time inventory system that has transformed retailing, lowered consumer costs, and, arguably, diminished the economy's susceptibility to recessions.[72]

Ronald Reagan accelerated the trend toward less regulation: He eased or eliminated price controls on oil and natural gas, cable television, long-distance telephone service, intercity bus service, and ocean shipping. Efficiency gains and innovations naturally followed. Consumers benefitted from lower costs and more choices. The economy flourished.

Expanding Free Trade

More recently, economic freedom has expanded in the form of freer international trade. While bigger free trade agreements occurred under Presidents Clinton and Bush, Reagan got the ball rolling, negotiating two important bilateral trade agreements.[73] The first was the U.S.–Israel Free Trade agreement in 1985, eliminating all custom duties between the two countries.[74] The second came on September 28, 1988 when

President Reagan signed the U.S. Free Trade Agreement Implementation Act, eliminating many tariffs between the United States and Canada.[75] Reagan also launched the Uruguay Round of trade negotiations in 1986, which eventually lowered global tariffs and created the World Trade Organization.[76]

Over the next decade and a half, major groundbreaking trade agreements followed. In 1993, the North American Free Trade Agreement (NAFTA) built on Reagan's progress by expanding the U.S.-Canada agreement to include Mexico. NAFTA immediately eliminated a majority of tariffs on products traded among the United States, Canada, and Mexico, and phased out others. Both Presidents George H.W. Bush and Bill Clinton deserve credit for bringing this major agreement to fruition. In 2004, the Central America Free Trade Agreement (CAFTA) immediately eliminated tariffs on more than 80 percent of U.S exports of consumer and industrial goods to Central America, and phased out the rest over 10 years.[77] From 1985 through 2007, we have had bilateral or multilateral trade agreements with fourteen countries,[78] and today, international trade is freer than it has been at any time in the last 100 years.

The economic benefit of these trade agreements have been staggering, despite the protests of protectionists. Over the fourteen years since NAFTA's inception, for example, bilateral commerce between the United States, Mexico, and Canada has more than tripled, from $297 billion to $930 billion. In a single day, the NAFTA countries conduct over $2.5 billion in trade.[79]

The greatest story never told is truly remarkable. It is nothing less than the story of the greatest period of prosperity in the history of the United States. And it was made possible because, bit by bit, in fits and starts, with advances and retreats, America was inching its way to greater and greater economic freedom. The evidence is overwhelming: Freedom makes prosperity possible.

Around the World—The Rise of the Celtic Tiger

America is not the only country to witness the amazing prosperity that flows from economic freedom. Like America in the 1970s, Ireland's turnaround story begins with a very bleak picture. From 1980 to 1986 real GDP growth averaged a meager 2.21 percent; the unemployment rate peaked at a dreadful 17 percent in 1986;[80] inflation averaged 12 percent per year between 1980 and 1986;[81] and government spending soared as high as 55.8 percent of GDP.[82] In order to sustain this spending binge, the government increased personal income taxes to a top marginal rate of 65 percent[83] and the Value Added Tax to a high of 35 percent.[84] Few, if any, would disagree about the near-fatal consequences of Ireland's fiscal recklessness. As the former deputy prime minister Mary Harney told Thomas Friedman: "We went on a borrowing, spending, and taxing spree that nearly drove us under."[85]

With this kind of dire economic environment, foreign companies were afraid to plant roots and invest in the country, and people were loath to stay. For the first five years of the decade, net migration was a negative 70,000.[86] Emigration was so bad that those left behind used to joke, "Would the last Irishman to leave please turn out the lights?"[87]

Compare these dismal numbers with the same statistics fifteen years later. By 2000, Ireland's unemployment rate was down to 4.3 percent, where it remained, on average, for the next six years;[88] real, annual GDP growth averaged 6.6 percent from 1990 to 2006, hitting a high of 11.5 percent in 1997;[89] and net migration for 1995–2006 was an inflow of 350,000.[90] And after living in Britain's shadow for centuries, Ireland's per capita GDP topped England's for the first time in 1999.[91] By 2006, Ireland was, per capita, the richest country in the European Union, excluding tiny Luxembourg with its population of 473,000.[92]

In 1988, the London-based magazine *The Economist* wrote the small island off for ruin. Only nine years later, the same magazine featured Ireland on its cover as "Europe's shining light."[93] The magazine wrote:

> Over the past ten years Ireland has enjoyed an astonishing economic success. The main facts, familiar by now, still cause a start of astonishment. Over the past three years the economy has grown at an average rate of more than 7% a year, a positively East Asian pace. A decade ago Irish incomes were less than two-thirds of British incomes; last year, on one measure, they surpassed them. Just yesterday, it seems, Ireland was one of Europe's poorest countries. Today it is about as prosperous as the European average, and getting richer all the time. . . . Miracles do happen, you know: look at the Irish economy.[94]

But Ireland's success story was not a miracle—at least not in the supernatural sense. On the contrary, Ireland's economic boom can be traced back to specific, major changes in the country's economic policies—changes in the tax structure, attitude towards government spending, and the country's regulatory regime. Other factors—like greater access to higher education and labor agreements helped—but the real economic driver was Ireland's newfound commitment to the principles of the prosperity. "It wasn't a miracle; we didn't find gold," Mary Harney explained. "It was the right domestic policies and embracing globalization."[95]

Tax Cuts Are Good for You

For decades, the standard corporate income tax rate for most companies in Ireland was a stifling 50 percent.[96] From 1987 to 2003, the corporate tax was gradually reduced to 12.5 percent for all companies. This made Ireland's corporate tax rate the lowest among Organization for Economic Cooperation and Development (OECD) countries and far lower than America's 35 percent.[97] In the 1990s, the Irish government applied the same low-tax philosophy to the personal income tax. Over a 13-year period, the top rate was reduced from 58 percent to 42 percent, while the standard rate was reduced from 35 percent to 20 percent.[98] In 2004, Ireland's workers had one of the highest gross earnings after taxes among OECD countries.[99] Ireland also lowered the top VAT tax from 35 percent to 21 percent.[100] In 1999, the government encouraged even more investment and risk taking by halving the capital gains rate from 40 percent to 20 percent.[101]

The dramatic reductions in the corporate tax rate helped to attract a flood of foreign investment to Ireland's shores, particularly in the technology sector. Major computer and electronic companies built facilities in Ireland, including IBM, Intel, Gateway, Dell, Fujitsu, and Motorola. According to *The Economist*, 40 percent of all American investment in European electronics since 1980 occurred in Ireland.[102] The same is true for other industries. Nine out of the ten top pharmaceutical companies and twelve of the top fifteen medical products companies in the world have large operations in Ireland. Some, like Abbot Laboratories, Johnson & Johnson, and Pfizer, even have multiple locations in the country.[103] Ireland proved former Citicorp Chairman Walter Wriston's famous observation: "Capital goes where it is welcome and stays where it is well treated."[104]

Government Spending Is Expensive

Throughout the 1970s and 1980s, Ireland saw government spending and public debt shoot up as the country grew a lavish social welfare state. After years of runaway budgets, government spending had soared from 39.6 percent of GDP in 1970 to 46.8 percent of GDP in 1979 to 55.8 percent of GDP in

1982.[105] Net government debt went from 76.2 percent in 1979 to 113.4 percent in 1984, while the government's deficit bottomed out at a 13.2 percent of GDP in 1982.[106]

By 1987, Ireland was ready for a change. For the first time since 1958, the budget's 1988 spending estimates were lower than the year before. At 6 percent less than 1987, the proposal included $618 million in budget cuts (out of a proposed $10.9 billion) with nearly every government department feeling the pain. Roadways, hospitals, schools and other capital projects saw a 15 percent reduction in spending.[107]

Only a couple of years later, Ireland's finances looked dramatically different. By 1990, government outlays were down to 42.9 percent of GDP with the government deficit at a relatively low 2.8 percent of GDP. Over the next 16 years, the financial situation continued to improve, with average annual government spending dropping to 34.1 percent of GDP. In 2006, Ireland's budget was one of the smallest as a percentage of GDP among OECD countries.[108]

Deregulation Brings Lower Prices, More Choices

One of the best examples of the economic benefits of deregulation in Ireland came relatively early with the introduction of competition to the country's government-run airline market. For a long time, the Dublin-London air route was dominated by a duopoly—the government-owned Aer Lingus in Ireland and British Airways in England. Like most government-run monopolies, Aer Lingus was crippled by low productivity, high costs, and little to no profit.[109]

In 1985, the government instituted major deregulation of fares and flight frequencies. Under these conditions, a small Irish airline, Ryanair, was able to enter the market with spectacular results. Ryanir's unrestricted fare offered customers a 54 percent discount from Aer Lingus' high fares and a 75 percent discount with advanced fares. As costs decreased, many more people were able to enjoy the Dublin-London trip, with passenger volume increasing 65 percent from 1985 to 1987—astonishing considering Ireland was still suffering from a weak economy.[110]

This one small change in the airline industry produced a ripple effect of economic growth. From 1987 to 1993, Ireland enjoyed a 60 percent increase in visitors, an additional 560 million pounds in tourist earnings, and an additional 25,000 jobs.[111] From 1993 to 1998, tourist spending in Ireland increased by 53 percent.[112] With these kinds of results, it is no surprise that Ireland has recently decided to privatize the industry completely. In 2006, the Irish government sold off most of its stake in Aer Lingus.[113]

It took a while, but the Irish government soon applied the same principles to other industries including telecommunications and electricity generation. Ireland has taken several other measures to encourage competition and make the country more business friendly. The country implemented many of the recommendations offered by the 1994 Task Force on Small Businesses and Services, such as a reduction in business licenses and permits, the simplification of information requirements provided by firms, and the streamlining of company registration.[114] In Ireland, new companies can register in less than two weeks. In 2008, the World Bank ranked Ireland fifth out of 178 countries in ease of starting a business and sixth in terms of dealing with licenses (the United States ranks ninth).[115]

What Can We Learn?

In three different examples, we have seen the real-world economic results of government policy. In the case of the Great Depression, we saw the negative consequences of unstable money, high taxes, ballooning budgets, heavy regulation, and protectionism. During the 1980s, we saw what happened in America when our government followed precisely the opposite of Depression era policies. And in the case of the Celtic Tiger, we saw that the principles of prosperity are not confined to a given time or place; these principles are universal.

During the height of Ireland's economic crisis, the small country could not ignore the lessons of Ronald Reagan's success across the Atlantic and Margaret Thatcher's success across the Irish Sea. In 1987, one Irish economist admitted as much. "The American tax debate has spilled over here. We got on TV and in newspapers the Reagan debate on tax policy."[116] Like Reagan in the early eighties, like Ireland in the latter half of the decade, it is up to us to learn both from the mistakes and the accomplishments of our predecessors, whoever and wherever they may be.

Over the next couple of chapters we will consider an array of policy issues from Social Security to trade to taxation. While some specifics of these issues are new, the basic principles are not. As we consider these policy problems, we will be presented with a choice between two diametrically opposed schools of thought: the government intervention model popularized by FDR or the Reagan model of less government and more freedom; restrictions on voluntary exchanges or facilitating those exchanges; and, ultimately, the principles of slow growth or the principles of prosperity. This was the choice Ireland faced in 1987 and it is the same choice every country faces in varying degrees and extremes. If we look carefully at the lessons of history, the choice between these two philosophies should not be that difficult. One is the story of unemployment, stagnation, and lost opportunity. The other is the story of freedom, innovation, productivity, improved standards of living, choice, and unimaginable prosperity.

Which will we choose?

Chapter 3

Tax Policy

The Supply-Side Idea: Incentives Matter

My first lesson in supply-side economics occurred as a young child, although I did not know it by that name. For many years, my father worked for the local electric utility installing underground electrical cable for an hourly wage. When outages required extra work to restore power, workers were given the opportunity to work overtime for a pay rate of one and a half times their ordinary hourly rate. With a family of six children to feed, my father would often volunteer for the overtime work and forgo rest, leisure, and other alternatives to work, in order to earn the extra income. Occasionally, the overtime opportunities came on weekends or holidays when the pay rate was double the ordinary rate. My father almost always volunteered on these occasions. The significantly greater return on his work induced him to sacrifice alternative ways to spend his time. During these times, his production increased, which in turn increased his income and his demand for goods and services for his family.

Supply-side economics is no more complicated than this example from my youth. At its most basic level, supply-side economics posits that economic incentives encourage production, and that production is the real source of wealth and, ultimately, demand for goods and services. An employee is willing to put in extra hours in the hope of earning a bonus. Some workers, like my father, will happily assume the Sunday night shift in order to earn extra income at a higher wage rate.

Conversely, if a worker is informed that a company will not be handing out bonuses this coming year, the incentive to go the extra mile is diminished. Why stay in the office until ten at night if those long nights will not be rewarded and he can reasonably fulfill his responsibilities by six? This is not to say that economic incentives will transform every slacker into a superstar employee. Incentives change behaviors on the margin—not every worker will burn the midnight oil for the prospect of a bonus. But some workers will put in an extra couple of hours; some will take some work home with them; some will take an extra shift; and some will come in on the weekends. The cumulative effect of this expanded production can have a dramatic effect on economic growth.

Changes in income tax rates change incentives as powerfully as pay raises or pay cuts because tax rates, together with pay rates, determine after-tax, or "take-home," pay. The only income that really matters to people is after-tax income—the portion of their earnings they get to keep and spend or save. A reduction in someone's marginal income tax rate makes each incremental hour of work more profitable, thereby encouraging more work. It is the exact same effect as a higher rate of pay for overtime work. Conversely, higher marginal tax rates make incremental work less rewarding, thereby discouraging additional work.

In any free economy there is always a powerful incentive for individuals to increase production—it is the consequent opportunity to increase their wealth and consumption. A tax code need not attempt to affirmatively enhance that natural incentive; it need only avoid excessively diminishing that incentive.

Thus, tax cuts generate overall economic growth primarily by restoring the natural incentives to produce. Greater production creates income, wealth, and increased demand for goods and services on the part of the producer. George Gilder put it well in *Wealth and Poverty*:

> The only way tax policy can reliably influence real incomes is by changing the incentives of suppliers. By altering the pattern of rewards to favor work over leisure, investment over consumption, the sources of production over the sumps of wealth, taxable over untaxable activity, government can directly and powerfully foster the expansion of real demand and income. This is the supply side mandate.[1]

Supply-siders understand that incentives matter. If we lower the tax government takes from people's work, savings, and investment, we increase the final return on those activities. Increasing the returns on those activities increases their appeal relative to alternative activities.

Members of Congress should bear this in mind when formulating tax policy. I have often heard some of my former colleagues in the House of Representatives justify cutting taxes with the argument that lower taxes will allow people to spend more of their own money, causing the economy to grow. I am all for lower taxes but this reasoning is a demand-side fallacy. A tax cut by itself does not increase aggregate demand for goods and services because the dollars the government does not take from the private sector through taxation it must take through borrowing. The net effect on money available to be spent privately is zero. This is why tax cuts that do not affect incentives—such as rebates and credits—have very little if any effect on economic growth. The power of the tax cut is on the supply side—its incentive to increase production. With this power in mind, we can consider three fundamental questions: how much to tax; whom to tax; and how to tax.

How Much to Tax

Congress could help generate a burst of strong, sustainable economic growth with two simple changes in tax rates that would do more than just about anything else. They should lower marginal income tax rates as much as politically possible and lower—ideally to zero—the taxes applied to capital gains. We will consider the compelling merits of comprehensive tax reform later in this chapter, but these two changes would be such powerful catalysts for growth that they deserve separate mention.

Lower Marginal Income Tax Rates

Lowering marginal income tax rates—those applied to the last dollar earned—increases the incentive for workers as overtime pay did for my father. A worker subject to a marginal tax rate of 50 percent gets to keep 50 percent of the last dollar he earns. If his tax rate is lowered to 40 percent, the worker keeps 60 percent, and the after-tax return on his incremental work increases by 20 percent. It is exactly equivalent to a 20 percent pay raise for increasing work in a constant tax environment. The added return on marginal income increases the relative appeal of increasing work compared to alternative activities whose returns have not changed.

Not everyone will choose to produce more with lower tax rates. But the added output of a relative few can have a large impact on economic growth. If lower taxes induce just one in five workers to increase their work by 20 percent, working 48 hours per week instead of 40, total economic output would increase by 4 percent from this source alone.

More importantly, consider the impact on individual families. A working-class father who responds to the incentives of lower taxes sees his family benefit in three ways. First, his take-home pay goes up as tax rates go down, directly enhancing his ability to provide for his family. Second, by choosing to work a few more hours, he further augments family income. Finally, as the entire economy expands in response to lower taxes, more goods and services of wider variety and higher quality become available to him and his family as consumers.

But an even more powerful source of growth would be entrepreneurs' responses to the higher return on the risks of their ventures. Small businesses, including very small corporations and partnerships, generate 60 to 80 percent of all new jobs in America, and these small companies produce an overwhelming percentage of the most important innovations that can drive explosive growth.[2] Microsoft, Google, and Intel each started with a handful of employees at most. Wal-Mart started as a single department store in Rogers, Arkansas. McDonald's was once a single burger joint in San Bernardino, California. These and millions of other vitally important businesses started because an entrepreneur had a vision and was willing to risk whatever capital he had or could raise to try to bring his vision to fruition. When personal income tax rates are lowered, the returns to the entrepreneurs on these risks are generally increased. Greater returns justify greater risk and encourage entrepreneurs to put their life savings on the line for that new idea, product, or service.

Of course, every time an entrepreneur takes a new risk and launches a new venture, jobs are created across a wide spectrum. The entrepreneur hires workers directly but he also increases job opportunities elsewhere as he enlists the services of suppliers, vendors, consultants, and others who, in turn, hire more workers to meet the increased demand for products and services.

This multifaceted, enormously beneficial spur to real economic growth is why supply-siders are strong proponents of lowering marginal income tax rates—especially the highest rates where changes produce the biggest gains in return on work.

Other forms of income tax cuts, such as credits, do not increase the return on additional effort if they do not affect the returns on the last dollar earned. They may be desirable if they constrain the growth of government, but they will not stimulate economic growth and create opportunities the way lowering marginal tax rates will.

Eliminate Taxes on Capital

The *Merriam Webster Dictionary* second definition of *capital* goes to the heart of why it should never be taxed:

> **capital** *n* (2) accumulated goods devoted to the production of other goods.[3]

Capital is the source of all improvements in productivity. All tools, technology, equipment, even knowledge are forms of capital. Without capital, we would all be hunter-gatherers or subsistence farmers. In fact, even hunter-gatherers and subsistence farmers have capital in the form of rudimentary tools. In the United States, we are very fortunate to have enormous accumulated capital that allows our workers to be among the world's most productive and, as a result, among the highest paid. Money and capital are not the same thing. But money can be used to accumulate capital. Since growth in capital is the precondition necessary for growth in productivity and wages, growth in capital should not be taxed away by the government. When government taxes capital, it destroys it and diminishes economic growth.

Consider the metaphor of the fruit tree, as explained by economist Irving Fisher. The tree can be seen as capital while the fruit it produces is income. If the government taxes away some of the fruit, that tax does not diminish the tree's ability to generate fruit, or income, in the future. But if the government cuts off a branch, it destroys part of the capital and diminishes the tree's production. Taxing the appreciation of the value of an asset, as we do with the capital gains tax, is like cutting a branch off the fruit tree. It destroys part of the accumulated capital and diminishes economic output.[4] That is one reason the correct capital gains tax rate is zero.

Another reason is that capital gains generally result from an increase in the income an asset produces. Share prices tend to rise when a company's earnings increase. But those earnings are taxed separately at the corporate level. Taxing the capital gain or dividend again at the personal level is double taxation—unfair and not conducive to economic growth.

Lifting the tax from capital gains would also unlock financial assets. Many people hold investments they would otherwise sell because they wish to avoid paying the capital gains tax. This "lock-up" effect diminishes economic growth by restricting the free flow of capital to its most productive uses.

To make matters worse, the capital gains tax is applied to nominal gains. A nominal gain occurs when the market price of something increases, even if that increase only reflects inflation. In contrast, a real gain is the amount by which a price increase exceeds the rate of inflation. An investment held for a long time may be worth far more dollars than it cost but the appreciation may or may not have kept up with inflation. If not, there is no real gain—in fact the investor has actually sustained a real loss. We nevertheless tax people on the nominal gain of an asset—disregarding the real change in value.

Abolishing taxes on capital gains would help make America a more attractive country for both domestic and foreign investment. Twelve OECD countries already have general capital gains tax rates of zero and others may be following in their footsteps.[5] Our top capital gains rate of 15 percent puts us in the middle of the pack of industrialized countries—our competitors for capital, companies, and jobs. Lowering our capital gains tax rate to zero would increase the returns on investments here immediately, which would certainly increase the investments made here by American and foreign businesses and entrepreneurs. Every such investment means more jobs and more competition among employers for workers. That competition lifts wages, benefits, and working conditions for all workers.

All assets currently subject to capital gains taxes would be worth more if these taxes were eliminated including the stock portfolios of the nearly 50 percent of Americans who are investors.[6] Imagine the help a stronger stock market and lower taxes would provide to families saving for their children's college tuition. Imagine the relief to seniors planning to live on their retirement savings if capital gains taxes were eliminated and they saw an immediate boost in the value of those savings.

But the biggest impact of lower capital gains taxes and correspondingly higher levels of invested capital would be a general elevation in the standard of living of ordinary workers. Workers earn more when they have access to tools that make them more productive. Tools are purchased with capital. The farmer using a GPS-guided, air-conditioned-cab, multi-use combine is far more productive than one using a primitive tractor. The former earns much more money. The architect who uses sophisticated Computer-Aided Drawing (CAD) programs can design more complex structures than the draftsman working with pencil and paper. The architect is more highly paid. The carpenter who uses an air-gun to rapidly drive nails produces and earns more than his counterpart who relies on a hammer. The fact is, capital is a worker's best friend. We should not tax it away.

While lowering income and capital gains tax rates would have a huge positive impact on economic growth, many other tax cuts would be very beneficial too. American corporate income taxes are far too high—both in absolute terms and compared to our economic competitors. In addition, states impose a variety of taxes, including income taxes, wage taxes, sales taxes, and property taxes, all of which impede economic growth to varying degrees. In all of these cases, the lower the rates, the less the tax will harm production and growth.

But some will ask, given persistent federal and state budget deficits, how can governments afford to cut taxes? Wouldn't the result of significant tax cuts be larger deficits and crippling increases in debt? The answer is not necessarily. First of all, governments can and should try the all-too-often novel idea of spending discipline. As we will see in Chapter 4, governments tend to spend as much money as they possibly can when maximizing economic growth would dictate spending as little as possible. Second, lowering tax rates does not necessarily result in lower tax revenues when the effects of higher economic growth are taken into consideration. The effect of tax rates on production is so pronounced that it has given rise to an entire theory on how to optimize rates for maximum government revenue.

The Laffer Curve

Since increasing tax rates discourages the activities being taxed and decreasing rates encourages those activities, a given change in a tax rate will not result in a proportional change in tax revenue. In other words, tax revenue is not a linear function of tax rates. A simple example illustrates the point. If tomorrow the federal government doubled all income tax rates, the resulting revenue from this tax would certainly not double. The main reason is that many, especially high-income, people would choose to work less and enjoy more leisure as the after-tax return on their work would be slashed. Twice the rate applied to a reduced income level would result in something less than doubling the revenue. The converse applies to tax cuts—a rate reduction does not result in a proportional reduction in revenue as the lower rate encourages a greater output to be taxed.

Recognizing this dynamic relationship between tax rates and revenues, the economist Art Laffer developed and helped popularize the graphic representation of this idea which is depicted in Figure 3.1. The Laffer Curve illustrates the fact that there are two tax rates that will produce any desired level of revenue—a low rate applied to a high output (point A) and a high rate applied to a low output (point B). This is easiest to intuit at the extremes. The two tax rates that would yield no revenue for the government are zero and 100 percent. Zero percent, for the obvious reason, and 100 percent because it would eliminate all incentive to work, precluding the production of anything—at least above ground—on which to apply the 100 percent rate. (The incentive to work and produce would still exist, creating an underground economy in order to escape the 100 percent tax rate.) Between these two extremes we have the curve that depicts the growth in tax revenue as tax rates increase from zero until revenues reach a maximum point (C) at which point further rate increases result in less revenue as

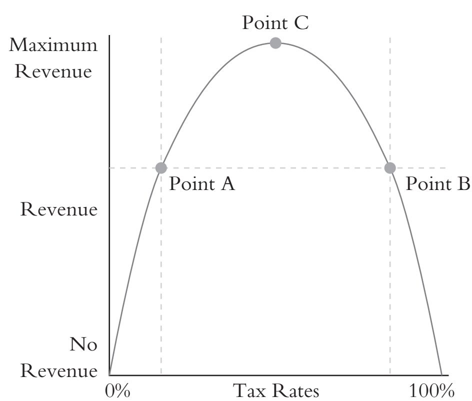

Figure 3.1 The Laffer Curve

the tax burden diminishes production at a faster rate than the increases in tax rates.

It is important to note that Figure 3.1 is a representation of a tax revenue curve, not necessarily an actual one. The point (C) is not likely to be at 50 percent (it is usually much lower), and the curve is not likely to be symmetric. Its shape is a function of the level at which people wish to be taxed at a given point in time with respect to whatever is being taxed. The important lessons imparted by the Laffer Curve are, first, if tax rates are in the counterproductive range—above point (C)—then a *reduction* in rates will encourage enough additional production to generate an *increase* in tax revenues. And second, governments should raise the minimum revenue necessary at tax rates at or below point (C).

It is difficult to know and probably impossible to prove exactly where on the Laffer curve a given tax rate is at any point in time. As Jude Wanniski argues in *The Way the World Works*, the revenue-maximizing point (C) varies from time to time based on the attitude of the population toward government spending.[7] Nevertheless, I believe it is very likely we are currently operating in the counterproductive prohibitive range, especially with regard to the top personal income tax rate. If we lowered this rate (my preference would be to lower the other income tax rates too), we would not only see greater economic growth, but would also see an increase in government revenue relatively quickly.

Consider just how high the current top marginal income tax rates are. The federal government's maximum income tax rate is now 35 percent, but by the time you add in the Medicare tax (2.9 percent), and wage taxes imposed by state and local governments, the effective marginal tax rate is much higher. Residents of New York City, for instance, pay top rates of at least 6.85 percent to the state[8] and 3.65 percent to the city[9] in addition to all federal taxes, bringing their top combined marginal income tax rates nearly to 50 percent. It is hard for me to believe that taking half of every incremental dollar a person earns does not significantly discourage the hard work it takes to generate those earnings.

Whom to Tax: The Distribution of the Tax Burden

Fairness is a highly subjective concept. People agree that everyone should pay their fair share of taxes, but there is great disagreement over what that means. Two facts about the American income tax system over the past several decades cannot be denied. First, marginal tax rates have declined dramatically, albeit, sporadically. Second, and despite the first fact, the tax burden has become more progressive, that is, a greater share of the tax burden is now carried by upper-income earners than before, even in relation to their share of total income.[10]

As recently as 1980, the top American income tax rate was 70 percent[11] and capital gains were taxed at a maximum of 28 percent.[12] By 2005, those rates were 35[13] and 15[14] percent, respectively, and scheduled to stay at those levels through 2010. Despite these large rate reductions, the upper-income earners are paying a much higher share of the total tax haul than they did in the 1970s. The top half of all workers in 1980 earned 82.3 percent of all income and paid 93 percent of all income taxes. By 2006, the top half earned 87.5 percent of income and paid 97 percent of income taxes. Conversely, the bottom half of workers used to earn 17.7 percent of income and pay 7.1 percent of income taxes, and now earn 12.5 percent of income and pay 3 percent of income taxes.[15]

In recent years, virtually every change in federal tax rates has been accompanied by an increase in the concentration of the tax burden at the upper end of the income scale. In addition, these tax changes have often increased the number of American workers who pay no income taxes at all.

Virtually all Democrats in Congress openly advocate concentrating the tax burden even further upon higher-income earners. Republicans typically acquiesce to this shift for fear of being accused of supporting "tax cuts for the rich." They have not yet accepted that any meaningful tax cut must necessarily be prone to that description with the "rich" already paying such a large share of taxes. But the consequences of this trend have been dramatic. In 1980, 21.3 percent of all filers owed nothing in federal income taxes.[16] By 2006, that number had risen to 33 percent.[17] And the Obama administration has made its desire to raise this number very clear.

Advocates for shifting an ever-growing share of the tax burden to the wealthy often cite an increase in the income gap between high- and low-income workers as a justification. They imply that low- and moderate-income people are stuck at stagnant income levels while other, higher-income people grow increasingly wealthy. It is true that the differences in incomes between top earners and the lowest earners have widened in recent decades. But the importance of this statistic has been wildly exaggerated.

First, incomes and living standards have risen for people in all income categories. The mean income of the bottom fifth of earners has grown from $10,326 in 1980 to $11,674 in 2006 (in constant 2007 dollars).[18] And even as people in high-income brackets grow wealthier, they do not do so at the expense of others. Their rewards come because they have found productive ways to serve the needs of others by producing goods and services that people value.

But even more importantly, people in America are not stuck at a given income level. When comparing different income levels, it is important to remember that one is comparing statistical abstractions—not real people. There is, and always has been, a great deal of economic mobility in America—both up and down. A Treasury analysis released in the fall of 2007 found that among a representative group of 1996 filers in the bottom 20 percent of earners, 57.6 percent had moved out of the bottom by 2005, and 5.3 percent had moved into the top 20 percent. Conversely, only 42.6 percent of filers in the top 1 percent in 1996 remained there in 2005.[19] Variations on this theme have been documented repeatedly in the past. This is not that surprising when you consider the fact that people typically experience a range of incomes over the course of their lives and immigrants typically swell the lower-income levels.

Consider a young man from a middle-income family who embarks on a business career. Early in his career, he earns an entry-level wage, dropping into the lowest income bracket. As his career advances, he moves up into higher income levels. Finally, he retires, perhaps from a senior level position, and his income drops dramatically, putting him back into one of the lower income categories.

This typical career path takes our hypothetical worker through several income levels over the course of his life. Many of the people in the lowest income quintile are there either because they are young and not yet in their peak earning years or because they are older and chose to forgo higher earnings in favor of retirement. A significant part of the gap between America's highest and lowest earners simply reflects the range of incomes people earn over the course of their lives. It is hardly a cause for alarm or redistributing wealth.

Nevertheless, the trend in America has been increasingly to concentrate the tax burden on higher income workers and to take ever more workers off the tax rolls. The former impedes economic growth as we have seen and we will discuss further below. The latter is troubling in two ways. First, is it right that millions of Americans who could afford to pay something in income taxes get their government services paid for by others? Second, where does this trend end? How long before a majority of American workers pays no income taxes at all? And when that day comes, what will be the political demand for additional government services from this majority that pays so little of the bill? And how high will tax rates go on those who are paying the bills to meet this likely demand for even more spending?

How to Tax: Be Simple, Transparent, and Neutral

It is hard to exaggerate the absurdity of our current tax code. Perhaps the best illustration is the fact that the IRS workers charged with explaining the rules to taxpayers often cannot understand them themselves.[20] Or consider the fact that the new treasury secretary, Tim Geithner, whose responsibilities include supervising the IRS, failed to pay his taxes properly. If the IRS cannot understand its own tax code—how can we?

Of course we cannot understand it either; no one can. It is far too long and confusing. Compare the length of the tax code to our founding documents as Steve Forbes observes in his book *Flat Tax Revolution*. Our Declaration of Independence made the case for the birth of a new nation, founded on a new principle of self-government and dedicated to the ideals of equality and freedom. It took about 1,300 words. Our Constitution designed the structure of our federal government, limited and enumerated its powers, and specified the fundamental rights of American citizens. It runs around 5,000 words. Our tax code and its accompanying rules, regulations, and interpretations check in at 9 million words and counting.[21]

Many of those 9 million words carve out innumerable credits, deductions, and write-offs for special interests. Consider one of the most egregious tax credits stuffed into the 2008 Farm Bill. Sponsored by Senate finance chairman Max Baucus, Congress authorized $500 million in tax credits to finance the sale of at least 40,000 acres of land. The language of the credit was written so narrowly to apply to one specific piece of property owned by the Seattle-based Plum Creek, one of the largest private landowners in the country.[22]

Congress also dispenses favorable tax breaks for the owners of race horses[23] and motorsport racing track facilities.[24] The qualified energy conservation bond allows states and nonprofits to issue bonds at taxpayers' expense for so-called energy conservation. Qualifying purchases include Al Gore's documentary on global warming and Lexus hybrids for the Beverly Hills police force.[25] The problem with all these special credits and loopholes is multifold. The potential for political corruption is obvious. But the unfairness of a system that rewards the few at the expense of the hard-working many is particularly offensive. Ordinary taxpayers are forced to pick up the slack and pay more in taxes to make up for the reduction in taxes enjoyed by the lucky few. How can anyone defend the fact that honest, ordinary, hard-working Americans are systematically charged more in taxes so that horse racers and politicians' best friends get to pay less?

In their quest to subsidize and penalize various activities, politicians ran into a problem. Since the highly progressive nature of the tax code results in many workers owing no income taxes at all, deductions and credits meant to lessen the tax load for these people are worthless. So the pols invented the "refundable tax credit." People who qualify for a refundable tax credit but who owe less in income taxes than the amount of the credit simply get a check from the government for the amount by which the credit exceeds the tax liability. The Orwellian term "refundable tax credit" could be scrapped for a more common appellation: government spending.

Currently there are three distinct, federal refundable tax credits but that number is likely to grow. Presidential candidate Barack Obama campaigned as a tax cutter. What he did not explain was the fact that his "tax cut" plan was based largely on new government spending in the form of expanding refundable tax credits. At some level one has to respect the political creativity and the sheer audacity of characterizing government spending as tax cuts. Orwell surely would have been impressed. But the purpose of a tax code ought to be to fund the necessary functions of government. Unfortunately, the "refundable tax credits" are examples of further complications to the tax code for the purpose of redistributing wealth.

Perhaps the ultimate confession of the absurdity of the tax code is the Alternative Minimum Tax. Designed in 1969 to prevent 155 wealthy people from legally avoiding taxes, it is really a parallel tax code. Since the income threshold above which it applies was never indexed for inflation, it now affects millions of Americans.

Here is how it works. If you are married, have two children, and earn about $100,000 a year, you must compute your tax obligation the hard way, following all the rules and taking only those credits, deductions, and write-offs to which the law entitles you. Then you have to do it all over again under a different set of rules designed to prevent you from using many of those very credits, deductions, and write-offs. You are then stuck with which ever version obligates you to pay the most. And it gets worse. As Nina Olson of the National Taxpayer Advocate explains, "The difficulty of projecting AMT tax liability in advance makes it challenging for taxpayers to compute and make required estimated tax payments, which often results in these taxpayers being subject to penalties." The AMT is a form of "'gotcha' taxation that is not good for taxpayers or the tax system."[26]

All of this complexity is not just frustrating; it is also awfully expensive. The average American tax filer spends nearly 21 hours each year filling out tax forms.[27] The average business spends $894 per employee just to comply with the federal tax code. For small businesses with fewer than 20 employees, that burden rises to an average of $1,304 per worker.[28] As a nation, we employ hundreds of thousands of accountants and tax lawyers to help us estimate our tax burdens. It all adds up to over $200 billion per year in tax code compliance.[29] And it is all a deadweight cost. All that time, effort, and money is spent just to keep us on the right side of the law—we hope—and out of jail. None of it, not one dime, produces a product or service that improves anyone's life. All the money spent on tax compliance is money that cannot be spent growing, mining, producing, designing, distributing, curing, or providing any of the unlimited goods and services that would allow us to consume more and improve the quality of our lives.

The cost of compliance with the tax code is precisely as valuable to the economy as paying people $200 billion each year to dig holes in the mornings and fill them back up in the afternoons. The opportunity cost of compliance is the sum total of all the useful goods and services we would otherwise enjoy if we did not have to pay this bill. And none of this even begins to account for the frustrations, aggravations, and worries that accompany the entire process.

In addition to the terrible cost of compliance, all the targeted credits, deductions, and loopholes diminish economic growth in at least two other ways. First, they encourage people to allocate resources in economically inefficient ways. For instance, high construction and installation costs together with unreliable wind make wind-generated electricity more expensive than electricity generated by, say, natural gas. For a given amount of generated electricity, our economy saves money by building and operating a gas-fired facility instead of a wind-driven one. This saved money is then available for other goods or services and thus, a bigger economy. If the tax code rewards wind-driven plant operators with a tax credit that is greater than the difference in cost between the two alternatives, the operators will choose the less efficient wind-driven option. The tax credit makes their final cost lower than that of the gas-fired plant operator, but our economy as a whole ends up producing electricity the more expensive way, with less money available for other things.

Perhaps the most important way in which all these special credits, deductions, and loopholes impede economic growth is by forcing general tax rates higher than they would otherwise be. In this way, they violate that cardinal rule of tax policy—broaden the base and lower the rate. For any given level of tax revenue sought, the more income that is excluded from taxation, and the more that tax obligations are reduced by credits, the higher nonfavored income has to be taxed. As we have seen, higher marginal tax rates result in lower economic growth.

Since the tax code is so complex, inefficient, expensive to comply with, harmful to economic growth, and fundamentally unfair, why hasn't it been reformed into a simple, efficient, fair system? There are two reasons. First, the tax code is the product of a political system that operates on the principle that concentrated benefits trump dispersed pain. To paraphrase the great conservative thinker William F. Buckley, Jr., if one man is given a tax benefit of $500, and it is offset by the rest of us having to pay an extra 5 cents in taxes, who goes to Washington to lobby Congress? Every targeted tax benefit in the code got there because someone successfully lobbied Congress for it. That is how we ended up with credits for horse racing. Once a tax benefit becomes law, the class that receives the benefit becomes intensely committed to preserving their gain. Any effort to reduce or repeal it meets with an aggressive counter campaign to protect it.

The second reason why it is so difficult to make meaningful simplifications of the tax code is that simplification is not in the interest of the politicians responsible for the code. Members of Congress, especially those on the tax-writing committees, derive a great deal of their power from their ability to manipulate taxes. They use the tax code to reward and punish personal and business behaviors in everything from healthcare to housing to energy to environmental policy. Very little human activity is unaffected by the tax code. For the politicians who get to write it, that is an awful lot of power. And politicians generally do not relinquish their power voluntarily.

Real, pro-growth tax simplification is very popular with those of the public who understand how terrible our tax code is. Achieving it requires overcoming the powerful resistance of the special interests who have a vested interest in defending their perks and the politicians who have a vested interest in protecting their power. This is no small task. To do it, we will need two things. First, we need to elect congressmen and -women more committed to economic growth than their own political power. Second, we will need strong political leadership from the one person in the American political system capable of developing the necessary political clout—the president. We need a candidate who makes fundamental tax reform a central part of his campaign—as Steve Forbes did in 1996 and 2000—to win decisively with a mandate to enact reform. If his party controls both Houses of Congress, he would have a real chance to roll the anti-reform coalition.

The Reform We Need

The free-market tax reform movement is dominated by two main camps: Those supporting a single-rate, flat income tax and those supporting a national sales tax. Both reforms have well-known, highly respected proponents, including Steve Forbes and former Congressman Dick Armey on the Flat Tax side, and Neal Boortz and Congressman John Linder (R-GA) in support of a sales tax, called the FairTax plan. Both systems share important similarities, including: The complete elimination of the current tax code; a vastly simpler approach than the current mess; the elimination of federal taxes on savings, investment, capital, and inheritance; a single rate; and a generous exemption to ensure that low- and some moderate-income Americans would not owe any taxes. Either system would be a vast improvement over current tax law, and either would generate a huge burst of economic growth, millions of new jobs, higher wages, and better standard of living for virtually everyone. But neither reform is likely to become law as long as reformers are divided.

As much as I would be thrilled to wake up one morning and discover our current monstrous tax code had been replaced with either of these alternatives, my preference lies with the Flat Tax. I will summarize the most salient features of each, then explain that preference.

The Flat Tax

The greatest features of a Flat Tax plan are the simplicity, fairness, and inducements to strong economic growth. Under both the Forbes and Armey plans, every taxpayer would get a generous personal exemption, and all earned income above that amount would be taxed at one low rate of 17 percent. There would be no taxes on interest income, dividends, or capital gains. The death tax would be dead. And you could fill out your taxes on a 3 by 5 postcard.[30]

Corporations would also pay just a 17 percent business tax—rather than the 35 percent top rate they now pay—and they would pay it based on a very simple calculation. The taxable income would be determined by taking revenue and subtracting wages, salaries, and retirement benefits; materials and other inputs needed to run the business; and purchases of plants and equipment.[31] There would be no loopholes, special credits, and, best of all, no depreciation tables as all capital purchases would be fully expensed whenever the expense occurs.

And the economy would certainly take off. With no more taxes on capital gains and dividends, entrepreneurs would be willing to take more risks, launch new businesses, and generate new products, services, and innovations. They would need literally millions of new workers to do this. The unemployment rate would drop like a brick. Workers would have their choice of jobs rather than the other way around. With a top marginal tax rate of just 17 percent, middle- and high-income workers would reap a huge take-home pay increase that would encourage them to work longer and harder for the greater rewards.

Output would soar by an estimated $5 trillion.[32] American businesses would no longer have to compete with the ball and chain of the second highest corporate tax rate in the world. And we would all be free of the enormous deadweight cost of complying with an absurdly complex code.

The 17 percent Flat Tax might initially take in less revenue than the current system, but the growth in economic activity that would follow would, in time, result in more revenue for the government than today's system takes in or projects.

The FairTax

The FairTax shares many of the attributes of the Flat Tax but it works in a very different way. It is a 23 percent (30 percent using the conventional approach to calculating sales tax) national sales tax that would be applied to all new goods and services sold to consumers and end-users (see the following text box). Like the Flat Tax, the FairTax would not tax personal interest income, dividends, capital gains, or inheritance. But unlike the Flat Tax, there would be no tax on income—no income tax, no payroll taxes, no earnings tax of any kind. The federal government would not even know how much income you earned.

That is all very appealing and would be very pro-growth. But there are two sets of problems that lead me to prefer the Flat Tax. The first are structural problems. The second are political problems.

On the structural side of the ledger, I have two major concerns. The first is that abolishing payroll taxes would abolish the link between Social Security taxes and benefits. The program would become, in effect, a pure transfer payment program in which it would be impossible to correlate benefits to contributed taxes. As such, the temptation for politicians to increase the benefits would be very strong and we would probably lose forever the opportunity to transform Social Security into

How to Calculate the FairTax Rate

The difference in the calculation of the FairTax depends on which convention you use. Under the conventional way of calculating sales tax, a retailer selling a product for $100, under the FairTax plan, must collect $130 and deliver $30 to the government. This is generally considered a 30 percent sales tax ($30/$100). However, the FairTax supporters argue that the $30 in taxes should be compared to the total cost of $130 for a percentage of 23 percent ($30/$130). They refer to this as the inclusive methodology. They point out that this method is used to calculate income taxes. For example, if a couple makes $100,000 and pays a 25 percent effective rate, they will have to pay $25,000 in taxes. The $100,000 of income earned includes the taxes paid. However, the take-home pay is only $75,000. So to earn $75,000 to spend, you have to pay $25,000 of income taxes, or 33 percent of their take-home pay. The FairTax supporters believe the take-home pay is analogous to the purchase price kept by the retailer, and therefore should be calculated with the same methodology.

From Neal Boortz and Congressman John Linder, *The FairTax Book* (New York: Morrow, 2005), p. 151.

the vehicle for wealth accumulation that I describe in Chapter 6 of this book.

The second structural problem is the transitional impact on savers—especially senior citizens. People who spent a lifetime working and paying income taxes would see the value of their lifetime savings effectively diminished by something approaching 23 percent. All the new goods and services on which they would like to spend their already-taxed savings would cost considerably more. The prices of these goods and services would fall due to the elimination of other taxes, but they would not fall enough to offset the new national sales tax.

Finally, on the political side, this is a hard reform to sell in a political campaign. For all its virtues—and they are many—it can easily be mischaracterized by political opponents as I have seen many times in congressional races. The FairTax would eliminate all income and payroll taxes thereby providing a huge take-home pay raise for workers. But it would also create new tax collectors like doctors, lawyers, and plumbers; new taxes on items like Internet purchases, colonoscopies, and concert tickets; and new taxpayers such as not-for-profit organizations and churches which would be obligated to pay the 23 percent sales tax like everyone else. Candidates in favor of the FairTax get attacked for all the new taxes. They get no credit from their opponents for the taxes that would be eliminated.

Freedom and Prosperity

Excessive taxes are morally offensive because they directly diminish our economic freedom, and economic freedom is a fundamental part of personal freedom. We all get a certain, finite number of potentially productive days in our lives. The vast majority of us spend many of those precious days working for the money we need to provide life's necessities for ourselves and our families and, when possible, to buy the things that enrich our lives—a camping trip with the family, piano lessons for a daughter, a precious book, CD, or an afternoon at the ball park. When government takes some of our earnings, they take some of those days; they take necessities or some of the enrichment we must forego; they take a part of our lives. Americans understand this reality and accept that there are many vital, justifiable governmental functions that require the funding that comes from our sacrifices. But our government should never diminish our freedom this way more than is absolutely necessary.

Economic freedom and economic growth are two sides of the same coin. When government takes an increasingly larger portion of one's wages, it discourages work, investment, and production. The result of this discouragement is invisible to the human eye, but still devastating. We fail to see the business that is never built, the employees that are never hired, the investments that are never made, and the new products that are never created. We also fail to see the tremendous prosperity that would come from greater economic freedom.

Currently, we are laboring under a tax code that actively deprives the country of that prosperity. This seems awfully foolish especially as the country contends with a steep recession. We have the tools to set this country on a path of unprecedented prosperity. One of them is a new, fair, simple, low-rate tax code. But first we have to remove our burdensome tax code and the excessive tax rates that impede the natural incentive to be productive. This idea is embraced by a majority of Americans. So what are we waiting for?

Chapter 4

Government Spending

The Stimulus That Will Not Stimulate

On January 8, 2009, then-President-Elect Barack Obama gave a speech at George Mason University, making the case for the massive spending bill he wanted Congress to send him promptly upon his upcoming inauguration. He started by painting a very grim picture of the American economy, and then went on to offer his prescription:

> Only government can provide the short-term boost necessary to lift us from a recession this deep and severe. Only government can break the vicious cycles that are crippling our economy—where a lack of spending leads to lost jobs which leads to even less spending.[1]

This is a truly breathtaking claim. President-Elect Obama was right to be concerned about the dangers of a prolonged and severe recession. But he could not have been more wrong about the solution. In fact, the dramatic expansion of government that he demanded will likely increase both the duration and severity of the 2008–2009 recession, just as the policy errors of Presidents Hoover and Roosevelt exacerbated the Great Depression.

The bulk of President Obama's nearly $1 trillion stimulus plan was a massive surge in government spending. After being widely discredited by economic events in the United States in the 1970s and in Japan in the 1990s, Keynesian economics has made a huge comeback under Barack Obama's leadership. Popularized by John Maynard Keynes in the 1930s, the condensed version of the theory maintains that a recession results from an insufficient demand for the goods and services an economy is capable of producing. Since consumers and businesses have reduced their consumption, government spending must make up for most of the shortfall. This was the reasoning behind FDR's spending frenzy, only to be resuscitated seventy-five years after its dismal failure.

But these big-government-spending advocates forgot one of the most important lessons Milton Friedman taught us about economics: There is no such thing as a free lunch or, in this case, a free stimulus. All money spent by the government first has to be taken from the private sector through increased taxes, borrowing, or the inflationary printing of new money. In any case, that money is no longer available to the private, productive sector of the economy.

Of course, new government spending and programs will create some economic activity—it does contribute to aggregate demand in Keynesian jargon. But it also diminishes economic activity and demand to at least an equal degree in the private sector. A government-spending stimulus bill is tantamount to taking water from one side of a bucket, pouring it into the other side and expecting to raise the water level. In fact, there is no net gain—no free lunch. This has been widely understood by classical economists for ages. The 19th century French writer Claude Frédéric Bastiat and the 20th century economist Henry Hazlitt both famously explained the fallacy of considering only the visible effects of a given policy and ignoring the very real, and often negative, invisible effects. Those who think the government can borrow-and-spend us back to prosperity would do well to revisit this commonsense wisdom.

It would not be so bad if the net effect of government spending were neutral—merely offsetting equally productive private sector spending. But, in fact, there is almost always a net loss because government spending is directed by a political process, unlike the market-driven private sector.

In the private sector, money is either spent on consumption or saved and invested. The former satisfies particular wants and needs; the latter funds the buildings, machines, tools, and learning that make future production and consumption possible. In both cases, market discipline ensures that money is efficiently allocated. When consumers spend their own money, they only purchase what they want. Investors seek to maximize the return on their investments relative to the risk they take. While many investments fail, an unfettered process of experimentation allows the economy to "discover" the valuable activities which in turn attract more investment.

In contrast, government spending is driven by political whim. Government is, necessarily, spending someone else's money, and no one spends other people's money as carefully as they spend their own. Nor is there a mechanism to reward prudent government spending and punish imprudent spending, except for the very cumbersome and indirect election process itself.

The Obama stimulus bill demonstrates the inefficient and wasteful results of this political process. While he and his Democratic congressional allies insist that the stimulus bill is absolutely essential to restore economic growth, it is chock full of items that no one—not even a Keynesian economist—believes will revive the economy: $50 million for the National Endowment for the Arts; $198 million for Filipino World War II veterans; $8 billion for high-speed rail investments including a magnetic-levitation rail line between Los Angeles and Las Vegas; and $25 million for the Smithsonian Institution.[2] Other programs, like increasing welfare and Medicaid funds and expanded unemployment insurance, reflect long-cherished Democratic dreams of dramatically expanding the welfare state. Even President Obama's chief of staff Rahm Emanuel admitted that the Democrats are using the stimulus to promote political programs that have little, if anything, to do with stimulating the economy. "You never want a serious crisis to go to waste," Emanuel said. "And what I mean by that is an opportunity to do things you think you could not do before."[3]

As I will explain, the federal government perennially spends huge sums of money on projects no rational person would ever fund with his own money ($50,000 for a Mule and Packers Museum?). But even many of the least objectionable projects in the stimulus bill are of dubious real value to the economy. Transportation infrastructure is rightly recognized as an important precondition to economic growth, but after Congress passed a record-large, six-year transportation infrastructure bill in the summer of 2005, President-elect Obama insisted on spending $46 billion on new transportation projects through his 2009 stimulus bill.[4] One has to wonder why these new projects were not funded in the previous bill. Probably because they did not meet even the lenient government standard for cost effectiveness that applied to that bill.

President Obama's eloquent promises of million of new jobs is similarly misleading. Consider his enthusiastic emphasis on alternative energy spending in the stimulus bill:

> We will double the production of alternative energy in the next three years. . . . In the process, we will put Americans to work in new jobs that pay well and can't be outsourced—jobs building solar panels and wind

> turbines; constructing fuel-efficient cars and buildings; and developing the new energy technologies that will lead to even more jobs.[5]

These lofty promises are deceptively one-sided. No doubt, billions of dollars in energy spending will create many new jobs. Unfortunately, the new spending will destroy more jobs than it creates in two ways. First, it will destroy the private sector jobs that would have been funded by the money government takes in order to fund its own jobs program. Second, it will destroy jobs by forcing us to expend unnecessary resources producing expensive energy and cars people do not want to buy.

The reason we produce electricity from coal and natural gas and drive cars powered by gasoline is simple—these are the cheapest sources of energy and transportation available today. When we use the cheapest sources of energy and transportation available, we maximize the resources left over for the production and consumption of all other resources. If the Obama administration forces us to use the more expensive, non–carbon based energy and produce the less efficient cars he favors, we will have fewer resources left over for everything else. That means less total output and fewer jobs overall. If the real goal is simply to reduce our consumption of carbon-based fuels for environmental reasons, the president should be candid. He should admit that he is willing to sacrifice jobs to achieve that goal. But he should not pretend that mandating high-cost energy will create a net gain in jobs.

Whatever the merits of the many individual projects contained in the stimulus bill, the bottom line is simple: Governments cannot spend their way to prosperity. The government will not be able to spend us out of this recession any more than it was able to spend us out of past recessions. As we saw, President Roosevelt's massive spending increases, combined with other disastrous expansions of government intervention in the economy, helped to drag out the depression for over a decade. Even FDR's own treasury secretary, Henry Morgenthau Jr., admitted in 1939 that the New Deal's spending programs had not worked. "We have tried spending money. We are spending more than we have ever spent before and it does not work. . . . I say after eight years of this Administration we have just as much unemployment as when we started. . . . And an enormous debt to boot!"[6] If all it took to emerge from a recession was government spending, recessions would be a laughing matter. They are not.

If we could simply borrow-and-spend our way to prosperity as Keynesian advocates claim, then why was the United States mired in a major recession in 2009? After all, government spending prior to the stimulus was already at an all-time record high, growing by more than 26 percent from 2000 to 2007 (adjusted for inflation),[7] and that was before all the bailout spending. If President Obama were right and all this government spending could create millions of new jobs, then why stop at $800 billion? Why not $5 trillion or even $10 trillion? If government can magically conjure up jobs, wealth, and prosperity with the passage of a bill, why limit government spending at all?

Government spending is no cure for recessions because governments do not, and cannot, create prosperity or economic growth. People in the private sector create jobs, income, growth, and wealth when they increase production of goods and services that consumers and investors value. Governments do not create wealth, they redistribute it. In the process of confiscating the wealth they choose to transfer, governments discourage the creation of new sources of growth and wealth. This is the fundamental reason why government spending should always be kept to the minimum necessary to fund the vital, legitimate functions of government—including in recessionary times.

Unfortunately, the federal government has imposed no such discipline upon itself in recent years. Democrats and Republicans have been complicit in the greatest expansion of government spending in the history of the Republic.

Worse, through commitments they have made, they have put the government on a ruinous spending trajectory. The sooner we get off this path, the sooner we can restore robust economic growth.

Government Spending Balloons

Total federal government spending has been growing at an alarming rate under both political parties. Since 1980, real, inflation-adjusted spending has more than doubled—since 1965, it has more than quintupled.[8] Since 1992, federal spending has grown at more than twice the rate of inflation and most of that growth has been non-security related.[9] Population growth explains some of the increase in government spending but not all. Total spending per American household has more than doubled since 1965—in constant, inflation-adjusted dollars—while the average household size has shrunk.[10] (See Figures 4.1 and 4.2.)

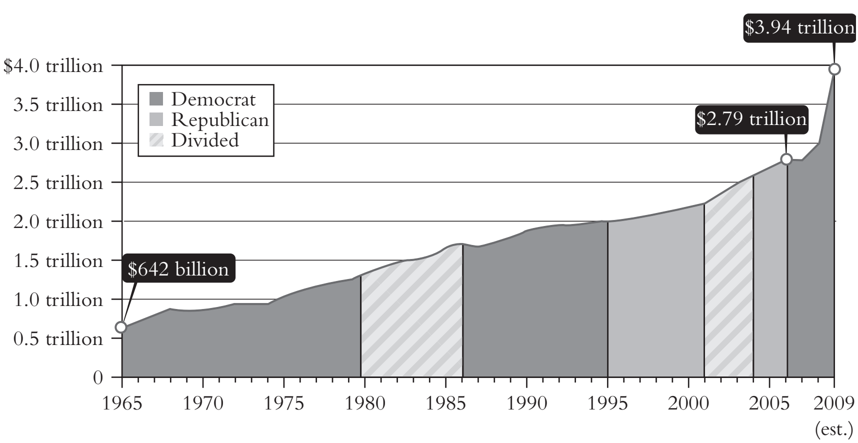

Figure 4.1 Total Federal Spending, in Billions, 1965–2009
SOURCE: Heritage Foundation.

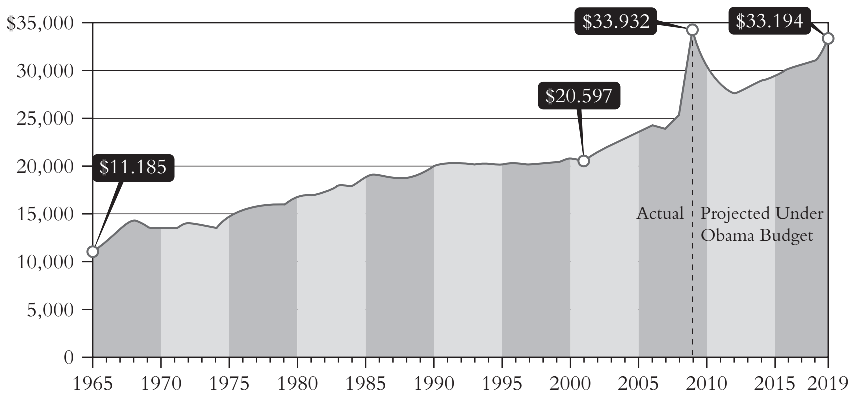

Figure 4.2 Total Federal Spending per Household, 1965–2019
SOURCE: Heritage Foundation.

Most importantly, spending as a percentage of GDP has been increasing too.[11] This means that government has been taking an increasing portion of our country's economic output. Whether government spending is funded by tax dollars or borrowed dollars, that money is removed from the productive, private sector of our economy and spent mostly on transfer payments from some Americans to others. Thus, government spending acts as a drag on the growth of our economy. The greater the percentage of our economy taken by government, the greater the drag. President Obama's first budget increases federal spending by 7 percentage points—from 21 to 28 percent of GDP. In contrast, even FDR managed an increase of only 2.7 percentage points—from 8.0 to 10.7 percent of GDP.[12] As troubling as the recent growth in federal spending has been, the future looks worse.

Mandatory Spending: On Auto-Pilot with the Afterburners On!

The federal government's spending is traditionally divided into two categories: Discretionary spending, so named because it is subject to Congress's annual discretion, and mandatory spending, which is determined by formula and eligibility as established by law. Discretionary items include national defense; homeland security; education; the operations of the government itself; and foreign aid, to name just a few items. Mandatory spending consists primarily of Medicare (health care for the elderly), Medicaid (health care for the poor), and Social Security (mostly retirement income). In 1965, mandatory spending accounted for 29 percent of all federal spending with discretionary spending making up the remaining 72 percent. By 2009, mandatory spending constituted 66 percent of the budget while discretionary spending was down to 34 percent.[13] The rapid growth in federal spending to date and the explosive growth projected are being driven by mandatory spending. (See Figure 4.3.)

Three factors combine to drive mandatory spending to unsustainable levels. First, our population is aging, and as the baby boomers begin retiring, the number of people eligible for Social Security and Medicare is growing and will accelerate dramatically. Second, as nutrition and health care have

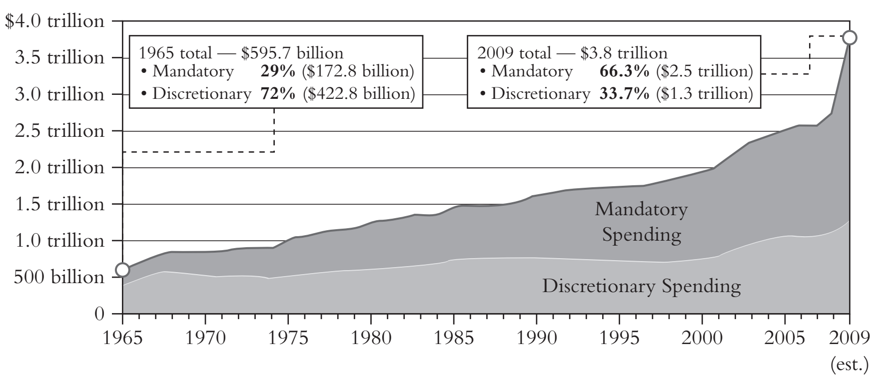

Figure 4.3 Total Discretionary Spending versus Mandatory Spending, 1965–2009, in Billions
Source: Heritage Foundation.

improved, a wonderful trend of increasing longevity has developed and will almost certainly continue. This means people will remain Medicare and Social Security beneficiaries for longer than ever before. Finally, the government's excessive intrusion into health care has caused health care prices to rise at a pace far greater than prices generally throughout the economy. In 1960, the United States spent about 4.7 percent of our total economic output on health care. Medicaid and Medicare did not exist. By 2005, we spent about 15 percent of our economy on health care, about a third of which was devoted to Medicaid and Medicare.[14]

Absent major structural reform, federal entitlement spending will become unsustainable. The big three entitlement programs—Social Security, Medicare, and Medicaid—consumed 8.4 percent of GDP in 2005. By 2050 these programs will more than double their share of GDP, reaching 18.1 percent of all American economic output.[15] If that does not sound sufficiently alarming, consider this: Total federal tax revenue, from all sources, averaged 18.4 percent of GDP over the last 30 years. In other words, in just over 40 years, Social Security, Medicare, and Medicaid will consume *all* federal revenues, leaving nothing for defense, transportation, education, our judiciary, interest on our debt—and pretty much anything else.[16] (See Figure 4.4.)

Some have suggested that this is alarmism. After all, we could always raise taxes in order to afford both mandatory and discretionary spending at its projected levels. These folks should think again. According to the Congressional Budget Office, we will have to nearly double all personal and corporate income tax rates by 2050 if current spending trends continue. As Figure 4.5 shows, the lowest income bracket rate would have to go from today's 10 percent level to 19 percent; the middle bracket would have to go from 25 percent to 47 percent; and the highest personal and corporate rates would have to go from their current 35 percent rates to 66 percent.[17]

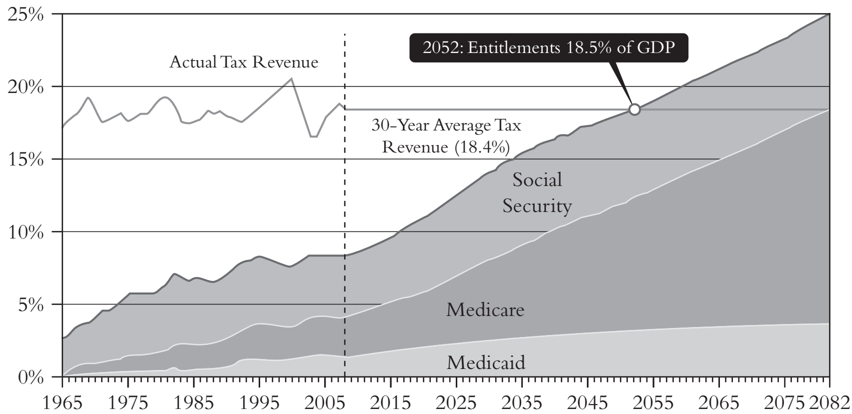

Figure 4.4 Three Major Entitlements and Tax Revenues as a Percentage of GDP, 1965–2082
Source: Heritage Foundation.

This is indisputably unsustainable. Tax rates this high would cause the economy to collapse as capital and labor would flee to less oppressive places. The collapse in economic output would cause a collapse in government revenue—not despite the

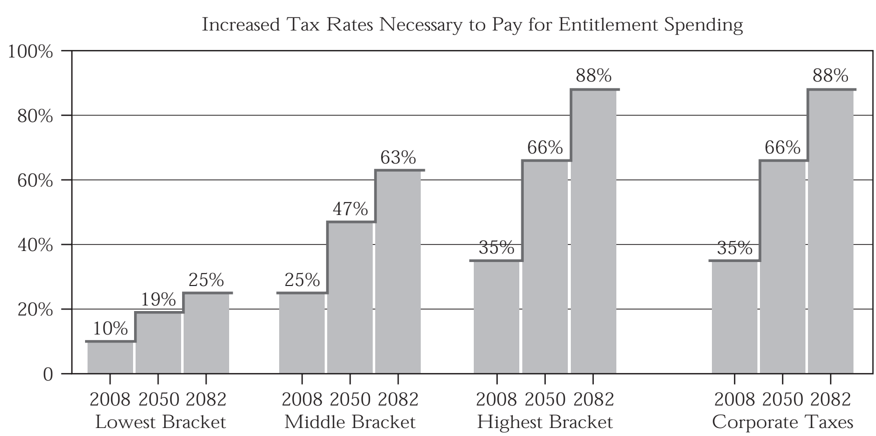

Figure 4.5 Raising Taxes to Afford Both Mandatory and Discretionary Spending?
Source: Heritage Foundation.

sky-high rates, but because of them. The entitlement programs would implode along with the rest of the economy.

The only way to prevent this disaster is to fundamentally restructure these programs. The current trajectory is so manifestly unsustainable that reform is inevitable. The only real questions are, what form will it take and when will it get done? Winston Churchill once said, "You can always count on Americans to do the right thing—after they've tried everything else."[18] But when it comes to entitlement reform there is a huge cost to delay or experimenting with false solutions. That is why I have dedicated a full chapter in this book to the kind of transformation the biggest of these programs—Social Security—needs. The other programs could follow a similar model. The essence of the necessary and desirable reforms is to convert these programs from the defined-benefit, government-owned and -operated systems they are now, to the defined-contribution, personally owned and managed programs they must become. But this will not be easy. And the longer we delay, the harder the job will become.

Earmarks and Rancid Pork

While the big entitlement programs are clearly the main drivers of unsustainable government spending, there are other, smaller items in the federal budget that are much more objectionable and insidious. Perhaps the most outrageous of these is what is known in congressional parlance as earmarks, or pork projects.

Earmarks are funding designations for lawmakers' pet projects. They are written into appropriations bills without having undergone the normal congressional deliberations, and without any meaningful scrutiny or review by experts or opposing lawmakers. They are usually targeted to a specific and narrow interest and are often outrageously wasteful. In some extreme cases, these items are air-dropped into bills *after* the bill has been voted for. Here are a few recent gems:

- $97,000 for maple research in Vermont[19]
- $740,000 for olive fruit fly research[20]
- $1.95 million for Charles B. Rangel Center for Public Service (no prizes awarded for guessing that this one was requested by Rep. Charles B. Rangel)[21]
- $50 million for an indoor tropical rainforest in Coralville, Iowa[22]
- $49,000 for the construction of a National Mule and Packers Museum in Bishop, CA[23]
- $500,000 for the Sparta Teapot Museum in Sparta, NC[24]
- $238,000 for the National Wild Turkey Foundation[25]
- $90.8 million for wood utilization research since 1985[26]
- $68.7 million for shrimp research since 1985[27]
- $188,000 for the Lobster Institute in Maine[28]
- $1 million for the Waterfree Urinal Conservation Initiative[29]
- $853,000 for coffee and cocoa in Beltsville, MD[30]

I wish I could say I was making these up but I am not that creative. These are all real earmarks requested by individual members of Congress and approved by the full Congress. All of them were in legislation that passed.

Over the last several years, the use of earmarks like these has exploded. In 1987, President Ronald Reagan vetoed a transportation bill because it contained too many earmarks—152 of them to be precise. Fast forward twenty years. In 2005, the same bill looked entirely different, containing a grand total of 6,371 projects. In 1991, total earmark spending totaled $3.1 billion. After years of listening to Republicans and Democrats promise to put the appropriators on a diet, that number grew to $29.3 billion in 2006. So much for promises.[31]

In addition to being offensively wasteful, earmarks can be a corruptive force. The lack of transparency and scrutiny invites abuse. Consider the story of Randy "Duke" Cunningham, a former House member from the San Diego area. Duke was a war hero. Decorated repeatedly for achievements as an ace fighter pilot during the Vietnam War, Duke would often regale us during Republican Conference meetings with stories of his wartime exploits. He was passionate about the military, affable, and well liked by everyone. But it turned out Duke had a major character flaw. He could not resist the temptation to direct earmarks to companies which, in turn, showered him with lavish gifts. In 2005, he pleaded guilty to accepting $2.4 million in bribes and is now serving time in a federal prison.[32] Several other House and Senate members are either under investigation or have already been prosecuted for similar offenses. Nothing excuses Cunningham's behavior, but we should not tolerate a system that makes the abuse so easy and, for some, so tempting.

The pro-earmark crowd argues that someone has to make earmarks. If members of Congress are forbidden, they say it will be done by faceless bureaucrats who do not know the needs of a district as well as the person elected to represent it. This is a specious argument. Congress has the authority to abolish earmarks and determine project funding according to objective criteria—cost-benefit analysis and competitive evaluation as with other government spending. Bureaucrats would administer these programs, but they are much less likely to engage in the vagarious practices we see from Congress. Bureaucrats do not stand for election so they are not tempted to reward supporters and buy votes from targeted constituencies the way politicians are. What bureaucrat feels the need to spend taxpayer dollars on the Cowgirl Hall of Fame?

Earmark apologists often cite the fact that, collectively, they comprise a relatively small percentage of total federal government spending. This argument ignores the pernicious role earmarks play in the larger legislative process. Too often, earmarks are used as a currency to buy votes. Most earmarks are found in the annual appropriations bills that allocate all of the federal government's discretionary spending. I learned early in my congressional career that there is an unwritten but vigorously enforced rule on the Appropriations Committee of the House of Representatives. If a legislator asks for an earmark in a particular bill and gets it, then he must vote for the bill—regardless of what else is in it. Failure to comply with this rule risks the denial of all future earmark requests.

Many House and Senate members believe that their reelections depend on securing earmarks for their district or state. They are wrong. Voters are fed up with all the wasteful spending emanating from Washington, and they know that earmarks are among the most offensive. But as long as these congressmen are unwilling to be cut off, they surrender their votes to the appropriators. I used to wonder why big-spending appropriation bills and obscenely bloated omnibus bills sometimes passed with broad, bipartisan support. Then I learned about the rule.

Unfortunately, the use of earmarks as a currency for buying votes is not limited to appropriations bills. When either party badly needs a particular vote on a given bill, some members of Congress will refuse to commit until they get a promise from the party's leaders to grant them their preferred pork. An energy bill can cost several bridges; an education bill might run one or two museums; a labor bill might take a college library renovation. The availability of the earmarks often supersedes the merits of the unrelated legislation. The American taxpayer loses doubly from this kind of unprincipled log-rolling. He must pay for both the pork project and the separate bill it buys.

Earmark abuse has been a bipartisan problem for years but it worsened during the Bush administration, in part because President Bush refused to veto Republican spending bills regardless of how stuffed with pork they were. Gorging on earmarks became part of the congressional culture, and despite their promise to curb the abuses, Democrats have done little to improve matters since taking control of Congress. There are, however, a few principled and courageous members willing to withstand the enmity of their colleagues in order to reform the earmark process.

In the House, Rep. Jeff Flake (R-AZ) has led the way with help from Reps. John Shadegg (R-AZ), Jeb Hensarling (R-TX), John Campbell (R-CA), and others. In the Senate, Tom Coburn (R-OK) and Jim DeMint (R-SC) have caused appropriators and party leaders fits by holding up wasteful spending bills. These men are making progress in putting a spotlight on the most egregious abuses. A steady trickle of their colleagues has been joining them in foreswearing the pursuit of earmarks. The congressional culture is improving but it has a long way to go. Ultimately, we will eliminate, or at least dramatically curb, earmarks by electing the right people to Congress in the first place. When the American people are sufficiently tired of being fleeced, when we elect enough Jeff Flakes and Tom Coburns to approach congressional majorities, earmarks will become a problem of the past.

Deficits

Excessive government spending always leads to budget deficits and/or high taxes. Usually, we get both, starting with the former. High taxes definitely diminish economic growth for reasons we explored in Chapter 3. Deficits can do likewise but, as with taxes, it is a matter of degree.

In 2004, Vice President Dick Cheney incurred the wrath of deficit hawks when he said that "Reagan proved deficits don't matter."[33] A little context is in order. For years we heard from some, particularly senior Clinton administration officials such as treasury secretary Bob Rubin, that government borrowing needed to fund budget deficits would drive up interest rates as the treasury competed with private borrowers for scarce savings. Higher interest rates would slow down economic growth. According to these deficit hawks, raising taxes would improve our economic prospects by relieving upward pressure on interest rates. Secretary Rubin's theory omitted one important factor: scale. The world's total dollar savings are vast; they can finance vast dollar-denominated borrowing—both private and government. The deficits to which vice president Dick Cheney was referring were modest by any reasonable measure and thus, of little economic consequence. Cutting spending to reduce the deficits would have helped the economy grow. But raising taxes to eliminate them would have done much more harm than good.

The most important measure of government budget deficits is their size relative to the total output of our economy. A $1,000,000 mortgage is unaffordable for a family earning $50,000 per year, but trivial to Bill Gates. So, too, a deficit comprising a large percentage of our GDP is problematic, but a small one is easily affordable. In 2007, the federal budget deficit was 1.2 percent of GDP—only half of the 40-year average of 2.4 percent and readily affordable.[34] The affordability was manifested by the fact that modest increases in these relatively small deficits have shown no correlation to higher interest rates. In fact, since the early 1980s, interest rates have steadily declined even as budget deficits, at times, were growing.[35]

Interest rates can decline in the face of growing budget deficits and government borrowing because there are other factors that contribute significantly to determining market interest rates. Expectations of future inflation, alternative investment opportunities, expected economic growth, and the perceived risks of financial markets generally all contribute to determining interest rate levels. The financial panic of 2008 drove U.S. treasury yields to historic lows as investors worldwide fled all kinds of assets in favor of the relative security of treasury bonds.

But there are limits to how much the government can borrow without triggering the higher interest rates Secretary Rubin predicted. The serial bailouts, partial nationalizations, and massive spending measures the government has taken in

2008 and 2009 in response to the recession are very likely to test those limits.

Prior to enactment of the massive February 2009 stimulus spending bill, the budget deficit for 2009 was projected to reach $1.2 trillion, or 8.3 percent of GDP.[36] Following the passage of the stimulus, the projected deficit for 2009 was upped several notches to $1.84 trillion, or 12.9 percent of GDP,[37] more than twice as high as the previous postwar record.[38] And the Obama administration has threatened even more spending. These deficits have recently driven our national debt—the cumulative total of all past and present deficits—to record levels. While long-term interest rates are still quite low in early 2009, that is primarily a function of the panicked flight to quality as the financial crisis and economic recession have driven investors around the world to dump assets of virtually all kinds and park their money in the sovereign debt of the United States—still the safest investment in the world.

The bottom line is that small deficits do not matter; large ones do. The unprecedented spending and bailouts by the federal government are now producing record deficits. Our national debt is reaching alarming proportions that will surely have major negative consequences for economic growth. And who ends up paying for all this debt in the form of slower growth and higher taxes? Our children and grandchildren will. We have been financing our consumption today with borrowed money that our children will have to repay. It is one thing to incur this much debt to fight an existing threat such as the Axis powers of World War II. It is quite another to borrow vast sums to fund today's consumption whether it is entitlement spending, bailouts, or pork projects. Never before has one generation of Americans imposed such a burden on the next generation. Our parents never would have considered doing this to us. Yet we are doing it to our children. It is time to try another approach.

Controlling Spending

When You Are in a Hole, Stop Digging

It would certainly help if the government stopped making things worse. We need to stop the stimulus spending nonsense, and we need to stop expanding entitlements. With every House Republican and a handful of Democrats voting against the February 2009 stimulus spending bill, there is hope that the loyal opposition will put the brakes on future spending monstrosities.

We have to stop growing the entitlement programs too. The ultimate insolvency of these giants was well-known to government officials in 2003 when President Bush pushed for, and Congress acquiesced to, a huge expansion in Medicare to include prescription drug coverage. I was serving in the House at the time and I opposed this bill. Together with a handful of my Republican colleagues, I asked how we could afford this new entitlement when we knew we could not afford the existing ones? I never received a good answer. Unfortunately, most Republicans supported the bill because they refused to stand up to their own President or because they thought it would help their reelection efforts. Most Democrats opposed the bill because they thought President Bush's version of the program didn't spend enough money!

I would love to see Congress pass a rule requiring a supermajority vote to expand any mandatory spending program—especially any of the big three. This procedural hurdle could always be overcome or simply set aside if Congress were determined to grow one of these programs, but the added step might generate some more public scrutiny and, perhaps, increase the chances of derailing unsustainable expansions.

Presidential Vetoes

During the first six years of his presidency, while Republicans controlled both Houses of Congress, President George W. Bush vetoed only one bill.[39] This was fewer than any other president since James A. Garfield, who was shot six months after his inauguration, and far fewer than all recent presidents.[40] In their first six years in office, Presidents Reagan and Clinton vetoed 59 (including pocket vetoes)[41] and 25 bills,[42] respectively. President George H.W. Bush vetoed 44 (including pocket vetoes) bills in his single, four-year term.[43] It is always the tendency for Congress to spend too much money as each member tries to cater to the parochial interests of his district or state. Only the president is elected by the entire country; only the president is immune to the pull of parochial politics. He is, therefore, the person we must rely upon to impose the fiscal discipline that is usually lacking in Congress. George W. Bush abrogated this responsibility in favor of maintaining good relations with the congressional leaders of his party. It was a terrible mistake. We need to insist that our presidents exercise this vital responsibility.

In fact, we should give the president the power of a line-item veto. Most governors have this power[44] and a president—if he were willing to use it—could prevent a lot of wasteful spending with this tool. It is a standard routine in Congress to send to the president a "must-pass" bill, such as an urgent measure to fund an ongoing war, loaded up with assorted earmarks, pork projects, and program spending increases. Congressional leaders know he will be very reluctant to veto a vital bill over the spending excesses. A line-item veto would free the president from this quandary and save taxpayers a lot of money.

Adopt Strong Budget Rules

On September 30, 2002, the Budget Enforcement Act of 1990 expired.[45] A reasonably successful measure meant to achieve budgetary discipline, the act placed caps on discretionary spending and imposed pay-as-you-go rules (known as "paygo") that required any tax cuts or new mandatory spending increases to be offset with other tax hikes or spending cuts in order to remain "deficit neutral." The flaw in the bill was that it focused not on spending but on deficits. It treated tax cuts and spending increases as economic equivalents because they both increased budget deficits. In fact, tax cuts and spending increases are not economically equivalent at all. The former, properly designed, accelerate economic growth while the latter generally impede growth. Still, the act did help to restrain spending somewhat during the 1990s and, together with a huge surge in capital gain tax income, contributed to a briefly balanced budget around the turn of the century.

Congress would do well to reinstitute a form of the old Budget Enforcement Act. Strict caps on discretionary spending would be welcome and a requirement that any new entitlement spending programs, or additions to existing programs, be offset would help limit the growth in spending. They should avoid, however, restoring the restriction on cutting taxes. While offsetting lost revenue from a tax cut with spending cuts would be ideal, the restoration of the old rule would most likely prevent the tax cuts from being implemented at all. The last thing Congress needs is further obstacles to lower taxes.

Stronger Economic Growth

Finally, all fiscal problems are easier to solve if the economy is strong. Robust growth, rising wages, and high employment levels provide greater revenues to the government, thereby facilitating reforms and transitions. More importantly, these conditions mean greater financial security for working and retiring people. They also mean larger and safer nest eggs to supplement government programs. This book reviews many measures the government could take to help ensure a robust recovery and strong, long-term growth including lower taxes, free trade, sound monetary policy, and limited spending. While a stronger economy alone will not enable us to grow our way out of our spending problems, it would make the necessary reforms much easier.

Chapter 5

Free Trade Facilitates Economic Growth

We take it for granted that it makes good economic sense to engage in trade among different political subdivisions within the United States. People would think it ludicrous to worry that their town has a trade deficit with a neighboring town. And no one questions whether Pennsylvania has an imbalance of trade with Florida. Yet, as soon as we discuss trade in goods and services crossing national boundaries, a fog of confusion descends, and otherwise sensible people come to deeply flawed conclusions.

When thinking about international trade it is helpful to bear in mind a couple of thoughts. First, with the rare exceptions of totalitarian regimes like North Korea and Cuba (with whom trade restrictions make geopolitical sense despite their economic costs), countries do not trade with each other. People who happen to live in different countries do. Thus, when people in different countries engage in voluntary exchange, they do so for exactly the same reason as people within a given country—because it is to their mutual benefit. Otherwise, the exchange would not occur.

An American mom chooses to buy Chinese-made clothes for her children only because she believes those clothes represent the best value available to her. Similarly, a Chinese farmer buys an American-made Caterpillar harvester only because that harvester best suits his needs. Each of these exchanges clearly benefits the parties involved. The multiplication of beneficial exchanges like these among many people cannot destroy the associated benefits—it multiplies them.

The great Adam Smith summed up the commonsense rationale of free trade in *The Wealth of Nations*:

> In every country it always is and must be the interest of the great body of the people to buy whatever they want of those who sell it cheapest. The proposition is so very manifest that it seems ridiculous to take any pains to prove it; nor could it ever have been called into question, had not the interested sophistry of merchants and manufacturers confounded the common sense of mankind.[1]

International trade is a win-win situation in which both buyers and sellers benefit. If this were not the case, the trade would not occur. When governments interfere with cross-border exchanges by imposing various obstacles such as quantitative limits (quotas) and taxes (tariffs) on imports, they impede these mutually beneficial exchanges and reduce economic growth.

Trade restrictions help domestic producers, but consumers are harmed in equal measure in the form of higher prices and fewer choices. Tariffs, quotas, and the myriad other legislative obstacles to trade are merely governmental tools used to secure benefits for special interests at the expense of consumers. But this patent unfairness is not even the worst part. Trade restrictions also misallocate resources and leave all affected countries with less economic growth than they otherwise would enjoy.

Comparative Advantage

It is easy to see why countries trade for things they either cannot produce themselves or can only produce at great cost. Sweden imports olives from Mediterranean countries; Japan imports oil from the Middle East; and Hong Kong imports food from many of its neighbors. Given their geographies and limited natural resources, it would be impossible for these importers to produce those products domestically in sufficient quantities to meet domestic demand.

But importing certain products can make economic sense even if a country is capable of producing those products domestically. Counterintuitively, it can sometimes even make sense to import products that a country can make cheaply. It makes sense if the exporting country has a *comparative advantage,* relative to the importing country, in the production of those products. The English economist David Ricardo is generally credited with developing and articulating this theory in his 1817 book, *On the Principles of Political Economy and Taxation.*

The theory begins with the assumption that there is a finite amount of output that a person or country can produce in any given period of time. Therefore, the production of any particular item precludes the production of other things. In choosing which items to produce, total production in all countries is maximized when each country chooses to produce those items for which they have the greatest cost advantage over other countries, or the least cost disadvantage, while trading for all other items. Each country, Ricardo argued, should focus on the products and services for which it has a comparative advantage relative to other countries and products.

This theory can be illustrated with a numerical example as illustrated in "Steel and Lumber" on page 102, but you can also think about comparative advantage by comparing two hypothetical men. One man, Tim, is reasonably efficient at trimming trees. The other man, Sam, is more efficient at tree trimming but he is

Steel and Lumber

Imagine two similar countries, A and B, both of which can produce steel and lumber. By devoting all resources to one or the other commodity Country A can produce either 1,000 units of steel or 1,000 units of lumber. Likewise, Country B can produce either 2,000 units of steel or 1,000 units of lumber.

Clearly, Country B has an absolute advantage over Country A in the production of steel while neither has an absolute advantage in the production of lumber. At first glance, there is no obvious reason that both countries should want to trade in these commodities. But when we consider their respective opportunity costs, we can see that specialization and trade will, in fact, maximize production for both countries.

For Country A, the opportunity cost of producing one unit of lumber is one unit of steel and vice versa. For Country B, the opportunity cost of producing one unit of lumber is two units of steel and the opportunity cost of producing one unit of steel is 0.5 unit of lumber. The cost of producing lumber is relatively more expensive for Country B than for Country A since Country B must give up twice as much steel production as Country A for each unit of lumber produced. Conversely, the cost of producing steel is relatively more expensive for Country A since it must forego producing a full unit of lumber for each unit of steel produced while Country B foregoes only .5 unit. Thus Country A has a comparative advantage over Country B in the production of lumber and Country B has a comparative advantage over Country A in the production of steel.

As the charts below show, total production, and thus wealth, is maximized if Country A produces only lumber while Country B produces only steel and they trade for what they do not produce.

Total production without trade:

	Steel	**Lumber**
Country A	500	500
Country B	1,000	500
Totals	1,500	1,000

Total production with trade:

	Steel	Lumber
Country A	0	1,000
Country B	2,000	0
Totals	2,000	1,000

With specialization in the areas of each country's comparative advantage and trade between the two countries, total lumber production remains unchanged while total steel production increases by 500 units.

The two countries' opportunity costs become the outside bounds of the prices at which each is willing to trade. Country A would be willing to sell one unit of lumber provided it can get at least one unit of steel. Country B would be willing to trade up to two units of steel for each unit of lumber. They can settle at a price somewhere in between.

also a talented heart surgeon. Both men live in a town where there are plenty of trees that need trimming and plenty of hearts that need repair. It is pretty clear that the two men as well as the townspeople are better off if the heart surgeon sticks to surgery and leaves the tree trimming to the man who does it less well.

There are many assumptions made in the comparative advantage theory, and none of them are perfectly met in the real world. Nevertheless, the basic principle holds and is almost universally accepted by economists. By producing those things for which they have a comparative advantage and trading for the rest, countries maximize their individual and collective output and thus, their well-being. International trade works to the mutual benefit of all trading partners; that is why they engage in it.

But what about all the criticisms we hear of the effects of free trade in America? Isn't the persistent trade deficit proof that America is a net loser from international trade? Shouldn't our government restrict some trade to protect threatened industries? Doesn't "fair trade" make more sense than "free trade?" Is trade "hollowing out" our economy and destroying our manufacturing sector? When we import cheap products are we really exploiting poor foreign workers and their environments? Let us consider each of these five concerns in turn.

The Truth About Trade Deficits

Much of the popular misgivings about trade arises from a misunderstanding of the nature and importance of trade *deficits.* It is unfortunate that we use a word so laden with negative connotations to describe what is often an innocuous condition of imports exceeding exports. Many economists and the popular press propagate the mistaken notion that exports are good for our economy and imports are bad; thus a trade deficit manifests the bad outweighing the good. They view imports as a measure of American demand satisfied by foreign production instead of American production. From this perspective, imports seem deleterious to our economic well-being and deficits must diminish economic growth. In fact, neither is true.

The Purpose of Exports is Imports

As economists from Adam Smith and David Ricardo through Fredrik Hayek and Milton Friedman have explained, exports are the price we must pay in order to import. Products and services that we toil to provide overseas are not available for us to use. The only rational purpose for making and shipping exports overseas is the access we have to foreign goods and services in return.

Trade Deficits and Investment Surpluses are Two Sides of the Same Coin

When we import more than we export, we have a net inflow of goods and services and a corresponding outflow of dollars. But the story does not end here. Once in foreign hands, those dollars can be used in only two possible ways. Foreigners can sell them to someone who wants dollars, which will ultimately be used to purchase American goods and services, or they can invest those dollars in American assets. In the former case, foreigners reduce the trade imbalance by increasing U.S. exports. In the latter case, they expand our economy by providing direct investment capital or by lending our government money by purchasing U.S. bonds (until they decide to use the dollars to buy our goods and services or assets).

Japanese car makers have taken the direct investment approach on a large scale. Since 1979,[2] Japanese car makers have used proceeds from the sale of Japanese cars to Americans to build 22 automobile assembly plants in the United States.[3] In the process, they have expanded the American economy, created hundreds of thousands of jobs, and provided American consumers with attractive products to choose from.

Lenders Risk More than Borrowers

China has taken a different approach. While American exports to China have surged in recent years, our imports from China have grown even faster (in absolute dollars).[4] The Chinese government has taken the resulting dollars and invested much of them in United States treasury bonds. These bonds allow our federal government to borrow money cheaply as the interest paid on these bonds in recent years has averaged less than 5 percent.[5]

Trade skeptics worry about the risks Americans take when we borrow heavily from the Chinese. They argue that the Chinese government might quickly sell off our bonds some day, driving down bond prices and raising the corresponding interest rates the United States would have to pay on new debt. But the Chinese have no incentive to do such a thing–at least not for now. A fire sale would probably result in huge losses for the Chinese since the bonds would sell for much less than they paid for them. A massive sale of U.S. Treasury bonds would also create a major dilemma for the Chinese: What would they do with all the dollars they received from the fire sale? They cannot spend them in China as they use a different currency. They would be right back to the two options mentioned above: Sell them to someone else who will buy American goods or assets, or trade them for a different category of dollar-denominated asset. But there is no other category of dollar-denominated assets as large, liquid, and safe as United States treasury securities. That's why the Chinese hold so many and probably won't be selling them en masse any time soon.

If, however, the Chinese become convinced that the United States intends to devalue its currency by inflating its way out of the extraordinary debt it has recently taken on, then the Chinese will have an incentive to try to sell their dollar-denominated bonds before the devaluation occurs. This is another example of why it is so important for us to maintain a sound dollar.

On balance, it is the Chinese who are taking the greater risk in this arrangement—not Americans. We already have their products. They are holding on to U.S. bonds, with the promise that we will repay those bonds in dollars so that they can, someday, purchase American goods and services. I am very confident the United States will repay those bonds when due. But what happens if we repay those bonds in devalued dollars as it currently appears we will? In that case, the Chinese will be able to purchase fewer American goods in exchange for the goods we have already bought from them. This is a significant risk they are taking.

Growing Trade Deficits are Correlated with Faster Economic Growth

We do not have to rely on theoretical arguments to defend the proposition that trade deficits do not impoverish our country. We can look at the economic statistics. Dan Griswold, the director of the Center for Trade Policy Studies at the Cato Institute, has documented the positive correlation between growing trade deficits and American economic growth between 1980 and

2005. Tables 5.1 and 5.2 illustrate his findings which he summarizes with the observation that:

- Economic growth has been more than twice as fast, on average, in years in which the current account deficit grew sharply compared to those years in which it actually declined. If trade deficits drag down growth, somebody forgot to tell the economy.[6]
- In those years since 1980 in which the current account deficit actually shrank as a share of GDP, real GDP growth averaged 1.9 percent.
- In those years in which the deficit grew modestly, between 0.0 and 0.5 percent, GDP growth averaged 3.0 percent.

Table 5.1 Growth of the Current Account (CA) Deficits, 1980-2003

Years in which the CA deficit shrank as share of GDP				**Years in which the CA deficit grew up to .5% of GDP**			
Year	**CA/ GDP**	**Change in CA/GDP**	**Real GDP Growth**	**Year**	**CA/ GDP**	**Change in CA/GDP**	**Real GDP Growth**
1980	0.1%	0.1%	−0.2	1982	−0.2%	−0.3%	−1.9
1981	0.2%	0.1%	2.5	1985	−2.8%	−0.4%	4.1
1988	−2.4%	1.0%	4.1	1986	−3.3%	−0.5%	3.5
1989	−1.8%	0.6%	3.5	1987	−3.4%	−0.1%	3.4
1990	−1.4%	0.5%	1.9	1992	−0.8%	−0.2%	3.3
1991	−0.6%	0.7%	−0.2	1993	−1.3%	−0.5%	2.7
1995	−1.5%	0.2%	2.5	1994	−1.7%	−0.4%	4.0
2001	−3.8%	0.4%	0.8	1996	−1.6%	−0.1%	3.7
				1997	−1.7%	−0.1%	4.5
				2003	−4.8%	−0.3%	2.5
Average Growth:			**1.9**	**Average Growth:**			**3.0**

DATA SOURCE: Dan Griswold, the Director of the Center for Trade Policy Studies at the Cato Institute.

Table 5.2 Years in Which the CA Deficit Grew More Than .5% of GDP

Year	CA/GDP	Change in CA/GDP	Real GDP Growth
1983	−1.1%	−0.9%	4.5
1984	−2.4%	−1.3%	7.2
1998	−2.4%	−0.8%	4.2
1999	−3.2%	−0.8%	4.5
2000	−4.2%	−1.0%	3.7
2002	−4.5%	−0.7%	1.6
2004	−5.7%	−0.9%	3.9
2005	−6.4%	−0.7%	3.2
Average Growth:			**4.1**

DATA SOURCE: Dan Griswold, the Director of the Center for Trade Policy Studies at the Cato Institute.

- And in those years in which the current account deficit expanded by more than 0.5 percent of GDP, real GDP growth grew by an average of 4.1 percent.[7]

None of this is meant to suggest that growing trade deficits actually cause higher rates of economic growth. More likely, strong economic growth expands trade deficits in two ways. First, a growing American economy increases demand for goods and services produced domestically and overseas. When our economy is growing faster than most of the rest of the world, our demand for foreign products grows faster than their demand for our products. Imports grow faster than exports and the trade deficit grows.

Second, when our economic growth is outperforming most of the rest of the world, it naturally generates attractive investment opportunities and attracts foreign investment. We have seen that foreign investment in America is made possible by American purchases of foreign goods and services. But it is equally true that foreign investment in America can drive American purchases from abroad. As foreign companies buy dollars to invest in the U.S., Americans enjoy an inflow of foreign currency that can only be spent abroad.

History suggests that we could perhaps "cure" our trade deficit with a recession which would reduce demand for foreign products while making America a less attractive place in which to invest. But from any perspective, a growing economy and a trade deficit are preferable to a shrinking economy and a trade surplus.

The Problem with Protecting Certain Industries

Some argue that, even if free trade is generally good for an economy, surely there are particular industries that need and deserve protection. The worthy industries usually fall into one of three categories: Those needed for national defense; nascent industries; and those that cannot compete against foreign producers because the foreigners are unfairly subsidizing their exporters. I will discuss the last of these under the discussion of "fair trade" that follows, but first, I want to consider defense-related and nascent industries.

Protecting Defense-Related Industries

It is helpful to begin this discussion by recognizing that government protection of a given industry is the same thing as consumers or taxpayers subsidizing that industry. When governments impose tariffs or quotas, consumers and businesses are saddled with the higher prices that result.

There are cases in which it makes sense for taxpayers to subsidize individual companies that produce materials or items vital to national security. But these cases are very rare. If, for instance, there were only a handful of companies in the world with the patents and technological ability to produce sophisticated missile guidance systems, we may not want to rely on foreign companies for those systems if that reliance puts American producers out of business. A foreign country's geopolitical interests might induce it to block the sale of those systems to us during a conflict, leaving us with few, or no, alternative sources. To avoid that risk, it could make sense for American taxpayers to pay more for those systems if that were necessary to keep American companies in business.

In rare cases like this, it can make sense to subsidize high-tech, hard-to-make, systems-critical, defense-related materials and components. It can often make sense to ban their export to unfriendly and unstable countries for obvious national security reasons. But the "interested sophistry of merchants" notwithstanding, it does not make sense to force consumers and taxpayers to subsidize the production of high-volume commodities.

Protecting Nascent Industries

People have long justified protectionism for nascent industries that cannot sustain the start-up losses of their early years as they try to compete with more mature, established foreign competitors. It is reasonable, the argument goes, to force consumers to subsidize these industries for the sake of the jobs they will create and the products they will offer in the future when they no longer need the subsidies.

But this is simply sophistry. First of all, if these industries have reasonable prospects of ultimately becoming viable and self-sustaining, then private sector financiers—venture capitalists and private equity managers—will provide the capital to see them through the early losses. Why should consumers or taxpayers be forced to provide this capital in the form of higher prices or direct government subsidies without getting anything in return? If private investors are unwilling to invest in a given industry, that can only be because its prospects do not justify the risk. Why should consumers and taxpayers be forced to take that risk?

Second, everyone knows that government programs never end. Ronald Reagan famously said: "Government programs, once launched, never disappear. Actually, a government bureau is the nearest thing to eternal life we'll ever see on this earth!" Any industry, once on the dole, will never stop asking for government money.

Consider the long and turbulent relationship American taxpayers have had with America's cross-country railroad. Since its creation in 1971, Amtrak received more than $40 billion in government subsidies,[8] with taxpayers footing the bill for $1.3 billion for 2008 alone.[9] But, like many subsidies, this was not the government's initial intent.

When Congress created the National Rail Passenger Corporation, it was meant to be a temporary program. Government subsidies were supposed to end after two years and Amtrak was supposed to become self-sufficient.[10] Twenty-five years later, Amtrak is no closer to its goal of self-sufficiency and continues to make loud demands for more and more funds. Once a subsidy program is enacted, for whatever the reason, the recipients have every motivation to keep the program alive. Amtrak is just one of many examples proving that subsidy programs never die, even if the reason for their enactment has.

The Siren Song of "Fair Trade"

It is hard to argue with "fair." Opponents of free trade appeal to Americans' innate sense of fairness when they couch their protectionism with such a reasonable sounding euphemism. Wendell Willkie once said, "A good catchphrase can obscure analysis for fifty years," and this is certainly the case with the notion of "fair trade." But when it comes to trade, it is free trade, not "fair trade," that maximizes prosperity. It makes little economic sense to force taxpayers to subsidize industries even if they are subject to "unfair" foreign competition.

Proponents of "fair trade" object when foreign governments subsidize their own producers, allowing them to sell their products to American consumers at artificially low prices. If the U.S. government denies domestic companies similar subsidies, they cannot be expected to compete. Fair traders only support trade liberalization so long as it is completely reciprocal, tariff for tariff. That is the rationale for the extensive laws and regulations that impose tariffs on foreign-subsidized imports. These consumer taxes raise the prices of imports to the extent necessary to "level the playing field" and enable American producers to compete. It all sounds very "fair," but it is a bad deal for consumers and our economy. What's fair about that?

Foreign Export Subsidies Are a Gift to American Consumers

Foreign subsidies should be seen for what they are: Gifts to American consumers at the expense of foreign taxpayers. The same protectionist ideas plaguing our government infect many of our trading partners too. Some of them substantially subsidize their exporters, but when they do, American consumers benefit directly from lower prices. Rather than harming our economy, these countries are helping us—even if that is not their intent.

The illogic of the "fair" trade position is easily illustrated with a hypothetical example, albeit an exaggerated one. If the German government decided to subsidize its auto industry to the tune of $1,000 per exported car, American car manufacturers would file a case with the International Trade Commission seeking tariffs to offset this subsidy on the grounds that they are unfair and harmful to our economy. If the Germans raised their subsidies to $10,000 per car, our car companies would be outraged. If the Germans lost all sense and decided to give their cars away to Americans for free, American manufacturers and the auto workers union would be apoplectic. After all, how can American automakers compete with foreign giveaways? But how terrible would it be for American consumers to be able to drive Mercedes and BMWs for free? As consumers and as a country, we obviously stand to benefit from such "unfair" behavior. We would all have wonderful cars to drive without having to go through the significant expense and labor of producing them. The saved time, effort, and resources could go into producing other valuable things which we could enjoy along with our German cars. Of course, no foreign government would go to this extreme, but the magnitude of the subsidy does not change its nature. Foreign subsidies are gifts to American consumers that should not be confiscated by our government in the form of import taxes.

The Impact of Foreign Subsidies on American Jobs

What about all the jobs that would be lost in the American auto industry if we tolerated this unfair advantage the German car makers would have over their American competitors as a result of government subsidies? Certainly, substantial foreign subsidies (if not offset by tariffs) would result in fewer American cars sold, and consequently fewer American auto workers. This is a very real problem for those individual auto workers and their families, and, as a society, we should have a serious discussion about the public policy options for helping them deal with this problem.

But we should not confuse the loss of specific auto jobs with lost jobs overall. In fact, there are no net job losses caused by foreign subsidies. As we have seen, dollars spent by American consumers on foreign cars end up being spent in the United States eventually. The savings that result from foreign subsidies are spent directly by American consumers on other products and services. That means jobs are created in other industries in similar numbers to those lost in the auto industry. Unfortunately, these job gains are dispersed across the entire economy and are not easily discernible. It is impossible to attribute particular new jobs to consumers' savings on subsidized imports. The obvious, concentrated job losses versus the hard-to-see, dispersed job gains make it difficult to convince the public that it is the tariffs on subsidized imports that are harmful—not the subsidies themselves.

Mining Our Own Harbors

Many people find it galling that the United States often allows products to be imported with little or no tariffs from countries that do not reciprocate for American products. Aren't we being taken advantage of, they wonder, when we open our domestic market to countries that restrict access to their market? Some would have us maintain tariffs on imports from these countries at least as high as those imposed on our exports.

This wayward thinking has been analogized to mining our own harbors because someone else is mining theirs. When foreign countries erect obstacles to American imports, whether through quotas, barriers, or tariffs, they harm their own consumers and American exporters. Our recent bilateral trade agreements focus extensively on reducing these obstacles, and whenever we can persuade a country to open their markets to our products, we should.

But imposing retaliatory tariffs on these countries only exacerbates the harm we are already suffering. Denying American consumers the benefits of access to another country's products results in fewer choices, higher costs, and a less efficient allocation of resources, diminishing overall economic growth. It may be counterintuitive and it may offend our sense of fairness, but our economy would benefit from the unilateral elimination of virtually all tariffs and quotas. We would benefit even more from a global elimination of all obstacles to trade. As the biggest and richest economy in the world, we should use our leadership position to encourage worldwide free trade.

Our Not-So-Hollow Economy

I am amazed at how often I hear intelligent, well-informed people talk about the demise of manufacturing in America. They have heard so much about the so-called hollowing-out of our economy that they believe we no longer manufacture much of anything in America and that our economy stands on the rickety legs of a service sector dominated by low-paying retail jobs and mostly unskilled labor. They usually attribute the supposed decline primarily to international trade, which is blamed for replacing domestically produced products with imports. The gap between this perception and reality is breathtaking.

America Is Still the World's Number One Manufacturer

Most of these people would be shocked to learn that 2007 was an all-time record year for manufacturing in America. The total value of manufactured goods reached $1.62 trillion in 2007[11]—twice the level it was in 1985 (in real dollars).[12] That was enough to keep the Untied States number one in the world in total manufacturing output. And no one else was even close.[13]

America comprises about 5 percent of the world's population, yet we produce about 25 percent of all manufactured goods.[14] In fact, real, inflation-adjusted American manufacturing output has grown almost every year since 1960. Its growth accelerated in the decade after NAFTA went into effect in 1994 and, after a modest downturn during the 2000–2001 economic slowdown, manufacturing output resumed its climb in 2003—two years after China joined the World Trade Organization.[15] (See Figure 5.1.)

One could argue that American value added (the additional value of a product over the cost of components and materials used to produce) more accurately measures American production than total output. By this standard too, manufacturing was thriving right up until the recession of 2008–2009 caused a global fall-off in output of all kinds of goods and services. 2007 was a record year in value added American manufacturing, continuing a half-century trend of generally steady growth.[16]

It was not only total output that reached new highs in recent years. Along with output, American manufacturers were setting records for revenue, profits, profit rate, and return on investment.[17] And the strength in American manufacturing, although not universal, was broad-based. Of the 18 manufacturing industries in the North American Industrial Classification System, 13 showed increasing revenues between the 2002 economic downturn and 2006.[18]

Far from causing its demise, imports have actually helped our manufacturing sector to grow. That is, in part, because manufacturers themselves rely heavily on imports to produce their goods. In recent years, nearly 55 percent of all American

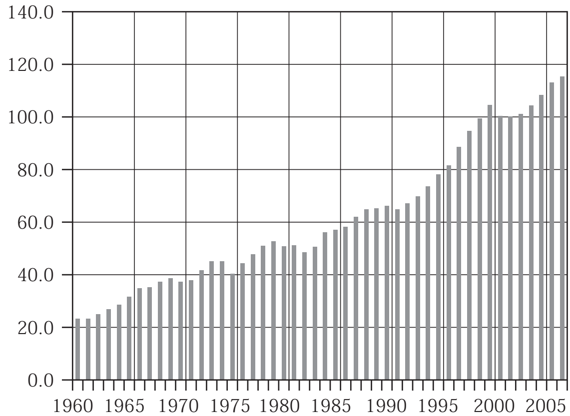

Figure 5.1 Real U.S. Manufacturing Output, 1960–2007 (Indexed to 2002 Output)

SOURCE: Daniel Ikenson, Cato Institute, Center for Trade Policy Studies, "Thriving in a Global Economy: The Truth about U.S. Manufacturing and Trade," August 28, 2007.

imports were to manufacturers buying raw materials, intermediate goods, and parts.[19] Low-cost imports help these manufacturers keep their product costs down. Higher tariffs on imports are very harmful to American manufacturers who have to buy imported items. By keeping American tariffs lower than those of our manufacturing competitors, we can help our manufacturers compete for global sales.

With virtually every meaningful measure of manufacturing production showing strong steady growth and record, or near-record performance levels right through the economic expansion up to 2008, how can the myth of the demise of manufacturing persist? The confusion arises primarily from two sources: One is the large decline in the percentage of Americans working in manufacturing, which has occurred despite the growth in manufacturing output. And two is the natural and simultaneous creation and destruction of millions of jobs in a dynamic economy.

Decline in the Percentage of American Manufacturing Jobs

In 1959, 28.7 percent of working Americans worked in manufacturing. By 2007, that figure was 10.1 percent. But the total absolute number of manufacturing jobs declined much more modestly over that time period, from 15.3 million to 13.9 million.[20]

One the biggest causes for the decline in the percentage of American manufacturing jobs is the spectacular growth in nonmanufacturing sectors. With manufacturing jobs holding nearly constant, rapidly growing total jobs naturally result in a declining percentage. At the same time, technology has generated enormous gains in productivity.

It was not primarily imports that reduced the number of manufacturing jobs—robots and the automation of the assembly line now allow more items to be made by fewer people. And lest anyone think that that is a good reason to ban robots and automation, keep in mind all the jobs that had to be created in the robotics, electronics, consulting, engineering, computer, and software industries—just to name a few—in order for the manufacturing sector to modernize.

Creative Destruction—Many Jobs Are Lost; Many More Are Created

Another factor that contributes to the perception of a decline in manufacturing is the natural turnover of a dynamic economy. At any given time, many companies, and sometimes whole industries, are closing down for many reasons. Changing technologies, consumer preferences, legal and regulatory factors, and economic cycles all take their toll. As they close, many jobs are lost. At the same time many more companies and industries are being born, and new jobs are created in the process. For example, during 2007, the American economy lost about 29.3 million private-sector jobs while creating 30.1 million new jobs for a net gain of about 800,000 jobs.[21] The failing companies understandably evoke our sympathy and make the front pages of our newspapers; the new and expanding companies are born and often grow in relative obscurity.

You would not know it from reading the average American newspaper but the truth is, American manufacturing has been the envy of the world, growing steadily up to the 2008–2009 recession, profiting solidly, and providing millions of great jobs. Free trade has helped to make it possible.

Trade Actually Helps Poor Foreign Workers

Trade skeptics, especially many in organized labor, sometimes argue that it is morally wrong for Americans to buy products made by foreign workers whose wages are meager and whose working conditions are far below those we enjoy. They suggest we are exploiting these workers by buying their products. Putting aside the self-interest of many of those making this argument, let us consider its merit.

As we have repeatedly seen, people enter into voluntary transactions only when they believe it is in their interest to do so. This is as true when people trade their labor for cash as when they trade their cash for goods.

The desperately poor subsistence farmer who leaves his rural Chinese village and travels hundreds of miles to a coastal city to take a job Americans would consider unpleasant, for wages Americans would consider unacceptable, does so for one reason. It is a better deal for him than staying in the village. Otherwise he would stay. His wages are low, but they afford him a better standard of living than life in the village. That is not my subjective comparison—he proves it so by his decision to leave the village and stay in the city. The poverty of the village probably precludes extensive education. The farmer who leaves may not even be literate. He is probably only modestly numerate. He has no applicative knowledge or skills. Thus, he is initially able to contribute only his unskilled labor. He is relatively unproductive and that is why his wages are low.

If the U.S. Congress insists, at the behest of self-interested groups, on higher wages, shorter hours, and better working conditions for foreign workers, such as our hypothetical Chinese villager, as a condition for allowing their products into the American market, they will not succeed in getting the workers a raise. In fact, such efforts will probably cost the villagers their jobs. Congress cannot suspend the fundamental laws of economics. One such law is that people can only get paid based on what they produce. If an employer is forced to pay a worker more than the value of his production, the employer has no choice but to lay off the worker or not hire him in the first place.

Far from exploiting foreign workers, international trade is the greatest anti-poverty tool there is. Simple commerce is more effective than foreign aid or loans from multinational development banks. In the last 25 years, more people around the world have lifted themselves out of poverty than ever before in human history. They have been able to do so in part because the explosion in international trade has given them the opportunity to use whatever comparative advantage they have—often it is just low wages—and offer it in a global market place.

As these people gain experience and knowledge, they become more and more productive, enabling them to earn higher wages and enjoy a better standard of living. It is happening all around the world, and we all gain by this great march out of poverty. Formerly impoverished people obviously gain directly, and it should be a source of great joy that we, through our commerce, can help millions emerge from poverty. But we in America gain economically too. As consumers, we benefit from the products produced by these people. As producers we gain from the increasing sales of our products and services as these people become consumers themselves.

This is not to say that there are no limits to the size and duration of chronic trade deficits. There are practical limits. But it is impossible for anyone to know what those limits are at any point in time. Thus, governments should not attempt to restrict trade in an effort to curb trade deficits or surpluses. If trade imbalances become large enough to be unsustainable, they are ultimately self-correcting. For example, if a country chronically imports far more than it exports, then, over time, the value of the importing country's currency will tend to decline relative to the currencies of the countries from which it imports. This is the market-driven mechanism that results from an imbalance of sales of the importing country's currency and corresponding purchases of the exporting countries' currencies. This decline in the value of the importing country's currency makes further imports more expensive thereby reducing them, while its exports become less expensive, thereby increasing them. Thus, the markets, acting through currency exchange rates, tend to stabilize trade imbalances.

Free Trade Works

All of these arguments reinforce the most fundamental premise of this book. Since trade across national boundaries is just another form of voluntary exchange, it necessarily contributes to and cannot detract from overall economic growth. Trade, like new technologies, can sometimes result in dislocations and concentrated job losses. But like technological advances, trade creates more opportunities than it destroys. It is no coincidence that the greatest period of economic growth in human history has occurred in an environment of expanding globalization and relatively free trade.

It is always a good idea to be skeptical when our government seeks to impose limits on personal freedom. Trade restrictions are such an imposition that they curtail American citizens' freedom to decide from whom they may buy and to whom they may sell products and services. Rather than limiting our freedom to trade and thereby diminishing the growth of our economy, our federally elected officials should be striving to create global free trade. We should oppose barriers to trade everywhere, but mostly where we can control them, namely here in America. Broad, multilateral agreements are best as they create the most opportunities. But where they are not possible, we can continue to pursue the kind of bilateral trade agreements that have been increasing in recent years. The rest of the world has been embracing freer trade—with and without us—and we can either be a part of this ongoing process or we will be left behind. For the sake of our prosperity, I hope the United States will lead the way.

Chapter 6

Transforming Social Security

Social Security is the biggest program in the history of government. Not just our government, but any government. Nearly every American will participate in the Social Security program either as a taxpayer contributing to it or as a beneficiary receiving checks from it—most of us do both at different times in our lives. In 2006, the program dispensed $546 billion dollars in benefit checks,[1] consuming 21 percent of the federal budget[2] and 4.2 percent of our country's entire economic output.[3] America's Social Security Administration spends more money than the entire government budgets of all but six of the world's countries.[4] It is bigger than the GDP of roughly 90 percent of the world's countries.[5]

And the program is going broke. The demographics that make it unsustainable are clear. The changes that could transform this program into a permanently solvent mechanism for wealth creation are equally clear.

But making the necessary changes has proven to be an enormous political challenge due to the unique and powerful hold Social Security has on the American psyche. That power derives not primarily from scale but from the program's effect on individual Americans. To understand that power, consider the story of Ida Mae Fuller, the very first American to receive a monthly Social Security check.

When Congress passed and FDR signed the Social Security Act into law in August 1935, Ida Mae Fuller was a secretary from the small town of Ludlow, Vermont. Like all wage-earning Americans, she became obligated to pay 1 percent of her wages, up to $3,000, in Social Security payroll taxes, or a maximum of $30 per year.[6] Her employer was obligated to match her payments. Miss Fuller paid a total of $44 in Social Security taxes before she retired at age 65 in 1940. She received her first Social Security check in the mail in January 1940 in the amount of $22.54. Mrs. Fuller then had the good luck to live to the ripe old age of 100. Over the last 35 years of her life, she collected more than $22,000 from Social Security—after having contributed just $44![7] Needless to say, Social Security was a very, very good deal for Ida Mae Fuller.

Certainly, few Americans live 100 years. But for many of the first few generations of Social Security beneficiaries, the combination of low initial taxes paid and rising benefits received meant that Social Security paid an excellent—in Ida Mae Fuller's case a spectacular—return on the money they paid in. These folks, and their children who were significantly relieved from the obligation to support them, understandably fell in love with the program. If you just lived long enough, you cleaned up in spades. It is not surprising that Social Security quickly became, and among many Americans of a certain age remains today, the most popular government program ever.

If this sounds too good to be true, it's because it is. Milton Friedman told us there is no such thing as a free lunch, and that is certainly true for Social Security. The flaws in the program's fundamental design have rendered it unsustainable. When

FDR created the program, he modeled Social Security after its European predecessors as a pay-as-you-go system. The payroll taxes workers and employers paid into Social Security have never been set aside, saved, or invested. It was never a savings program. Instead, these monies have been used all along to pay out the benefits to contemporaneous retirees—starting with Ida Mae Fuller. It all seemed to work so well for a while because there were so many workers paying into the system for every retiree collecting from it. In 1940, there were about 40 workers for each retiree.[8]

But in order to sustain this ratio, America would have to add 40 workers to the payrolls every time the number of retirees grew by one. We haven't even come close. Thanks to longer life spans, earlier retirement, and a decreasing birth rate, that ratio has been dropping like a brick. As Table 6.1 shows, the ratio of workers (think Social Security taxpayers) to retirees (think Social Security recipients) has steadily declined to the point where we now have just over three workers struggling to support each retiree's Social Security income stream in 2006.

With the arrival of the baby boomer generation, this problem was readily apparent. As the worker-to-retiree ratio steadily decreased over the years, Congress was repeatedly forced to deal with the prospect of a Social Security shortfall. But instead of fixing the program's fundamental flaws, Congress applied a series of quick fixes, including raising the retirement age; raising the payroll tax rate; increasing the amount of wages subject to the payroll tax; and expanding the types of workers required to participate in the program. Table 6.2 shows the periodic progression of ever higher tax rates applied to ever larger wages.

Private investment schemes that depend on ever more new "investors" to pay the "returns" to the earlier "investors" really aren't investments at all. What they are is illegal for the obvious reason that they are unsustainable. The earliest "investors" are paid off just fine, but later investors always end up losing out when the inflow of new "investors" slows down or ends.

These types of schemes always end in total collapse. Congress has avoided the total collapse of the Social Security program

Table 6.1 Ratio of Workers to Retirees

Calendar year	Covered workers per beneficiary
1945	41.9
1950	16.5
1955	8.6
1960	5.1
1965	4.0
1970	3.7
1975	3.2
1980	3.2
1985	3.3
1990	3.4
1995	3.3
2000	3.4
2005	3.3
2010*	3.2
2020*	2.6
2030*	2.2
2040*	2.0
2050*	2.0
2060*	2.0
*Projected	

SOURCE: Social Security Administration, 2004 OASDI Trustee Report, Part IV, Table IV. B2, www.ssa.gov/OACT/TR/TR04/trLOT.html

by raising the stakes on the later "investors" or, more precisely, workers. The ever-growing tax burden on younger workers has enabled the program to honor its commitment to retirees. But now Social Security taxes people at a much higher rate than when the program began. That means the promised benefits offer

Table 6.2 Tax Rates as a Percent of Taxable Earnings

Calendar year	Tax rate (worker and employer combined)	Income subject to tax	Tax amount per person per year
1937–1949	2.000	$3,000	$60.00
1950	3.000	$3,000	$90.00
1951–1953	3.000	$3,600	$108.00
1954	4.000	$3,600	$144.00
1955–1956	4.000	$4,200	$168.00
1957–1958	4.500	$4,200	$189.00
1959	5.000	$4,800	$240.00
1960–1961	6.000	$4,800	$288.00
1962	6.250	$4,800	$300.00
1963–1965	7.250	$4,800	$348.00
1966	7.700	$6,600	$508.20
1967	7.800	$6,600	$514.80
1968	7.600	$7,800	$592.80
1969–70	8.400	$7,800	$655.20
1971	9.200	$7,800	$717.60
1972	9.200	$9,000	$828.00
1973	9.700	$10,800	$1,047.60
1974	9.900	$13,200	$1,306.80
1975	9.900	$14,100	$1,395.90
1976	9.900	$15,300	$1,514.70
1977	9.900	$16,500	$1,633.50
1978	10.100	$17,700	$1,787.70
1979	10.160	$22,900	$2,326.64
1980	10.160	$25,900	$2,631.44
1981	10.700	$29,700	$3,177.90
1982	10.800	$32,400	$3,499.20
1983	10.800	$35,700	$3,855.60

(*Continued*)

Table 6.2 (*Continued*)

Calendar year	Tax rate (worker and employer combined)	Income subject to tax	Tax amount per person per year
1984	11.400	$37,800	$4,309.20
1985	11.400	$39,600	$4,514.40
1986	11.400	$42,000	$4,788.00
1987	11.400	$43,800	$4,993.20
1988	12.120	$45,000	$5,454.00
1989	12.120	$48,000	$5,817.60
1990	12.400	$51,300	$6,361.20
1991	12.400	$53,400	$6,621.60
1992	12.400	$55,500	$6,882.00
1993	12.400	$57,600	$7,142.40
1994	12.400	$60,600	$7,514.40
1995	12.400	$61,200	$7,588.80
1996	12.400	$62,700	$7,774.80
1997	12.400	$65,400	$8,109.60
1998	12.400	$68,400	$8,481.60
1999	12.400	$72,600	$9,002.40
2000	12.400	$76,200	$9,448.80
2001	12.400	$80,400	$9,969.60
2002	12.400	$84,900	$10,527.60
2003	12.400	$87,000	$70,788.00
2004	12.400	$87,900	$10,899.60
2005	12.400	$90,000	$11,160.00
2006	12.400	$94,200	$11,680.80
2007	12.400	$97,500	$12,090.00
2008	12.400	$102,000	$12,648.00

SOURCE: Social Security Administration, Trust Fund Data, Social Security and Medicare Tax Rates, www.ssa.gov/OACT/ProgData/taxRates.html and Social Security. Administration, Automatic Increases, Contribution and Benefit Base, www.ssa.gov/OACT/COLA/cbb.html#Series.

workers a paltry return on the taxes they must pay throughout their working years.

It gets worse. Even this much higher tax burden will not be sufficient to pay the benefits promised to baby boomers who are just starting to retire. Thus, policy makers who refuse to embrace reform face a terrible dilemma: Cut promised benefits; raise future taxes; or some combination of both. But any combination of these options will necessarily exacerbate the already meager returns today's workers are promised. Absent structural reform, the Social Security program will offer little, or even a negative, return on the taxes many young workers will be forced to contribute.

Imagine being forced to pay into a retirement program for your entire working life only to end up decades later getting less back from the program than what you paid in! This would be worse than taking the money and burying it in your backyard. A corporate retirement plan like this would be considered absurd.

But the Social Security system we have now is even worse than that. If you buried a portion of your wages in your backyard, at least they would belong to you. One day you could dig up the money and spend it on necessities. Or if you had the misfortune of dying before you retired, at least your spouse or children could dig up the funds and provide for themselves in your absence. Not so with Social Security.

In the 1960 case of *Fleming* v. *Nestor*, the U.S. Supreme Court ruled that once you turn over your Social Security taxes to the government, you own neither the taxes paid nor the promised benefit. Ephram Nestor learned this lesson the hard way.

Nestor was a Bulgarian immigrant who paid Social Security taxes from the program's inception in 1936 until his retirement in 1955. When he was deported a year later for being a member of the Communist Party, his monthly checks of $55.60 were terminated. Nestor claimed that he had a right to his Social Security benefits because he paid into the system for nineteen years in the form of payroll taxes. But the Supreme Court didn't agree.[9]

Writing for the majority, Justice Harlan declared: "To engraft upon the Social Security system a concept of 'accrued property rights' would deprive it of the flexibility and boldness in adjustment to ever changing conditions which it demands."[10] It's tempting to think that because of his Communist ties Nestor got what he deserved, but the Supreme Court's decision applies to all of us. In other words, your property right to that portion of your wages is simply gone. Congress can decide to raise, lower, or cancel the benefits you were promised at any time, and you have no recourse whatsoever.

No ownership means no inheritability. If you work for forty years paying tens of thousands of dollars into the Social Security system and you have the misfortune of dying before you retire, you are out of luck. Since those contributions aren't your property, they are not yours to pass on. Your adult offspring would get nothing. Even your surviving spouse would receive only a fraction of what you had coming—assuming she hadn't earned comparable benefits herself.

No one within or outside government could propose starting such an arrangement from scratch today and be taken seriously. Yet this is exactly what those favoring the status quo are proposing to force on today's younger American workers.

If we were starting from scratch today to build a retirement security program for American workers, we would not ignore the virtually immutable demographics that make a transfer payment system unsustainable. Instead, we would almost certainly use the ancient, common sense prudence called savings. We cannot change the history of Social Security but we can change its future. It is long past time to transform this giant program from the transfer payment program it is to the personally owned savings plan it can become.

Personal Accounts Mean Personal Prosperity

The first principle of reforming Social Security has to be that people who have been in the system for a long time, whether already retired or soon approaching retirement, must not lose any benefits when it is too late in their life to make alternative arrangements. Our government has been promising people specific benefits for their entire working lives and it would be outrageously unfair to renege on that promise. So anyone already receiving Social Security checks, and those soon to start, must get exactly the benefits they've been promised.

But younger workers should be given a choice. Those who would prefer to stay in the current system should be allowed to do so. If they don't mind the lousy returns, the lack of ownership, and the risk of losing it all in the event of premature death, that's their prerogative. Others, however, should be free to deposit a portion of the payroll taxes they already pay into a personal savings account instead of sending their hard-earned money to Washington.

These workers would own and control these accounts. No one could take the money from them. As workers add to their accounts each pay period, the savings in these accounts would accumulate and appreciate over time as financial assets do. They would grow dramatically under the force that Albert Einstein is purported to have called the greatest power on earth—compound interest. While current workers could choose between the old and the reformed programs, new workers would automatically be enrolled in the new system. When these workers decide to retire, they could take their accumulated savings and convert some or all of it to a monthly payment stream, or annuity, through a creditworthy financial institution. If they are allowed to save and invest a sufficiently large portion of their current payroll tax, they would accumulate far more than the entire Social Security benefit they were once promised. Thus, the Social Security system could be relieved of some or all of the need to make monthly payments to these folks.

The benefits of personal accounts over the current system can be illustrated with a simple numerical example. Let's take a hypothetical 25-year-old male earning $33,573 a year with average wage growth. Under the current system, he will receive

$2,890 per month when he retires, or a measly −0.78 percent return on his contributions, according to the calculations done by the Heritage Foundation. Now imagine that our hypothetical worker invests the retirement portion of his payroll taxes in a bundle of stocks and bonds, earning a modest 4.9 percent return. When he retires at age 67, he will have an account with his name on it worth $1.2 million. He could convert that sum to an annuity paying him $9,990 per month. So the debate over Social Security comes down to one simple question: Would you rather have $2,890 a month in your retirement years or $9,990 a month?[11]

But even the above anecdote is overly generous to the current Social Security system, because it assumes Social Security will be able to make good on its promised benefits. Unfortunately, this is not the case. As we saw earlier, Social Security is going broke and will either have to cut benefits or raise taxes to maintain the current level of benefits. That means the −0.78 percent return earned under the current system by our fictional worker above will be even less, either because he receives less in benefits or because he is forced to contribute more to the system for the same promised benefit level. So the real question is: Should we perpetuate a broken system that will only become more unfair with time?

Certainly, there are many complex details that have to be addressed in a reform such as this. I should know. As a member of Congress, I worked long and hard with fellow Rep. Sam Johnson, my staff, and some very knowledgeable experts such as Michael Tanner from the Cato Institute, David John from the Heritage Foundation, and William Shipman from State Street Bank to develop and introduce a bill which would achieve this transformation. The bill was 60 pages long! But the underlying idea is really quite simple. Workers will be much better off when they can accumulate their own savings instead of relying on a government promise that can't be fulfilled.[12]

While the superior returns should be sufficient reason to make this change, there are other, perhaps even more powerful reasons to give workers this freedom.

One such reason is the dignity that will come from giving workers the freedom to provide for their own retirement income instead of relying on the government to do it for them. So much the better that they will almost certainly do a better job of it than the government! No longer would workers have to worry about politicians cutting their benefits or delaying their permissible retirement age. No longer would people be helplessly dependent on the government for the benefits they earned. The investment accounts would be the property of the worker as much as a home or car is today, and *no one* would have the right to take it away.

Another great advantage of that ownership is the flexibility and freedom that comes with it. Today, the government dictates the ages at which workers can begin collecting partial or full Social Security benefits. As a practical matter, that means the government sets Americans' retirement age. Why should such a personal decision as retirement be taken away from the individual and mandated by the government? And why does it make sense to force all workers to retire at the same age despite the infinite array of needs, desires, and circumstances of actual people? A fashion designer in Miami may want to continue working well into her 60s and beyond while a coal miner in West Virginia may want to retire well before 60. This decision should not belong to the government.

Under a reformed Social Security plan, the aforementioned miner could convert his accumulated savings into an annuity as soon as he accumulates enough money to generate an agreed upon minimum income level. If that level is equivalent to what the traditional Social Security program would have paid, most workers would reach sufficient savings long before they turned 65. These workers could begin enjoying their monthly benefits when they retire, regardless of their age.

Alternatively, they could continue working and contributing to their accounts, even after they have accumulated sufficient savings to purchase the minimum required annuity. These workers would build up excess savings to be spent as they want, when they want. People could travel the world, launch a small business, give the money away to their children or their alma maters—the possibilities are endless.

As these older workers look for ways to spend their excess savings they would inevitably discover investment opportunities in their own communities. The private capital that they would be able to bring to bear could play a critical role in revitalizing neighborhoods and cities badly in need of capital infusion. The poorest communities in America are, by definition, starved of capital. The absence of capital means businesses are not launched, workers are not hired, neighborhoods are not restored. In short, the absence of capital is part of what keeps these communities from breaking out of poverty.

The great virtue of this reform plan is that all of these decisions could be made as they should be made—by the individual, not the government. It's exciting to think about how empowering and transformative these reforms could be for America. We would become, for the first time in our history, a society in which virtually everyone would have accumulated savings. Every American worker would be a saver and investor in our economy. Everyone would have a much greater stake in our nation's economic well-being, and everyone would have a better shot at the American dream.

The Proof is in the Pudding

Despite their numerous advantages, personal Social Security accounts have become the bugaboo of modern American politics. Opponents of personal accounts—usually Democrats—have convinced workers that a market-based system will sound the death knell for retirement security. This is awfully silly when you consider that millions of Americans invest in the market every day. It is even sillier when you consider that at least twenty countries have already enacted some version of personal Social Security accounts and their workers are doing just fine. In fact, many are doing better than ours.

Although America is woefully behind on the Social Security reform curve, we don't have to start from scratch. We don't have to rely on educated guesses or theoretical arguments. We can learn from the successes and yes, the mistakes, of other countries that have transformed Social Security before us. And we can build our reform on the infrastructure of the world's largest, most sophisticated, liquid, and transparent capital markets—our own!

In November of 1980, Chile was the first country to enact a personal savings-based retirement system.[13] Since then, many countries have followed suit, including Peru, Columbia, Argentina, Uruguay, Bolivia, Mexico, El Salvador, Poland, and Australia.[14] Most of these countries were forced to reform their retirement systems for the same reasons that America is now grappling with its own Social Security crisis. Prior to their reforms, these countries had some version of a "pay-as-you-go" retirement support system that relied on payroll taxes to provide current retirees with their due benefits. The inherent structural flaws of a "pay-as-you-go" system had brought many of them to a breaking point.[15]

Chile is a prime example. When Chile enacted a personally owned investment-based retirement system in 1980, its government retirement system was on the verge of collapse. The worker-to-retiree ratio in Chile had declined from 10.8 in 1960 to 2.2 in 1980[16]—beyond sustainability even with a crippling payroll tax of 26 percent.[17]

The brainchild of José Piñera, Chile's Secretary of Labor, the resulting program was fairly simple. Chile's system mandated participation for all workers who entered the workforce after January of 1983. Current workers were given a choice between staying in the government-run system and moving into the private system. Those who opted to stay in the old system were guaranteed full benefits just as before. Those who opted to move to the new system were allowed to invest the payroll taxes they were previously paying in personally owned pension funds.[18]

This is how it works. Each month, a worker is obligated to deposit 10 percent of his wages (up to an annual cap of $22,300) in a private savings account, with the option of depositing an additional 10 percent, if he wishes. Workers can choose to invest with a number of pension fund administrators, with the option to transfer from one fund to another twice a year. In order to begin withdrawing from the savings account, male workers must reach the age of 65 and female workers must reach the age of 60. There is no mandatory retirement though, and workers are not penalized if they opt to continue working. A worker can qualify for early-retirement withdrawal if he has enough money in his account to qualify for a reasonable annuity. The government continues to play a role in two important ways. It regulates the system, including setting criteria for acceptable pension funds, and it continues to act as a safety net of last resort.[19]

One challenge facing Chile was what to do about workers who had previously contributed payroll taxes to the old system but switched to the new system when it went into effect. Understandably, these workers were loath to relinquish previous contributions. To its credit, Chile devised a creative solution to deal with this problem. It issued those workers "recognition bonds"—certificates of obligation proportional to the amount of payroll taxes already paid into the system and redeemable upon retirement.[20]

Over 25 years have passed since Chile's reforms have been in place—enough time to evaluate the system's successes and failures, though it will still be another 20 years before the system's new workers (those who entered after 1983) will retire. So what have the results been? Has Social Security reform wrought the devastation the left wing has long predicted?

Far from it. In 2005, the number of Chilean workers investing in private accounts was at 3.6 million, or 65 percent of Chile's 5.5 million workforce.[21] These workers have experienced an astounding average annual return of more than 10 percent, far higher than originally predicted.[22] Nor can one ignore the tremendous effect that Chile's private accounts are having on economic growth in the country. Assets have grown to over 40 percent of GDP, with projections to increase to 134 percent of GDP by 2020.[23] This is an astonishing achievement for a small country like Chile with relatively underdeveloped capital markets. A savings-based retirement system has translated into millions of new investors who are now players and stakeholders in the market place. This, in turn, has translated into millions of dollars in new capital formation, driving productivity gains and a better standard of living for Chilean workers.

To be sure, Chile is grappling with new problems—some of which do not apply to the United States, and some of which we can address from the start with the benefit of hindsight. The Chilean system has suffered from high administrative costs and limited investment options due to heavy regulation and its relatively underdeveloped capital markets.[24] While this is an important challenge for Chile, it need not pose a concern for American reform since the vastly larger size of our pooled savings would lead to far lower fees, and a broader range of investment options would enable excellent diversification.

It is also important to remember that while Chile has been the leader in free-market Social Security reform, it is not the only model from which the United States can draw guidance. There are a number of important differences between the numerous private programs adopted by countries around the world. These include: the voluntary nature of the system;

the transition process from public to private pensions; how much a worker can invest into the account; and the regulation of investment choices and withdrawal options. These are important issues, worthy of a much longer discussion, but the fundamental lesson from each of these countries is the same: Personal accounts have been a great success, affording workers the opportunity to accumulate wealth and greater freedom in their working and retirement years.

The Opposition

So, you're probably thinking, if personal Social Security accounts are so terrific, why don't we use them in America?

There are a number of answers to this question. First, there is the widely held misconception that there is no Social Security crisis. Second, there are a number of legitimate concerns raised by thoughtful people that must be carefully addressed as part of the legislative process. Finally, there are politicians who use these factors as excuses to serve their own selfish interests in maintaining the status quo.

Inventing a Crisis

The most pernicious fallacy about Social Security is the idea that there is nothing wrong with it financially. In 2004, liberal *New York Times* columnist Paul Krugman accused Republicans of "inventing a crisis."[25] After all, seniors receive their checks each month, Social Security is currently experiencing a surplus, and there is a giant Social Security Trust Fund to fall back on when the program falls into deficit. The Social Security Board of Trustees projects the Social Security Trust Fund will not run out of money until 2041.[26] So what's the problem?

Here is the problem. While payroll tax revenues currently exceed benefit payments, this surplus is not going to last. On

October 15, 2007, Kathleen Casey-Kirscling became the first baby boomer to file for Social Security benefits, with as many as 80 million more to follow over the next couple of decades. Assuming the tax rate remains unchanged, outgoing payments to retirees will start exceeding incoming revenue by 2017. [27] And once the deficits begin, they just keep getting bigger. On that everyone agrees.

Opponents of reform argue that these deficits are easily manageable. The Social Security administration can simply take money from the Social Security Trust Fund to cover the shortfalls. There is just one problem with this solution: The Social Security Trust Fund is the biggest hoax since the Loch Ness Monster. It exists only in form—not in substance.

As I mentioned above, Social Security tax payments have never been saved or invested. Instead, these payments fund contemporaneous benefit payments to retirees while surplus funds are spent on other government programs. These programs include everything and anything from pork projects to fighting wars to education spending. Each year in which payroll taxes exceed benefit payments, the Social Security Administration prints out a tidy little certificate stating that the U.S. Treasury owes the Social Security Administration the amount of that year's surplus. These certificates are all neatly filed in a cabinet in the Federal Bureau of Public Debt in Parkersburg, West Virginia. That filing cabinet is the Social Security Trust Fund.[28] And it is absolutely meaningless.

To see just how perfectly meaningless these IOUs are, consider what will be done with them when 2017 arrives and the Social Security system switches from surplus to deficit. The theory is that these certificates will then be presented to the U.S. Treasury for payment. But the Treasury has no money lying around waiting for that day—the old surpluses were all spent. In any case, the Treasury is part of the very same federal government as the Social Security Administration. Thus, these certificates are really IOUs the government has issued to itself! Writing oneself an IOU for $1 million does not make one a millionaire. An amount of money one owes oneself is neither an asset nor a liability—it is a nullity. Businesses naturally consolidate intracompany loans on their balance sheets for the same reason. A loan from one part of the government to another is nothing more than an accounting mechanism. It is certainly not an asset that can be liquidated to make real payment obligations to real people.

Thus, the Social Security Trust Fund, despite $2.4 trillion dollars in certificates,[29] is perfectly irrelevant to the discussion about the solvency of Social Security. The system would be exactly equally distressed if there were no Social Security Trust Fund at all, or if there were ten times as many certificates in the filing cabinet.

When it comes time to pay promised retiree benefits, and the payroll tax is not sufficient to cover those payments, the government will have the same three alternatives it would have if the Social Security Trust Fund had never been invented. It can raise taxes, either payroll or elsewhere; it can cut spending, either Social Security benefits or other spending; or it can borrow real money in the capital markets. The exact date in 2041 when the Trust Fund is projected to "run out" is completely meaningless. The date that matters is the day when promised benefits start exceeding actual receipts. And that date is just around the corner.

The Stock Market Is a Scary Place

There are more legitimate questions raised about personal Social Security accounts, and they deserve to be addressed. Many concern the vagaries and volatility of the stock market.

It is certainly true that the average worker is no expert on the stock market and is unqualified to construct a prudently diversified investment portfolio. But this is no reason to deny him the opportunity to accumulate savings and investments—he need only hire the services of those who are qualified. After all, how many of us could assemble our own car? Yet we have no trouble evaluating cars, comparing features and their accompanying costs, and making suitable decisions about which one to buy or lease. Similarly, workers who opt into a reformed Social Security program could select the investment portfolios that best suit their preferences offered by competing, licensed financial institutions.

Reformers argue about the extent to which these financial institutions and their respective investment services should be regulated by the government. A broad set of regulatory guidelines would be reasonable. Since the purpose of these savings accounts is to provide a secure income stream in retirement, it would make sense to require that risks in the portfolios be mitigated. The best way to mitigate against investment risk is through broad diversification. There are vast bodies of research on historical financial market returns from which could be drawn general diversification guidelines. Maximizing returns within acceptable levels of volatility would be achieved with portfolios consisting of stocks, bonds, and probably some commodities. Conservative workers might prefer forgoing some upside in return for even less volatility by selecting a portfolio that would consist primarily or exclusively of bonds. They should have that choice. But the important thing to remember is that the individual worker would not have to worry about constructing his portfolio. He would simply select one from among several offered by the financial institution of his choice.

In addition to a widely diversified portfolio, it would make sense for investment portfolios to vary depending on the age of the worker participant. Young workers, decades from retirement, could sensibly accept greater volatility in return for greater total returns. As workers approached retirement age and conversion of some or all of their investments into an annuity, it would become very important to reduce the volatility and short term risk of the portfolio. Thus a typical portfolio would gradually shift its weighting of stocks and bonds over time.

These kind of age-based arrangements are commonly done today in investments such as the popular 529 plans that parents use to save for their children's college educations. Volatility and, typically, returns are higher when the children are young and the need for cash to pay tuition is distant. As the children approach college age and looming tuition bills, the 529 fund managers automatically shift the portfolios into lower yielding, less volatile instruments like bonds and cash equivalents so that any sudden, temporary stock market downturn will not have catastrophic consequences for the family. Here, too, the entire process happens without any intervention by the actual investor. For a very modest fee, a financial services firm provides this service efficiently and seamlessly. Social Security reform could work the same way.

Perhaps paradoxically, the stock market crash of 2008–2009 demonstrates how well a reformed Social Security system based on personal savings accounts would work. I am 47 years old. When I began full-time work after college in 1984, the Dow Jones Industrial Average was trading at just over 1,000 points. In mid-2008, after the worst crash and during the worst recession since the Great Depression, the Dow is over 8,000. This is quite disappointing after seeing the Dow reach an all-time high of over 14,000 in 2007, but it still represents an eight-fold increase from the levels of my early working days. If people my age had had the opportunity to invest a portion of their payroll taxes each month since the early-to-mid 1980s, they would be financially far ahead of where they are today without having had that option. Older workers would be even better off as their early investments in stocks at even lower prices would have produced huge gains before being transitioned into the security of CDs, bonds, and cash, all of which have performed very well throughout the recent crash.

Transition Costs

Another frequent objection to personal Social Security accounts is the so-called "transition cost." According to these skeptics, allowing younger workers to divert the taxes that are currently funding today's retiree payments to their own investment accounts would require massive borrowing to pay today's retirees their benefits. The truth is, personal accounts would lead to larger near-term deficits in the Social Security system, and these deficits should be financed through borrowing. But to consider these deficits "costs" is a mistake. The "cost" was incurred when we promised people a specific benefit. Whether we pay that cost primarily by taxing today's workers or through a combination of taxes and long-term borrowing doesn't change the cost. Either way, it must be paid.

Absent any reforms, the system will soon develop a permanent and growing cash shortfall. At least, in the reformed system based on personal accounts, that shortfall ends eventually when the last person collecting traditional Social Security transfer payments dies and all remaining workers and retirees are relying on accumulated savings for their retirement incomes.

The amount of payroll taxes workers should be allowed to divert into personal savings accounts; the regulation of the accounts themselves and their managers; the nature and timing of the financing used to transition; and many other complex technical questions have all been thoroughly debated and resolved in many creative ways by the researchers, economists, analysts, and financial experts who have been working on this challenge for years. Other countries have long ago implemented very similar reforms. I and other members of Congress, including Representative Paul Ryan, Senator John Sununu, and Senator Jim DeMint, have all introduced comprehensive legislation with much help from outside experts that would guide the transformation. We can readily solve the mechanical challenges of reforming Social Security.

Political Obstacles

Like most serious public policy problems, the most daunting obstacles are often political in nature. The virulence of this opposition should not be underestimated. In early 2005, President Bush embarked on a cross-country campaign on behalf of his Social Security reform plan based on personal retirement accounts. Senate Minority Leader Harry Reid responded by dispatching a letter to the White House, signed by all but three Senate Democrats, urging the President to "unambiguously announce," a rejection of personal accounts.[30] To date, Congress has yet to hold a single vote on any major structural reform of Social Security.

For the Democratic Party, the first line of offense has always been retirees and older workers who can often be scared into believing that reform is part of an evil plot to eviscerate their Social Security benefits. Senior citizens vote in large numbers, and they won't vote for a candidate if there is even the slightest doubts about his devotion to preserving Social Security benefits. Of course, no prominent supporter of personal accounts has ever suggested cutting Social Security benefits to current retirees, but that does not stop some politicians from inciting fear in the hearts of seniors.

Just listen to the attacks of some senior congressional Democrats. In 2006, New York Senator Chuck Schumer labeled the Bush plan "a sneak attack on seniors and all those who expect to receive Social Security benefits when they retire."[31] A 2005 town hall meeting sponsored by the American Association of Retired Persons (AARP) and the National Association for the Advancement of Colored People (NAACP) in New York City featured more demagoguery. Blasting the president's plan. Rep. Charlie Rangel declared: "We have to get rid of the bums that are trying to take it away from us."[32] The Republican Party generally, and individual candidates personally, must reassure seniors with the truth: Older folks are going to get exactly what was promised them and the reforms apply only to younger workers. Once seniors are thus assured, they become open to the idea of fixing a system they know is unsustainable.

The nationally organized senior citizen groups will still oppose reform as surely as the sun will rise. Their mission is to maximize transfer payments to their constituent seniors from whomever they can get the payments. Although this reform plan would not reduce transfer payments to today's seniors by a dime, in time, it certainly would reduce transfer payments to future generations of seniors as they became less and less dependent on government checks and more and more self-reliant for their retirement security. It is for this reason that AARP launched a $5 million ad campaign to stop President Bush's reform plan dead in its tracks. Apparently, the contradiction of a $912 million investment portfolio with AARP's name on it didn't bother the folks at the nation's largest senior lobbying group.[33]

The same holds true for organized labor leaders. Personal retirement accounts for workers would allow their members to accumulate wealth, often for the first time in their lives. Like the AARP, the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) and the Service Employees International Union (SEIU) thrive on the dependence of their members. Once workers realize their own ability to accumulate wealth and provide for themselves, they might question how much they need the union that duns their weekly paychecks. That kind of thinking would be a deathblow to organized labor. Fortunately, rank-and-file union members are famously independent of their union bosses when it comes to political decisions.

I know this is true from personal experience. In both of my campaigns for reelection to the House of Representatives from the 15th Congressional District of Pennsylvania, I faced the same union-executive Democrat. The blue-collar, Fifteenth District was, and still is, a classic swing district. The Democrats have a registration and presidential voting advantage, while Republicans tend to hold the congressional seat.

I remember debating my Democratic opponent in a union hall packed with union workers. He predictably decried the idea of "privatizing" Social Security, as he called it. I countered by explaining that I was the guy who wanted to give the workers in the audience the opportunity to accumulate wealth. Judging by their demeanor, I am very confident that many of those workers quietly voted for me on Election Day. Of course I'll never know for sure how the union workers voted, but I did win both my reelection races.

The biggest institutional opposition to Social Security reform, however, will continue to be the leadership of the Democratic Party itself. Other than a very small handful of mostly retired members of Congress, federally elected Democrats simply refuse to endorse the personal account alternative. And few, if any, Democrat leaders will join the crusade any time soon. Personal Social Security accounts would profoundly undermine the fundamental organizing principle of the Democratic Party.

Today's Democrat Party leadership fundamentally rejects the traditional American idea of individualism and personal responsibility. Instead, the Democratic Party is inspired by the collectivist view that ordinary Americans are incapable of taking responsibility for themselves. Instead, government is required to provide an ever-growing litany of goods and services, with retirement benefits topping the list.

The Democrat Party needs Americans to perceive themselves as dependent on government in order to convince the electorate of its need for the endless array of programs the Democrats want to enact. How better to foster the perception of dependence than to enforce actual dependence? Forcing people to wait until the government sends them their check each month makes them dependent. Allowing people to provide for their own retirement—and do so better than the government does—would do the opposite. Once people start enjoying the dignity, freedom, flexibility, and better standard of living personal retirement accounts would make possible, how enthusiastic will they be for government-controlled health care, education, unemployment insurance, and so on? Not very.

This is certainly not lost on Democratic members of Congress. A friend of mine, and fellow Republican House member serving on the committee with jurisdiction over the Social Security, once relayed to me a conversation he had with a senior Democrat from the same committee. After a committee hearing on personal Social Security accounts, the Democrat asked my friend if the reform plan was ultimately designed to enable workers to provide for their own retirement income. My friend said yes, that was a big part of the objective. Without missing a beat, the senior Democrat replied, "But then they [the workers] wouldn't need us. We [Democrats] can't be for that."

Republican congressmen are certainly not without blame for the lack of progress on Social Security reform. While I was serving in the House, and I believe still today, most Republican House members are at least somewhat supportive of the idea. Some, like Jeff Flake, Jeb Hensarling, John Shadegg, and Paul Ryan are outspoken advocates. But too many are unwilling to openly support this vital reform, despite believing it to be right, because they fear the inevitable attacks from the left. This timidity does a great disservice to the American people in general and rank-and-file Republican voters in particular, who look to congressmen for leadership.

In fact, no Republican congressman has ever lost his seat because he supported Social Security reform. Several House members, such as South Carolina's Jim DeMint, have been elected to the Senate after campaigning in favor of this reform. Others, like Mark Sanford, have been elected governor.

It is time Republicans united in support of this powerful idea to liberate and empower American workers. It is terrific policy that would enable working American to accumulate wealth. And good policy makes good politics.

Chapter 7

School Choice

Competition breeds excellence. We should demand both in education.

I should start by disclosing my bias. I benefited enormously from having had a choice of high schools to attend. That choice created opportunities for me that, among other things, ultimately led to a challenging, rewarding, and satisfying professional life. I am convinced that millions of other children would benefit as much as I did if they could have the advantage of school choice that I had. And we would all benefit from the stronger economy and higher productivity that would result from a better educated workforce.

From second through eighth grade, I attended public schools in East Providence, RI. I had every expectation of attending the city's public high school, as my brothers after me did, as did almost everyone in our neighborhood. East Providence High was an average Rhode Island high school. There were several excellent private high schools in the greater Providence area, but we could not afford their tuitions so I never gave them any thought.

One day, my mother found a small notice in the local newspaper announcing that a full, four-year scholarship would be awarded to the top five finishers on the entrance exam of La Salle Academy, a highly regarded Catholic high school in neighboring Providence. I had always been a very good student so my parents thought it was worth the time and effort for me to take the test.

Until the Saturday of my marriage, the testing day ranked as the best-spent Saturday morning of my life. A week or two later we received a letter stating that I had won one of the scholarships. Thanks to the generosity of a local businessman and La Salle alumnus named John Moran, I got the chance to attend a very rigorous and competitive all-boys Catholic high school.

I do not mean to imply that East Providence's public high school was deficient. But La Salle was a much better fit for me. I thrived there, excelling academically and in extracurricular activities. Four years later, I was accepted to Harvard University, from which I received my bachelor's degree. My experience at Harvard was terrific and has been helpful ever since. I am convinced I never would have seen the inside of its halls had I not received a scholarship to La Salle Academy.

I had a choice. Not because the education system in Rhode Island provided school choice, but because I was lucky enough to be the beneficiary of a generous philanthropist. It galls me that we have an education system that needlessly, but systematically, denies children the kind of choice that made such a big difference in my life.

I understand that not every kid with access to an education voucher is going to end up at Harvard. But that is not the goal of school choice. The goal is to create a market for primary and secondary education that will force schools to compete for students by innovating, specializing, and most of all, becoming excellent schools. Students and parents with a choice will be able to choose the school that best suits the child, as my parents did for me. It is hard to see how a child with a choice is worse off than a child with no choice. And it is easy to see that a better educated workforce will strengthen our economy.

Education has often been thought of as a social issue, but the country's economic future is inextricably tied to the quality of our education system. After all, intellectual capital is at least as important as any other form of capital. A well-educated workforce was less important when the economy was dominated by low-skilled, manual labor. Long ago, a high school diploma was optional; a college degree a rare luxury. But today, our economy is driven by knowledge and applying abstract ideas to concrete problems. From telecommunications to financial services; software development to operating sophisticated manufacturing equipment, today's workers need knowledge that can only come from a quality education. A failure to keep up with the changing times means that our workers and businesses will be stuck on the sidelines while other countries pass us by. In a globalized economy, our education system must be, at least, among the best in the world if we want to remain competitive and grow our economy and standard of living.

Our public education system was founded on the Jeffersonian principle—"a system of general education, which shall reach every description of our citizens from the richest to the poorest." Jefferson believed that an educated citizenry would be a prosperous and free citizenry. He was right. Our society has an interest in a universally educated citizenry, so it makes sense to use government as the conduit through which taxpayers ensure that all children have access to a quality education.

But the picture Jefferson envisioned is quite different from the public education model we have today. The current concept of public education is more about protecting the institutions and employees of public education than actually educating the public. Of course, it does not have to be that way. Government can be the conduit of educational resources without actually delivering the educational product. We have many instances of government paying for a service without actually providing the service. Government provides health care through Medicaid for the poor without owning the hospitals, and government provides food for low-income families in the form of vouchers—that is, food stamps—without owning and running grocery stores. We could use these models to deliver educational services, too, and, in the process, approach the Jeffersonian ideal of a well educated citizenry.

The Problem: Monopoly Breeds Mediocrity

For decades, the public education establishment and many politicians have told us that the education system is not broken; it is just underfunded. On the 2008 presidential campaign trail, Barack Obama made this argument and, predictably, promised more spending.

But the problem with America's public education system is not a lack of funds. The problem lies in the fundamental design of the system. It is a virtual monopoly. Like all monopolies, it serves the monopolists—the public school establishment of school boards, administrators, and teachers—more than the consumers—children and parents. While we have many excellent public schools and public school teachers, our public education system is badly broken. Fixing it will require breaking the monopoly.

Why Can't Johnny Learn?

If you ask a random college-age student to locate New York State on a map, there is a 50 percent chance he will look at you blankly. This is not a joke. According to a 2006 report, only half of college-age students can find the Empire State, and fewer can locate Iraq on a world map.[1] When asked a series of basic

American history questions—on topics from the Electoral College to the Declaration of Independence—college freshmen across the country earned an average grade of F.[2]

Over the past twenty-five years, public school test scores have been disappointing. The definitive study by the National Center for Education Statistics shows reading scores declining or remaining stagnant from 1980 to 2004 for all ages.[3] Math scores have seen some improvement,[4] but this increase narrows dramatically as students age. By the time public school students reached seventeen years of age, the improvement on their math scores since 1978 was a negligible 4 points.[5]

Graduation rates for public school students are no better. In the 1969–1970 school year, the average freshman graduation rate was 78.7 percent. This number hit a nadir of 71 percent in the 1990s, rising slightly in 2007–2008 to 74.4 percent, but still below its number thirty years ago.[6] Test scores and graduation rates for low-income and inner-city public schools are considerably worse than the national average. Even the biggest education union in the country admits that our public schools are not performing as they should: "General achievement [on the National Assessment of Educational Progress (NAEP)] has increased little over the past three decades, particularly in the upper grades," the National Education Association declared.[7]

Perhaps these numbers explain why public school teachers in urban areas are more likely to enroll their children in private schools than urban families or families in general. In urban areas, 21.5 percent of public school teachers enroll their children in private schools, compared with 17.5 percent of all urban families and 12.2 percent of all families.[8] What does it tell us when the people most familiar with the quality of public schools choose to send their own children to private schools in greater numbers than the general public?

America's education system also looks grim when compared to those of other developed countries. In 2008, the Thomas B. Fordham Institute published an "Education

Olympics," an analysis of American student performance based on a number of international studies. The results were unambiguous: "The United States trails many of its economic peers on international measures that assess students' reading, mathematics, and science performance." The institute used these studies to develop 58 medal events, awarding gold, silver, and bronze medals to the top three countries in each event. Out of 190 possible medals, the United States won just one. These meager results landed America in 20th place, behind Cyprus, Poland, and Greece.[9]

Are our children simply dumber than those in the rest of the world? Have they become dumber in recent generations than they were in the past? I am quite sure the answer to both questions is "no." And it certainly cannot be said that we have not been spending enough money.

Education Spending Explodes

Over the years, we have heard a variety of promises. If only we would increase teachers' salaries, test scores would increase. If only we offered smaller classes, graduation rates would improve. But we have done these things and then some without proportional results. Over the past five decades, spending on education has exploded. By every plausible measure—per-pupil spending, teacher salaries, administration spending, government expenditure—we have dedicated more and more resources to our public education system.

Between 1960 and 2005, per pupil spending on public primary and secondary schools has nearly quadrupled in real terms—from $2,606 in 1960 to $9,910 in 2005 (in constant 2006–2007 dollars).[10] Over the past five decades, the average salary for public elementary and secondary teachers nationwide has increased over 45 percent in real terms (constant 2006 dollars)—from $34,703 in 1960 to $50,379 in 2006.[11] Administrative spending in public elementary and secondary schools increased from $26.3 billion in 1989–90 to $34.8 billion in 2004–2005 (in constant 2006–2007 dollars).[12] At the same time, the pupil/teacher ratio has decreased from 26.9 in 1955 to 15.4 in 2007.[13]

As total spending on public primary and secondary education rose, the federal government has had an increasing role. From 1920 to 2005, the federal government's share of education spending increased by a whopping 3,000 percent, from 0.3 percent to 9.2 percent of the total.[14] Federal spending on education is not only growing dramatically, it is growing at a generally accelerating pace. After adjusting for inflation, federal funding for elementary and secondary education increased by 12 percent from 1985 to 1990, by 32 percent from 1990 to 1995, by 19 percent from 1995 to 2000, and by a whopping 38 percent from 2000 to 2005. Federal spending on education increased from $12.2 billion in 1965 to $72.5 billion in 2006 (in constant 2007 dollars).[15] And since the 2008 elections gave the Democrats control of the entire elected government in Washington, this acceleration will probably continue.

America's poor academic achievement compared to that of other countries is all the more stark when you consider that the United States ranked fourth out of 30 OECD countries in highest per-pupil expenditures for both primary and secondary schools in 2004.[16] Countries like Finland and Japan saw much higher scores on international standardized tests, but had much lower per-pupil expenditures.[17] In 2004, the average per-pupil expenditure in American elementary and secondary schools was $9,368, well above the OECD average of $6,608.[18] The United States also spends more on teacher salaries[19] and more net hours teaching than the OECD average.[20]

But these massive spending increases haven't come close to achieving the promised results. In 1983, the Department of Education published a chilling report on the poor state of America's education system, entitled "A Nation at Risk." "If an unfriendly foreign power had attempted to impose on America the mediocre education performance that exists today, we might well have viewed it as an act of war," the report warned. "As it stands, we have allowed this to happen to ourselves.... We have, in effect, been committing an act of unthinking, unilateral education disarmament."[21] Today, the results are not much better.

When it comes to education, the colloquial saying that you get what you pay for isn't true at all. In 1983, President Reagan told the annual meeting of the National Congress of Parents and Teachers: "We don't have an education problem because we're not spending enough. We have an education problem because we're not getting our money's worth for what we spend."[22]

This was not an epiphany even back in 1983. The great economist Milton Friedman had lamented America's education monopoly since the 1950s. In 1973, he wrote a brilliant article for the *New York Times Magazine,* in which he used a simple fable to underscore the absurdity of our education monopoly. "Selling Schooling like Groceries" was published 35 years ago, but Friedman's analogy remains just as relevant today as it did in 1973. Friedman demonstrated how a monopolistic system would make even a simple task like buying groceries a nightmare. (See excerpt on page 155.)

I am pretty confident that Americans would never tolerate such a government-run monopoly of the grocery business, or for that matter, the restaurant, home builder, automobile, movie, or just about any other industry. We insist on having our choices and the competition necessary to keep quality high and prices affordable. Yet, we tolerate this kind of government-operated monopoly every day when we send our children to school.

In the case of education, parents and children are the consumers; teachers, administrators, and union officials are the producers. The biggest problem with the public school system is that many consumers are not free to choose their product;

Milton Friedman: "Selling Schooling like Groceries"

Suppose that, 50 or 75 years ago the United States had adopted the same institutional arrangements for the distribution of food as it did adopt for elementary and secondary schools. Suppose, that is, that the retail provision of groceries had been nationalized, that food was paid for by taxes and distributed by government-run stores. Each family would be assigned to a store, as it is now assigned to a school, on the basis of its location. It would be entitled to receive, without direct payment, a collection of foods, as its children are entitled to receive a collection of classes. It would be able to choose among foods, as its children choose among subjects. Presumably, this would be done by giving each family some number of ration points and assigning point prices to various foods. Private grocery stores would be permitted (just as private schools are), but persons shopping in them would be taxed for the support of the public stores just the same.

Can there be any doubt what retail food distribution would be like today if this system had been in effect? Would there be supermarkets and chain stores? Would the shelves be loaded with new and improved convenience products? Would stores be using every device of human ingenuity to attract and retain customers?

Suppose that under such a system you were unhappy with your local grocery. You could not simply go to a different store unless you were able and willing to pay twice for your groceries, once in taxes and again in cash. No, you would have to work through political channels to change the elected or appointed Grocery Board, or the mayor, or the governor, or the president. Obviously this would be a cumbrous, inefficient process. And suppose you had different ideas from your neighbors about the kind of service you wanted? What then? You would have to find a neighborhood of likeminded people to which you could move.

Of course the well-to-do would escape all this by patronizing the few luxury establishments that would arise to cater to them. They would willingly pay twice for their food, just as they now pay twice for the schooling of their children. (I do not blame them. It is right and proper that parents should deny themselves in order to purchase the best products they can for their children's bodies or minds. I blame only those well-meaning persons who, while sending their own children to private schools, self-righteously lecture the "lower classes" about their responsibility to put up with government-supplied pabulum in the "public interest").

Consider the producer rather than the consumer. The supermarket is a modern invention that has contributed enormously to the well-being of the masses. What would the inventor have done—if he had existed at all—in the hypothetical world of government grocery stores? In the actual world, all he had to do to try out his idea was to use his own capital, or persuade a few people to venture some capital, and set up shop. In the hypothetical world, he would have to launch a successful political campaign to persuade a local grocery board, an entrenched civil service and harried legislators that his idea was worth trying. Obviously, innovations would come primarily from the few private stores serving the well-to-do.

SOURCE: Milton Friedman, "Selling Schooling Like Groceries: The Voucher Idea," *New York Times Magazine*, September 23, 1975; www.friedmanfoundation.org/friedmans/writings/1975.jsp.

therefore the producers have no economic incentive to improve the quality of their product. Of course, some consumers have a choice, either because they can afford private school or because they can afford to move to suburban school districts where the public schools tend to be better performing. But these choices are expensive and cumbersome, and most importantly, they leave children of low-income families trapped without any choices.

The Solution: A Competitive Education Market

When it comes to picking the best model for delivering goods and services, we have a virtually unlimited pool of examples. All we have to do is apply them to education. We know that market-based, private-sector competition is the best mechanism for delivering quality and quantity of products and services. Competition breeds lower prices, better quality, and a wider range of choices. This is evident in every aspect of our daily lives, from grocery stores, to computer makers, to barber shops. Primary and secondary education is no exception.

In a free and open marketplace, there is a carrot and a stick. The carrot is the reward, usually financial, that results from offering a valued product. The stick is the likelihood of going out of business from failing to do so. But in the closed universe of public education, there are few rewards for excellence, few consequences for failure. As with any monopoly, there is no real accountability. Quality suffers and prices rise as a result.

Milton Friedman went beyond identifying the problem with public education. Decades ago, he proposed a solution. This solution developed into the voucher program, which Friedman described simply in a 1968 letter to *Newsweek*:

> A far better alternative to political control is to introduce competition in schooling, to give parents a real choice. Why not say to every parent, "The community is committed to spending X dollars a year on schooling your child. If you do not send your child to our public school, you relieve us of this cost. In return, the community will give you a voucher for X dollars a year per child. You can use this voucher to purchase schooling at any other approved school, public or private, but for no other purpose." This would enable parents to exert economic pressure individually on the school, as on the department store, without having to go through a cumbrous political mechanism. It would establish a large market that does not now exist for medium-priced private schools. Supply would rapidly develop to meet the demand. If public schools met the new competition by improving their quality, they would keep their customers; if not, they would decline.[23]

A voucher program would simply give the consumers of education services—parents—the same kind of choices consumers of virtually all other goods and services take for granted. This is not an entirely foreign concept for American students. Despite the controversy surrounding school choice programs in the United States, the country benefits from such an education model at the tertiary level. Millions of college students receive loans and grants from the government to be used at the university of their choice. They are not forced to use those funds at specific schools in specific districts.

This model could work just as well at the primary and secondary level of education wherever there is a sufficient population to support multiple schools. The ideal school choice program would make choice available to all children, provide them with vouchers worth the full cost of public education, and enable children to use those vouchers at a wide range of schools—public and private; religious and non-religious; for-profit and not-for-profit. Unfortunately, there are no school choice programs in America today that reach this ideal but there are many programs moving in this direction.

Different Kinds of School Choice

Charter Schools

Charter schools have recently emerged as an alternative to the standard government monopoly schools. They offer a limited choice to some parents, and serve as a modest but important first step toward a truly competitive education system.

Like ordinary public schools, charter schools are government-funded institutions, but they are freed from many of the rules and regulations that restrict standard public schools. Charter schools have differentiated themselves from ordinary public schools through specialized curricula, a focus on the arts, and innovative teaching techniques—just to name a few ways. By 2007, over 1.4 million children attended nearly 4,600 charter schools across 40 states and the District of Columbia.[24] Their popularity is proof of widespread demand for alternatives to the one-size-fits-all government monopoly schools. But if this limited choice is good, greater choice would be better. Why limit kids to the specialization, focus, and innovation of government-owned charter schools when the private sector is capable of so much more specialization, focus, and innovation?

As parents have increasingly asked these kinds of questions, legislators have begun to answer. Today, many states have adopted some form of private school choice, from Rhode Island to Florida to Arizona to Pennsylvania. These programs fall into one of three categories: vouchers, tax-credit scholarship programs, and personal tax credits.

Vouchers

Just as Milton Friedman conceived them decades ago, vouchers allow parents to take a portion of the money that would be spent on their child in public school and dedicate it to the child's tuition at the private school of their choice. Public and private schools are forced to compete for students, or consumers. Both have an incentive to hire the best teachers, create the best curriculum, and distinguish themselves from their competition.

At the same time, parents can choose the school that best fits their individual child's needs. No school is perfect for every child. Children have different learning abilities and styles, and different social needs. The choices made possible by vouchers enhance parents' opportunities to accommodate these differences regardless of their incomes. This choice is so appealing that voucher programs now exist across the country, including in Milwaukee, Cleveland, Florida, Maine, and Washington, D.C.

Voucher programs can be limited in three ways: eligibility to receive the voucher; the amount of the voucher; and where the voucher can be used. Sadly, there are no universal voucher programs—available to all students—in American primary or secondary education today. Most programs limit eligibility to low-income families, children with special needs, or those enrolled in failing public schools. The more restrictions on a voucher program, the less choice available to parents and students and the less competition. To maximize choice and competition, voucher programs should be universally available.

Most voucher programs offer vouchers worth far less than the average per-pupil expenditure in their respective school districts. Even one of the highest dollar voucher programs in the country—up to $7,500 per student in Washington, D.C.—falls below the average per-pupil expenditure in the District.[25] These vouchers are nevertheless very valuable to the students who receive them because the cost of many private schools—especially the most common, Catholic parish schools—is far less than the cost of the public schools. These vouchers are often sufficient to cover the full tuition at an alternative private school.

Finally, most voucher programs limit which schools can participate in one form or another. Sometimes these limitations are geographic ones. Since there are practical limits to the distance parents are willing to send their children to school, geographical restrictions may or may not be problematic. Often, however, the restriction is targeted at the most controversial element of school choice programs: private religious schools. Programs that exclude religious schools from taking vouchers usually impose a severe restriction on students and families for the simple reason that the most common private primary and secondary schools in America, by far, are Catholic schools. Most Catholic schools admit non-Catholic children. Why shouldn't parents be free to decide whether a Catholic school is right for their children?

Tax Credit Scholarship Programs

Tax-credit scholarship programs allow individuals and/or corporations to take a tax credit for donating money to a school choice scholarship fund. The credit may or may not be for the full amount of the funds donated. In Pennsylvania, for instance, companies can get up to a 90 percent tax credit, up to $300,000 per year, for contributions to school choice programs. These monies are dedicated towards vouchers to cover the cost of private school tuition for eligible students.[26] These programs differ little from the voucher program, except in their financing. They tend to be less controversial since the scholarship money is not drawn from existing public education funds. As children leave the public schools for private schools, the funds available per remaining public-school pupil increases since public school funding does not leave with them. For the same reason, Tax Credit Scholarship Programs do not impose the same pressure on public schools to improve as pure voucher programs would, but they can offer real choices to parents. In addition to Pennsylvania, tax credit scholarship programs can be found in Florida, Arizona, Iowa, and Rhode Island.

Personal Tax Credits and Deductions

Minnesota, Iowa, and Illinois have adopted this model, in which parents are given a tax credit or deduction from state income taxes for education expenses. These approved expenses usually include private school tuition, in addition to books and supplies. Although Minnesota offers a substantial credit to parents, unfortunately, the other states have adopted severely limited versions of this program, giving parents at most a $250 or $500 credit—not enough to make a dent in private school tuition.[27] Ideally, a state would allow parents a 100 percent credit for private school tuition without a dollar cap. Then this mechanism would be as cost effective for parents as a full-tuition voucher provided their tax liability were at least equal to the tuition cost. That said, very few low or moderate-income families have state income tax liabilities large enough to take advantage of a 100 percent tuition tax credit. This is an intrinsic practical limit to the effectiveness of this approach to school choice.

Milwaukee Example—Design and Success

The nation's first successful school choice voucher program was sponsored by a liberal Democrat. Milwaukee State Rep. Polly Williams was the Wisconsin chair of Jesse Jackson's presidential campaign—twice.[28] That hardly makes her a conservative firebrand. But she also represented the 10th District in Wisconsin's State Assembly, an inner-city district, populated by low-income families and long plagued by poor schools.

In 1990, Representative Williams's Milwaukee Parental Choice Program (MPCP) was passed by the State Legislature despite the aggressive opposition of the public education establishment—most Democratic legislators, school board officials, the unions, and so on.[29] Defending the new program, Representative Williams said: "The Milwaukee schools constantly ask for more money each year, blame the students and say they can't learn. But the problem is the schools can't teach. These schools have to change."[30] Milton Friedman could not have said it better.

The program started out small and limited in scope. In its first year, there were 337 students at seven private schools.[31] The assistant state superintendent of public instruction, an opponent of the program, dismissed it, saying: "The whole thing hasn't amounted to a good-sized flea on the tail of a dog."[32]

But over the eighteen years since MPCP has been in effect, the assistant superintendent has been forced to eat his words. The scope of the program changed in several major ways in 1995. Then-governor Tommy Thompson, a Republican, proposed expanding the program dramatically. He proposed lifting the 1,500 students-per-year cap to 7,000 in 1995–1996 and 15,000 in 1996–1997; increasing the value of the vouchers to $3,200; and including religious schools for the first time.[33] His proposals passed into law and survived a state supreme court challenge. School choice was going strong in Milwaukee.

In 2003 and 2005, Democratic governor Jim Doyle vetoed expansion measures, implicitly threatening the entire school choice program.[34] Several local groups, including the Lynde and Harry Bradley Foundation, School Choice Wisconsin, The Alliance for Choices in Education, and the Milwaukee Metropolitan Association of Commerce, launched a massive public education effort throughout Milwaukee, and parents clamored to keep the program alive. The governor and legislature had no choice but to listen. Governor Doyle and the Republicans in the State Legislature agreed to increase the number of students in the program from 15,000 to 22,500. The compromise legislation required participating private schools to administer nationally normed standardized tests and submit the results for academic evaluation. It also increased funding for public schools.[35]

In 2008–2009, the program offered low and moderate-income families vouchers of up to $6,607 to enroll their children in non-religious and religious private schools. Today, the Milwaukee Parental Choice Program is one of the largest and most comprehensive in the nation.[36]

School Choice Works in Milwaukee

Even as new school choice programs are popping up across the U.S., opponents of these programs continue to argue that they don't work. "Vouchers are unproven," Senator Ted Kennedy declared.[37]

But the Milwaukee program has been around for 18 years now. And there is proof that the opposite is true—school choice works, and that's why more and more states are implementing their own programs.

Since 1990–1991, the Milwaukee program has grown from 337 students at seven private schools to 19,538 students at 127 schools in 2008–2009.[38] Absent school choice, 90 percent of these students would have ended up back in Milwaukee's public schools.[39] If the program is unproven, if it does not work, then why do so many parents choose to participate in it? Clearly, they believe the choices the program offers are helping their children. Not surprisingly, the data shows these parents have a much better grasp of the beneficial effects of school choice than Ted Kennedy does.

One reason so many parents opt to pull their children out of Milwaukee's public schools is to improve their chances of graduating. The Milwaukee public school (MPS) district has one of the lowest graduation rates in the country, rivaling Detroit and New York City.[40] But according to a number of studies, voucher students graduate at a much higher rate. According to a recent University of Minnesota study, MPS students had a graduation rate of 49 percent in 2003; their MPCP counterparts had a graduation rate of 62 percent. By 2007, the difference was even higher: 58 versus 85 percent.[41] Not only are these school choice students graduating at a higher rate than their counterparts in Milwaukee's public schools, they have dramatically outstripped the national public school average of 74.4 percent.[42]

Another reason is that private schools in MPCP are safer than Milwaukee public schools. A 2008 report demonstrated that MPCP schools are less likely to generate police calls than their public counterparts. This difference was most marked at the high school level, where the public schools were three times as likely to generate police calls.[43] MPCP schools are also proven to be less segregated, findings that have been replicated in other voucher programs in Cleveland and Washington, D.C.[44]

Test scores for voucher students have risen too. A 1998 study by Cecilia Rouse at Princeton showed voucher students had faster math score gains than their counterparts in the Milwaukee public schools.[45] A 1999 study by Jay Greene shows substantial gains in math and reading scores on the Iowa Test of Basic Skills among school choice students. These gains were most impressive for students with the most exposure to the choice program. For the first three years students were in the program, they scored 5 percentile points higher on math tests, but after four years in the program, they scored 10.7 points higher than the control group. The reading gains were as high as 5.8 percentile points in the fourth year.[46]

Just as Milton Friedman predicted, Milwaukee public schools, too, have benefitted from school choice, making specific improvements in response to the new competition. These have included offering parents more choices, demanding more accountability from public schools, and forging a new agreement with the teachers union. Board member Bruce Thompson admitted as much in a striking statement: "Without the competitive pressure from choice, [the new technical high school] never would have gone through. School choice helps step up the pressure and to give more clout to the person who says, 'We have to do it right away, because we're going to lose 10,000 students if we don't.'"[47]

As a result, we have begun to see small indications of academic progress in a troubled public school system. The University of Minnesota study shows that voucher students are not the only ones who have seen increased graduation rates. Milwaukee public school students have seen their average graduation rate improve from 49 percent to 58 percent from 2003 to 2007.[48] Another study showed graduation improvements largest among Hispanic and African American children.[49]

The best news is that these improvements are not unique to Milwaukee. Other communities—from Ohio to Maine—have seen academic improvements as a result of their own voucher programs. In Maine, students who live in towns too small to support a local public school are given a voucher to attend another school of their choice, with some towns allowing the voucher to be spent at private schools. A 2002 study demonstrated that public high schools closer to towns participating in the voucher program had better test scores than other public high schools.[50] Another 2002 study showed higher test scores for students using privately funded vouchers in New York City, Washington, D.C., and Dayton, OH than comparable students in public school.[51] More recently, a 2008 Friedman Foundation study showed that Ohio's voucher program has encouraged positive changes in public schools participating in the program.[52] The moral of the story is that choice works.

Arguments Against School Choice Refuted

So what is all the fuss about? Why is the simple idea of giving parents a choice in the education of their children so controversial in a country that takes choice for granted in virtually every other product and service? Every city and state that has undertaken a school choice program has faced a torrent of protests. When Milwaukee created its voucher program, it faced multiple lawsuits, and a suit over Cleveland's school choice program went all the way to the Supreme Court. Why are so many people so determined to keep America's children in failing public schools?

Many of these opponents have personal interests in preserving the status quo. The teachers' unions and public school officials stand to lose their jobs and their political power if they cannot keep up with private school competition. But these special interest groups seldom admit to pursuing their own financial interest. Instead, we hear that school choice drains funds from public schools; that it would harm the children remaining in the public schools; that only the ablest students would be welcome at private schools; that parents do not know enough to effectively evaluate competing schools; and finally, that it violates the Constitution. Let us consider each of these.

School Choice Drains Resources from Public Schools

This is a favorite argument of voucher opponents. On the presidential stump, Barack Obama used it more than once. When asked about school choice by ABC News in June 2008, the presidential candidate never missed a beat: "What you would see is a huge drain of resources out of the public schools."[53] Hillary Clinton made the same argument in her 2000 Senate race: "I do not support vouchers. And the reason I don't is because I don't think we can afford to siphon dollars away from our underfunded public schools."[54]

This argument is specious. Of course, school voucher programs *could* result in less money for public schools but only if parents were withdrawing their children from the public schools. Obviously, with fewer students, the public schools would need less money. If public education money were used to fund vouchers valued exactly at the per-pupil costs of the public schools, then the public schools would have no reduction in per-pupil funding. Certainly, this is the most meaningful measure of school funding. No one thinks a school serving 200 students needs as much funding as a school serving 2,000.

But the argument that vouchers drain public school funding is even more disingenuous. The fact is, nearly every voucher program ever initiated in America has created vouchers worth *less than* the per-pupil cost of the public schools. As children leave the public schools, they take with them less than their total share of public school funds, leaving the public school with *higher* per-pupil funding. A 2007 study by the Friedman Foundation shows that "instructional spending per student has consistently gone up in all affected public school districts and states." The reason for this, the study found, is that not all money associated with a student leaves the public school district when the student accepts a voucher. School choice actually has a positive fiscal impact for school districts and state budgets, and some produce real savings for the school district.[55] If school choice opponents were truly concerned about vouchers' impact on public school funding, they would support every voucher program in America.

School Choice Leaves Behind Children of Uninterested Parents

This argument is as common as the first and just as disingenuous. Of course, that did not stop Senator Ted Kennedy from declaring to a roaring crowd of voucher opponents: "Let the record show—private school vouchers leave too many children behind!"[56]

Senator Kennedy was repeating the tired old shibboleth that vouchers should be opposed because many parents are uninterested in, uninformed about, or uncaring for their children. These negligent parents would not avail themselves of the opportunities vouchers offer, putting their children at a disadvantage compared to the children of more responsible parents.

First, it is worth noting that this argument implicitly acknowledges that vouchers do work for the children whose parents use them. Second, it is predicated on an extraordinarily condescending view of parents, the vast majority of whom do care very much about their children's education. Finally, these "left behind" students would be no worse off than they were before school choice took away their neighbor. They would remain in the school they attend now. It is awfully silly to oppose an educational model because it helps some students, but doesn't help all of them.

But the "children left behind" argument is all the more ridiculous since public schools tend to improve when school choice is introduced in their cities and states. Competition is a very powerful motivator. As we have seen, school choice provides an incentive for public schools to improve for fear of losing so many students that they would have to close their doors. In Ohio, Florida, and Milwaukee, public schools have improved in response to the competition they now face. And there is no reason to think that the same fundamental market forces would not apply across the country.

In August 2008, the Freidman Foundation released a study analyzing the effects of school choice on Ohio public schools where students are eligible for vouchers throughout the EdChoice program. EdChoice offers vouchers to students in Ohio's chronically underperforming public schools to attend the private school of their choice. The findings were astonishing. In the 2006–2007 school year, the first year the program was in effect, the study found "substantial academic improvements in Ohio's most stubbornly underperforming public schools," and no negative changes.[57] A similar study in Florida produced similarly encouraging results. In 2002–2003, the first year in which Florida's vouchers were widely available, public schools in districts that offered vouchers outperformed other public schools significantly.[58]

Private Schools Will Only Take Top Students

"Vouchers fail to offer the 'choice' that proponents claim," the Minnesota teachers union writes on its website. "The 'choice' remains with the private schools that will continue to pick and choose the students they wish to accept and reject. Public schools open their doors to all students."[59] Like the second argument, this one implicitly acknowledges that school choice works for those lucky enough to participate. It condemns choice only by presuming it will not be available to all students.

More importantly, this argument has no basis in reality. The most common private schools in America—Catholic schools—typically accept virtually all applicants. And some programs, like Milwaukee, are prohibited from using admission criteria. But even if they did, a full-scale, universal voucher program would lead to schools geared toward meeting whatever need existed. As we discussed earlier, America already has school choice—at the college level—and college students have no trouble finding an array of schools at every level. Our tertiary education system boasts multiple colleges for all levels of student ability—from exclusive liberal arts colleges, to community colleges, to vocational schools. A universal primary and secondary school choice program would enable a similarly diverse market of educational services to emerge. Specialty schools would be launched for students with special talents and for those with special needs. In fact, any group of students being poorly served would create an incentive for educators, innovators, and entrepreneurs to develop a superior service suitable to those children's needs. And unlike today's public schools, the private schools would have to excel, or parents would not send them their children.

School Choice Violates the Constitution

Though the Supreme Court settled this issue in 2002, the church-state argument continues to surface. In 2003, then-Republican Senator Arlen Specter, a reliable handmaiden for organized labor, opposed the D.C., voucher program based on his dubious constitutional concerns.[60] Similarly, the largest teacher union in the country, the National Education Association, argues that "Vouchers tend to be a means of circumventing the Constitutional prohibitions against subsidizing religious practice and instruction."[61]

The best way to address this argument is to take a look at the Constitution itself. The relevant portion of the First Amendment reads: "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof." The text of the Constitution is pretty clear about what is prohibited—an establishment of religion. Constitutional scholars have argued for years over the subtleties of the Establishment Clause, as it is known, but how exactly does giving money to parents to choose their children's schools constitute "an establishment of religion?"

Proponents of the constitutional argument often refer to Jefferson's famous line regarding a "wall of separation between church and state." They neglect to mention that this metaphorical line was written in an 1802 letter and doesn't appear in the Constitution at all. These same proponents argue that most vouchers will be used at religious schools since most private schools are religious in nature. Therefore, vouchers are tantamount to the government's endorsement of religion. But even if you accept this creative interpretation of the Establishment Clause, the government is doing no such thing. The vouchers are given to parents to be spent at the school of their choice. The government shows no preference for parochial schools over nonsectarian schools—that decision is left up to parents to make. This is the conclusion a majority of justices arrived at in *Zelman* v. *Simmons-Harris* in 2002. Writing for the majority, Chief Justice Rehnquist put it well: "Three times we have confronted Establishment Clause challenges to neutral government programs that provide aid directly to a broad class of individuals, who, in turn, direct the aid to religious schools or institutions of their own choosing. Three times we have rejected such challenges."[62]

Change We Can Believe In

Shortly following Barack Obama's sensational victory, he and his wife chose for their children the exclusive, private Sidwell Friends School instead of the public school to which they would otherwise be assigned. Barack Obama is lucky. His wealth gives him the luxury of this choice, and I fully support his right to choose the school that he and his wife believe will best serve their children. But it is appalling that he insists on denying other, less wealthy parents the same choice. Low-income families are forced to settle for a subpar education. They cannot afford even less expensive private schools and often cannot afford to move to the suburbs where the public schools tend to be better performing.

This dichotomy is unacceptable on economic grounds, but it is also unacceptable on moral grounds. Many of the children stuck in failing public schools come from low-income families. In the worst cases, these children live in broken homes and are raised by a parent who has little education herself. These children cannot count on their parents to teach them how to read because, often, their parents can barely read themselves. Their only hope is to attend a quality school where they will be given the tools to succeed when they leave. For them, education is the precondition for climbing out of poverty and into the middle class. An education can give these children the hope and the courage to eschew the culture of crime that often surrounds them. For many of the poorest, most unfortunate children in our society, education is a matter of life or death.

Many politicians talk about school choice as though it were a risky, untested experiment. Instead, they advocate continuing down the old and failed path of dumping more money into the public education system. But school choice has been around since the 1990s and, as Milton Friedman predicted, it works! There is a reason school choice is occurring in cities and states throughout the country. Test scores are rising; more students are graduating; parents are happier; low-income children are finding hope; and even some public schools are improving. The principles behind school choice are economic in nature. But the rallying cry for its implementation is a matter of social justice.

Chapter 8

The Crash of 2008

A Failure of Government

It is never a good idea to have a crisis during an election campaign because in elections, as in wars, truth is usually the first casualty. As the financial institutions and markets careened and crashed through the fall of 2008, we heard causal explanations that ranged from the fanciful to the absurd.

If you listened to Democratic Chairman of the House Financial Services Committee Barney Frank (D-MA), the financial and economic crisis occurred because "the private market screwed itself up."[1] Presidential candidate John McCain found the crisis' root in "a casino on Wall Street of greedy, corrupt excess."[2] And President Obama blamed the Bush tax cuts: "Tax cuts alone can't solve all of our economic problems—especially tax cuts that are targeted to the wealthiest few Americans. We have tried that strategy, time and time again. And it's only helped lead us to the crisis we face right now."[3]

A determined effort has been made to impugn free enterprise and market-based capitalism by those who were never great fans. The truth is very different. The crisis of 2008–2009 was not caused by a failure of capitalism. It was caused by the failures—the repeated and colossal failures—of government. Understanding these failures is the precondition necessary for crafting the right remedies.

As with most financial crises, this one was born of failed monetary policy. The root cause was easy money which invariably leads to misallocations, bubbles, and crashes. Compounding the monetary errors were legislation and regulations that pumped more air into a rapidly inflating housing bubble. Finally, the government's responses to the crisis made a bad situation worse. The inconsistent, seemingly arbitrary handling of failing institutions, the serial bailouts, the counterproductive regulations, and the massive spending have had disastrous unintended consequences and have dramatically undermined people's already diminished confidence in the economy.

Certainly, there were greedy investment bankers, imprudent underwriters, and irresponsible home buyers. Greed, imprudence, and irresponsibility—to varying degrees—are permanent character traits of our species. But we do not have permanent crashes. When governments play their appropriate role—provide protection for property rights, the rule of law, and sound money, and interfere minimally in economic choices—markets tend to punish these vices and reward the virtues of hard work, thrift, and responsibility. When governments fail at these functions, havoc reigns.

Monetary Policy

Easy Money Mania

The largest of several factors which contributed to the crash of 2008–2009 was the earlier decision by the Federal Reserve to keep interest rates too low for too long. In adopting an easy money policy, it failed in its fundamental duty to maintain a sound currency. Artificially low interest rates create bubbles. And bubbles eventually pop.

For three years, from 2002 through 2005, the Fed maintained negative real interest rates,[4] taking the nominal Fed Funds rate to a shockingly low 1 percent in June 2003. Real interest rates are defined as nominal rates minus the inflation rate. When inflation exceeds the nominal rate, real rates go negative. It rarely makes economic sense to have negative real interest rates.

When real interest rates are negative, borrowers literally get paid to borrow. Imagine you could borrow money at a 2 percent annual interest rate while inflation is running at 4 percent. With a 2 percent cost of funds, and virtually any assets you would care to buy appreciating at 4 percent, you are making 2 percent per year profit with someone else's money. Traders and investors call it "positive carry" when an asset yields more than the borrowing cost of funding it. This normally entails any number of risks. But if the Fed sets interest rates below the rate at which the price level in general is rising, there is little risk except a change in Fed policy. The Fed eliminated even that risk by announcing that they would keep rates low "for a considerable period."[5]

Naturally this created a huge incentive for financial institutions to borrow massively and lend to just about anyone for just about anything. The Fed created a huge credit bubble. In 1975, total outstanding US debt, both public and private, was about 160 percent of GDP. By 1997, it had grown to 225 percent of

GDP, and by September 2007, it had reached a staggering 342 percent of GDP.[6] This was a post-war record, and an unsustainable one at that. The credit bubble, in turn, created major distortions as they always do.

One of the major distortions caused by the credit bubble was the collapse of credit spreads. Credit spreads are the premiums over the risk-free interest rate that borrowers have to pay to lenders to compensate the lenders for the risk of default. In general, the higher the perceived risk of default, the more the borrower has to pay to borrow. But when money is nearly free, financial institutions want to borrow so they can lend, lend, and lend some more. The competition to lend drives rates down even for risky borrowers. Spreads narrow to the point that lenders are no longer being adequately compensated for the credit risks they are taking. Loans get made to people and firms that may not be able to repay them. Banks and other financial institutions' balance sheets become the repository of dubious assets.

Perhaps the biggest distortion created by the credit bubble was the residential real estate bubble. With interest rates low and lending standards lax, mortgage lending exploded. By 2003, popular, thirty-year fixed-rate mortgages were less than 6 percent, their lowest cost in 40 years.[7] Ordinary, subprime, fixed-rate, adjustable-rate, normally amortizing, reverse amortizing—the proliferation of all kinds of mortgage products was staggering, as was the total volume of mortgages. Even more problematic were some of the people receiving mortgages. By 2006, lending standards had gotten so lax, in part due to new federal regulations, that 20 percent of all new home mortgages were to subprime borrowers (those with relatively weak credit histories) and another 20 percent were Alt-A loans (those made without the ordinary underwriting standards).[8]

The extraordinary availability of cheap financing drove up the prices of residential real estate virtually everywhere, and a classic bubble formed in many places. Between 2000 and 2002, average existing home prices were rising 7.5 percent annually across the nation,[9] while inflation never exceeded 3.4 percent annually.[10] Meanwhile, some markets were red hot. San Diego and New York saw prices rocket up 22 and 19 percent respectively.[11] Within three years, residential real estate price increases nationally peaked at about 16 percent.[12]

Everyone wanted to get in on the housing bubble, but incomes were not rising at the same pace as home prices. In this environment, many people bought houses they could not afford. Banks and other mortgage lenders were making mortgages to unqualified borrowers. Irresponsibility and avarice certainly contributed to the housing bubble and subsequent crash. But it is important to bear in mind that this never would have happened without the Federal Reserve's artificially low interest rates.

In fact, for all the people who were caught in the end with a house they could not afford and for all the banks caught with mortgages that later failed, there were millions of people and thousands of banks that profited handsomely as the bubble inflated. People learned that it paid to speculate in housing. Historically, single-family homes in America have been owned by their residents with investors seldom accounting for more than 10 percent of housing stock. In 2005, investors bought 28 percent of all houses sold.[13] For years and in many markets, it was a very profitable trade to buy a big house with little money down, hold it for six months or a year, then sell it at a substantial profit.

The Fed created a casino where bets consistently came up aces for home buyers. The more house one bought, the bigger the profit. Uncreditworthy borrowers were of little concern to many banks and mortgage buyers because the underlying collateral—the houses—kept increasing in value. That appreciation meant that the buyer would never default. If he could not afford his mortgage payment, he could sell the house at a profit, pay off the mortgage in full and walk away with a tidy sum to keep. As Nobel Prize–winning economist Gary Backer put it:

"The lending would not have continued unless there was this expectation that prices would continue to rise and therefore one could refinance these assets through the higher prices."[14]

Another reason bankers abandoned their usual caution was their confidence in what Wall Street called the "Greenspan Put." A *put* is an option that permits its holder to sell something at a predetermined price in the future. Puts are often used to hedge the value of some underlying asset against a fall in its price. Alan Greenspan had made it abundantly clear that he would not raise interest rates in order to pop an asset bubble but that if one developed and then popped, he would aggressively lower rates to minimize damage. This contributed to the perception of an asymmetric risk. If prices kept going up, investors of all stripes would profit. If they started to fall, Greenspan would limit the downside. It was a great racket as long as it lasted. But, alas, it was built on the flimsy foundation of unsound monetary policy. It had to collapse eventually and when it did, it fell hard.

Greenspan's Defense

So how did a guy as smart as Alan Greenspan make mistakes so large when he was Chairman of the Federal Reserve Bank? Although he does not acknowledge having erred, he gives us the answer in his memoir, *The Age of Turbulence*:

> At the FOMC meeting in late June [2003], where we voted to reduce interest rates still further, to 1%, deflation was topic A. We agreed on the reduction despite our consensus that the economy probably did not need yet another rate cut. The stock market had finally begun to revive, and our forecasts called for much stronger GDP growth in the year's second half. Yet we went ahead on the basis of a balancing of risk. We wanted to shut down the possibility of corrosive deflation; we were

> willing to chance that by cutting rates we might foster a bubble, an inflationary boom of some sort, which we would subsequently have to address.[15]

Deflation, a decline in the general price level, is a very rare phenomenon but still the great nightmare of central bankers. And it was apparently keeping the members of the Federal Open Market Committee (FOMC) up nights. Deflation is scarier than its opposite, inflation, for two main reasons. First, it can take away the monetary authority's main tool for providing monetary stimulus, namely, lowering real interest rates. Assume that the economy is contracting and deflation is running at 5 percent per year—in other words, prices are falling by 5 percent per year. The Central Bank can lower nominal lending rates to zero percent but real rates are still at 5 percent. And since zero is the lower bound of possible nominal rates, in this scenario, it is difficult for the central bank to reduce real rates.

A second problem with deflation is a declining value of collateral for loans that can jeopardize the health of financial institutions. In a deflationary environment, home prices, for instance, decline while the amount owed on mortgages does not. People in debt over their heads cannot escape by selling their home. And if they default on their mortgage, the bank will take a loss when it sells the property for less than it was worth when the mortgage was made. When the housing bubble burst in 2007, declining home values triggered the financial crisis of 2008–2009. But it is important to note that the housing crash was specific to housing—not a part of a decline in the general price level and not a general deflation.

Alan Greenspan has subsequently argued that Federal Reserve policy could not have caused the housing bubble. He maintains that housing prices were driven higher by declining 30-year, fixed-rate conventional mortgage rates and that, after 2002, those rates were no longer correlated to the short-term Fed Funds rate controlled by the Fed. Instead, Greenspan asserts the 30-year mortgage rates were being driven ever lower by a global savings glut that lowered long-term rates and increased real estate values globally.[16]

Greenspan fails to acknowledge the role the Fed, and other central banks, may have played in creating the global savings glut. In addition, he ignores the role that adjustable rate mortgages played in inflating the real estate bubble. The extraordinarily low interest rates on many kinds of adjustable rate mortgages were made possible by the very low Fed Funds rate. And these adjustable-rate mortgages grew dramatically in volume, from about 10 percent of all mortgages in 2000 to 40 percent by 2004.[17] This huge volume of very-low interest rate mortgages certainly contributed to the upward pressure on residential real estate prices.

At least in hindsight it is clear that Alan Greenspan and his colleagues on the FOMC were overly worried about deflation, and their actions had devastating consequences. They had their reasons. Long-term interest rates had declined dramatically, the inflation rate was relatively low and declining, and the Japanese had recently gone through an exasperating experience of deflation and economic stagnation. But modest deflations driven by technological innovations and productivity gains are not necessarily bad for economic growth. As Marc Sumerlin points out in his essay, "The Quick Death of 'The Great Moderation,'" "If aggregate demand is strong and an economy is experiencing a positive and widespread fall in goods and service prices, monetary policymakers should not fear an overall inflation rate that falls below zero for a time."[18]

Perhaps the fear of deflation is heightened by the employment portion of the mandate given the Fed by Congress. The Fed's obligation "to promote effectively the goals of maximum employment" must, at some level, increase the importance in the minds of Fed officials of preserving their tools for trying to stimulate the economy. Since excessive deflation can take away the ability to lower real interest rates, the Fed seems to be biased, at least slightly, in favor of inflation. As we have seen, that bias led to credit and asset bubbles the inevitable popping of which devastated our economy.

The Legislation and Regulation that Contributed to the Crash

The Fed did not cause the crash and recession of 2008–2009 all by itself. It got plenty of help from Congress and regulators carrying out Congress' bidding. In hindsight, the confluence of policy errors looks so egregious that it seems a disaster was inevitable.

Beginning in the early 1990s, the Federal government stepped up its use of the Community Reinvestment Act (CRA) to pressure private banks to lend to unqualified borrowers. The Government Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, were given actual quotas for loans to low- and middle-income borrowers. Meanwhile, Democratic and Republican administrations were increasingly subsidizing mortgages to people with no savings and dubious ability to make their payments. Finally, at the worst possible time, the fall of 2007, the Federal Accounting Standards Board reinstituted a Depression-era requirement that banks mark certain investment securities to market—with devastating implications for banks' regulatory capital. I will consider these blunders sequentially.

Community Reinvestment Act

From 1977 through 1993, the Community Reinvestment Act was a relatively innocuous law that required bank regulators to determine whether or not banks were providing their services to the "whole" community in which they did business.[19] The legislation was motivated by a concern that banks might discriminate against people on the basis of race or low income.

The legislators responsible for the act were evidently unaware that the profit motive was sufficient to induce banks to provide their services wherever they could do so profitably.

Nevertheless, a 1992 study by the Federal Reserve Bank of Boston found that, "whites seem to enjoy a general presumption of creditworthiness that black and Hispanic applicants do not."[20] Subsequent review discovered numerous and serious flaws in the methodology used and the quality of the data.[21] Despite these doubts, the study's conclusion generated considerable media and political interest. The new Clinton administration set out to toughen CRA and by 1995, the regulators had established specific quantitative standards that banks had to attain. As Peter Wallison put it in his February 2009 article in the *American Spectator*: "For banks, simply proving that they were looking for qualified buyers wasn't enough. Banks now had to show that they had actually made a requisite number of loans to low- and moderate-income (LMI) borrowers."[22]

Presumably banks, seeking to maximize their profits, were already doing all the LMI lending they deemed prudent and profitable. In order to comply with the new regulatory mandate to lend more, banks had no choice but to lower their credit standards. In fact, the regulators required the banks to adopt "innovative or flexible" lending policies in order to increase their LMI lending.[23] What could "innovative or flexible" mean other than to lend to borrowers previously deemed uncreditworthy? The regulators responsible for assuring the safety and soundness of banks were now assuring they would be less safe, less sound. The politicization of mortgage lending prompted the decline in lending standards, first with respect to LMI loans, but soon throughout mortgage lending in general. As Alan Greenspan said in his October 2008 testimony before the House Committee on Oversight and Government Reform: "It's instructive to go back to the early stages of the subprime market, which has essentially emerged out of CRA."[24]

Fannie Mae and Freddie Mac

The most disastrous manifestation of the politicization of the mortgage markets certainly was the explosive growth and subsequent collapse of the giant government-sponsored enterprises, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Chartered by Congress in 1938 and 1970 respectively, Fannie Mae and Freddie Mac were created for the purpose of developing an efficient, affordable mortgage market in the United States. Initially, they bought and held residential mortgages from local banks that originated them. In time, they began to pool and repackage mortgages as well, often selling them off to other investors. Fannie and Freddie were sold to private shareholders in 1968 and 1989 respectively, but even as private companies, these behemoths had the unique privilege of a special relationship with the federal government.[25] Officially, they were fully independent of the government with neither explicit nor implicit taxpayer backing. Investors knew better.

Fannie and Freddie were both exempt from state and local taxes, and, unlike any other financial institutions,[26] they had a small but symbolically important line of credit with the U.S. Treasury.[27] They were the darlings of Congress as we will soon see. Most importantly, they were considered way too big to fail. Their unique status enabled them to fund their operations at interest rates below those of any institution or corporation other than the federal government itself. For many years they were extremely profitable.

The problem with this arrangement was that while the profits went to private shareholders, the enormous risks and eventually the staggering losses they took were borne by taxpayers. And Congress, feeling entitled by virtue of the special relationship, actively encouraged, even forced, these GSEs to take on increasingly dangerous, massive, and imprudent risks.

When Congress passed The Federal Housing Enterprises Financial Safety and Soundness Act of 1992, they added an affordable housing mission to the GSEs charters. By 1997, the GSEs had lowered their underwriting standards in order to demonstrate their success in executing that mission. As Peter Wallison catalogues:

> By 1997, Fannie was offering a 97 percent loan-to-value mortgage. By 2001, it was offering mortgages with no down payment at all. By 2007, Fannie and Freddie were required to show that 55 percent of their mortgage purchases were LMI loans and, within that goal, 38 percent of all purchases were to come from underserved areas (usually inner cities) and 25 percent were to be loans to low-income and very-low-income borrowers.[28]

This dramatic expansion of credit to low and very low-income borrowers was hailed by members of Congress on both sides of the aisle. Representatives Maxine Waters and Barney Frank were some of the GSEs' biggest cheerleaders—so much so that they could not or would not see the impeding catastrophe. "Mr. Chairman," Waters declared at a 2003 hearing of the House Committee on Financial Services. "We do not have a crisis at Freddie Mac, and in particular at Fannie Mae, under the outstanding leadership of Mr. Frank Raines. Everything in the 1992 act worked just fine. In fact, the GSEs have exceeded their housing goals." Representative Frank chimed in, arguing that "Fannie Mae and Freddie Mac do very good work, and they are not endangering the fiscal health of this country."[29]

Fannie and Freddie were, after all, enabling many people to become first-time home buyers. American homeownership rates were rising steadily and everyone was thrilled that ever more Americans were experiencing that iconic part of the American dream. But the loosening of their credit standards that made much of their growth possible portended the disaster that would soon befall both GSEs.

Some foresaw the dangers and urged restraint. Representative Richard Baker (R-LA), a senior member of the House Financial Services Committee repeatedly warned that the GSEs had grown too large, that their risk management tools were inadequate and that they were undercapitalized. After an accounting scandal plagued the housing giants in 2003, President Bush urged Congress to create a new, stronger regulator who would put limits on the size of Fannie and Freddie's portfolios. [30] In 2005, Alan Greenspan warned of the possible systemic risks should either of the mortgage giants get into trouble.[31] By the end of 2007, at a combined $5.2 trillion in debt and guarantees and only $83.2 billion in core capital, Fannie and Freddie were enormous and wildly undercapitalized.[32]

Nevertheless, the GSEs repeatedly and successfully fought off efforts to rein them in. They argued that any limitations on their portfolio size or additional capital requirements would impede their ability to achieve their affordable housing mission. They showered members of Congress with huge campaign contributions, lavish entertainment, and ubiquitous lobbying on a scale seldom seen in Washington. Sen. Chris Dodd received $165,400 in campaign contributions from Fannie and Freddie over 20 years, and President Obama received $126,349 with only 3 years in the U.S. Senate.[33] And it worked.

Congressional leaders either denied there was a problem or worse decided to take their chances with the American economy. In 2003, Barney Frank fought off efforts to impose tougher regulations on the GSEs declaring, "I do not want the same kind of focus on safety and soundness that we have in OCC and OTS. I want to roll the dice a little bit more in this situation toward subsidized housing."[34] On September 7, 2008, the U.S. government nationalized Fannie Mae and Freddie Mac in a historic $200 billion bailout. Barney Frank blamed the financial crisis on private markets.

Mark-to-Market

You know something has gone badly wrong when an accounting convention becomes a household word. Mark-to-market accounting refers to a particular method of assigning a value to an asset on a corporate or financial institution's balance sheet. Essentially, this method values assets at the prices at which they can be sold in the market, hence the name.

This obscure accounting device achieved its current infamy in November 2007, when, after 60 years of dormancy, it was reinstituted by the Financial Accounting Standards Board (FASB) as rule SFAS 157. In one of the great ironies of the 2008–2009 financial crisis, while the U.S. Treasury was pumping hundreds of billions of dollars into banks to shore-up their capital, this new regulation was directly and indirectly destroying billions of dollars of bank capital.

Banks are heavily regulated in many ways including the amount of capital they must retain for any given quantity and combination of assets. In the fall of 2007, SFAS 157 began forcing banks to write down the value of assets to the last traded price of similar assets even if that meant a very low price in a barely existing market. More importantly, the paper losses that resulted flowed through banks' balance sheets severely depleting their regulatory capital. If a bank were already operating near the minimum capital permitted by the regulators, then such a markdown would put the bank out of compliance and leave the bank with only two alternatives to restore the mandated minimum capital-to-asset ratios. It must either raise additional capital or sell off existing assets.

By the fall of 2008, raising capital had become virtually impossible for the vast majority of banks in part because so many banks had serious asset quality problems, in part because the inconsistent, seemingly arbitrary actions by the Fed and Treasury had scared away private investors. Since they could not raise new capital, banks being driven out of compliance

Mark-to-Market's Impact on Regulatory Capital

Let's consider a simplified, hypothetical example. Assume that a regional bank has $5 billion in total assets, $500 million of which is in seasoned mortgage-backed securities, and $550 million in capital, as defined by its regulators (regulatory capital). Let's further assume that the mortgage-backed securities are somewhat distressed with a default rate of 3 percent of the underlying mortgages but otherwise making timely interest and principle payments. Finally, let's assume that based on extensive historical analysis, the bank can very reasonably expect to get back at least 90 percent of its original investment over the life of the mortgage-backed securities, but that the current market price, if they were forced to sell, would be only 65 percent of that investment.

Under current rules, the bank is forced to mark the mortgage-backed securities down to a price of 65 percent of the original investment or $325 million. This results in a loss of $175 million, which immediately reduces the bank's regulatory capital by the same $175 million leaving this bank with only $375 million in regulatory capital. Despite the reduction in total assets to $4.825 billion (since $175 million in assets were written down), this bank is no longer adequately capitalized as $375 million in capital is less than 8 percent of the $4.825 billion asset total. This bank would be forced by its regulator to increase its capital ratio by either raising new capital or reducing its total assets. In an environment in which raising capital is not feasible, selling assets is the only possible route—and that means further downward prices on whatever assets they are forced to sell.

The alternative is for the regulators to use a different valuation method for determining regulatory capital. If, for instance, the regulators used an approach based on the 90 percent expected value of the mortgage-backed securities instead of the 65 percent market price, they would consider those assets worth $450 million dollars and consider the bank to have lost only $50 million in capital. This approach would leave the bank with $500 million in regulatory capital to support a $4.95 billion dollar bank, or just over 10 percent—enough to avoid having to raise new capital or sell off assets.

by mark-to-market regulations were forced to sell assets. These forced sales, often of illiquid assets, naturally drove prices further down, setting off a viscious circle of asset and capital write-downs, followed by forced sales, and which caused more write-downs.

Consider the case of Merrill Lynch. In July 2008, Merrill Lynch sold $31 billion of collateralized mortgage obligations (CMOs) to a private equity firm for about 22 cents on the dollar.[35] This created a new low for these securities and, under SFAS 157, forced many other banks to write down similar assets to a comparable degree. The regulators were exacerbating the very problem they were supposed to be trying to solve.

Forcing banks to write down their capital in response to a drop in the market price of an illiquid but performing asset, especially one the bank is able and willing to hold to maturity, is a mistake that betrays a misunderstanding of the purpose of banks. Banks, by their very nature, are in the business of providing liquidity, or cash in the form of a loan, to a borrower who has illiquid assets he can pledge as collateral. Buildings, factories, manufacturing equipment, and houses all have real value but they are hard to sell. They are illiquid. Owners of these and similar assets often need cash but are unable or do not want to sell these illiquid assets to raise the cash. The business of banking is to provide cash to these asset owners and to take contingent ownership, or collateral as security against the loan. They are seldom required to mark these loans to market. Why do we impose this requirement on illiquid securities?

Trading in the many pools of mortgage-backed securities at the heart of this problem had virtually ceased by mid-2008. With so many banks looking to shrink their balance sheets back into regulatory capital compliance, almost no one wanted to buy another bank's mortgage-backed securities. Doing so would only increase the size of their balance sheets when they were trying to shrink them. Often the only prices available for these mortgage pools would be pennies on the dollar even though many of these mortgage pools were performing quite well. These assets fit the classic banking model of an illiquid form of collateral, that, despite little or no trading volume, nevertheless had real value. Marking these assets to market for the sake of informing bank investors is fine. Marking them to market for the purpose of determining regulatory capital has been disastrous.

Paulson and Bernanke—Contributing to the Crisis They Were Trying to Prevent?

Over a long period of time, the Federal Government has built up an elaborate network of institutions and practices meant to ensure an orderly functioning financial system. The Federal Reserve, through its discount window, is a kind of lender of last resort; the FDIC forces banks to purchase insurance for their deposits; and the various regulators require that financial institutions maintain what is deemed to be adequate capital and prudent business practices. The regulators collectively impose a vast web of regulations on financial services companies in an effort to keep them safe for investors, depositors, and the financial services firms themselves.

The serial government interventions of 2008—the bailouts, forced sales, nationalizations—actually undermined the financial system the regulators are meant to safeguard. Their ad hoc, seemingly arbitrary actions were no doubt motivated by the best of intentions. They nevertheless terrified the markets and contributed to the panic that nearly collapsed the financial system and has plunged our economy into a severe recession.

It all started with Bear Stearns. In March 2008, Bear Stearns was increasingly rumored to be facing serious financial trouble. It had large portfolios of distressed assets and credit lines were being withdrawn. There were doubts that Bear would be able to continue rolling over its short-term debt. But despite all the rumors, on Friday, March 14, 2008, Bear Stearns's share price closed the day at $30—well off its recent high of $92.89 (in February 2008), but still representing $3.5 billion of shareholder wealth.[36] Over the weekend, Treasury Secretary Paulson and Federal Reserve Chairman Bernanke wiped out 93 percent of that value.

Convinced that its failure was imminent and fearing a bankruptcy might drag down other financial institutions, Paulson and Bernanke forced the sale of Bear Stearns to JPMorgan Chase at the shockingly low price of $2 per share. The Fed further sweetened the deal for Morgan by providing substantial financing and agreeing to absorb a large portion of possible future losses on Bear Stearns' mortgage-backed securities.

On Monday morning, Bear Stearns shareholders were livid. The market refused to believe the deal would actually close at such a low price. Bear's stock traded well above $2 per share during the next week, reaching a high of $8.50.[37] Bear Stearns was widely believed to be worth well above $2 per share even in bankruptcy. Facing a revolt and likely litigation, Morgan renegotiated the deal to $10 per share—proving that Paulson and Bernanke had undervalued Bear Stearns by at least 80 percent!

The pair had intended to prevent a series of collapses by throwing Bear Stearns shareholders under the bus in March 2008. But Paulson's and Bernanke's action probably hastened the failure of Lehman Brothers and the extinction of the remaining large investment banks several months later. Donald Luskin, chief investment officer of Trend Macrolytics, LLC, put it well:

> When the Fed sets the precedent that it will, on a weekend when normal market processes aren't available, hand over a troubled bank to a competitor at a price well below its market value—below even its value in bankruptcy—there's no incentive to remain a shareholder at all. Long-term shareholders who ought to be incentivized to stick

> with banks that run into difficulty, instead receive the message that they should flee at the first sign of trouble lest they be wiped out by the "rescue."[38]

Investors became increasingly nervous. With a few exceptions, major financial institutions could not or would not raise the new capital they needed at such low share prices. Speculators had every incentive to short these stocks and spread rumors of their imminent demise, hoping that they would be weakened enough that Paulson and Bernanke would provide another coup de grace.

Next up were Fannie Mae and Freddie Mac. Presumably too big to sell, the two mortgage giants were nationalized over the first weekend of September 2008. "Conservatorship" is what the Treasury called it. Again, as in the case of Bear Stearns, the shareholders were wiped out and bondholders kept safe.

Next weekend was Lehman Brothers' turn. After seeing what had been done to Bear Stearns, as Lehman Brothers started looking increasingly troubled, investors dumped its stock, and lenders, not knowing what the government would do next, pulled their credit lines. Barclay's Bank had been seriously considering making a major investment in or outright acquisition of Lehman Brothers. But they walked away that weekend. At that point, Paulson and Bernanke simply allowed Lehman to fail. The 150-year old company filed for bankruptcy protection on Monday, September 15.

The failure of Lehman Brothers had significant consequences. Many financial institutions held Lehman debt. Unlike Bear Stearns creditors who were rescued by the sale of Bear to JPMorgan Chase, Lehman's creditors would have to await the outcome of bankruptcy proceedings. They took huge loses. The collapse of Lehman Brothers triggered a run on the venerable money market fund, the Reserve Primary Fund. Unable to honor the flood of redemption requests, the Fund was forced into a slow, painful liquidation.

American International Group (AIG) had written a huge volume of credit default swaps—contracts committing AIG to make large payments to various counterparties if certain companies—including Lehman Brothers—defaulted on their debt. Lehman's collapse and the weakness of other firms obligated AIG to post tens of billions of dollars in collateral to honor these commitments. Despite its enormous profitability and diversity, AIG was suddenly in trouble. So Paulson and Bernanke effectively nationalized it.

Meanwhile, seeing the fate of its investment banking brethren, Merrill Lynch sold itself to Bank of America. One week later, Goldman Sachs and Morgan Stanley both decided to seek the refuge of commercial banking licenses. And just like that, in a matter of weeks, America's giant, independent investment banks were gone. A forced sale, a bankruptcy, a voluntary sale under pressure, and two conversions to banks had rendered all the iconic American investment banks extinct.

But September was not over yet. On the weekend of September 27th and 28th, the FDIC forced the sale of Wachovia, then America's fourth largest bank, to Citigroup for $1 per share and huge taxpayer guarantees to Citi for the value of Wachovia's mortgage-backed securities portfolio. But someone at the FDIC must have gotten their math wrong. Within days, Wells Fargo offered to take Wachovia, lock, stock, and barrel for $9 per share—and without any government guarantees. Oops.

All of this turbulence contributed greatly to the stock market's free fall. Between September 2 and October 30, the Dow lost 2,179.99 points, or 19 percent. A panic had begun. Investor confidence had collapsed and consumer confidence was following right behind. The disasters befalling the big financial institutions were frightening lenders generally so credit became scarce. Financial markets were freezing up, credit spreads widened dramatically, and, worst of all, the panic spilled over into the real economy.

Many have attributed much of the debacle described above to the decision by the Treasury and Fed to allow Lehman Brothers to fail. They have argued that Lehman truly was too big to fail and that its bankruptcy set off a series of falling dominoes. There is no question that the fall of Lehman Brothers had large, serious consequences. But I am not convinced that its failure was the primary cause of the subsequent market and economic collapse. A more plausible theory has been offered by Stanford University professor John Taylor.

Taylor argues that it was not the collapse of Lehman Brothers that precipitated the credit freeze and market collapse of September 2008, but rather the market's realization that the federal government had no consistent or comprehensive plan for dealing with the crisis in general.[39] The week of Lehman Brothers' bankruptcy saw relatively stable credit spreads. It was the following week, after Paulson and Bernanke unveiled the Troubled Asset Relief Program (TARP), a $700 billion proposal granting the Treasury enormous latitude but containing few specifics and no oversight, that the market really began to panic. It certainly did not help that Secretary Paulson, and later, President Bush himself, threw gasoline on the fire by insisting that a calamity would result if Congress did not pass their vague rescue plan immediately.

Even worse than the government's ill-defined rescue plan was the massive and unpredictable manner in which it had been intervening. Bear Stearns' shareholders were wiped out despite the market's belief that the company had significant value. But its bondholders were made whole by the forced acquisition. Lehman Brothers was allowed to fail and its bondholders were wiped out, despite the general view that it had a stronger balance sheet than Bear Stearns had. AIG was nationalized and its creditors saved. Wachovia was sold at a below-market price.

The government's activities during the summer and fall of 2008 were characterized by a frightening caprice. There was no rhyme or reason whatsoever. No set of rules that investors and lenders could understand and follow. No reasonable explanation for why government intervened one moment and failed to intervene the next. Just when the markets were trying to deal with the major new risk of the collapsing real estate bubble and seriously troubled banks, the government introduced an additional, perhaps even greater risk—its own inconsistent, seemingly arbitrary, interventions.

Writing History Matters

Much will be written about the causes of this crisis in the years following it, and our understanding of the relative importance of the various contributing factors will evolve. But it is already clear that the crisis was caused largely by the repeated failures of government. Certainly, many mistakes and excesses occurred in the private sector along the way, but government policies directly and indirectly encouraged most of them.

The combination of too-low interest rates; the politicization of the mortgage industry, especially Fannie Mae and Freddie Mac; the reintroduction of mark-to-market accounting for highly illiquid assets and the use of that system to determine regulatory capital; and the utterly unpredictable and inconsistent actions taken by the government were undoubtedly the main culprits in creating and worsening this disaster. John Taylor summed it up right when he wrote: "My research shows that government actions and interventions—not any inherent failure or instability of the private economy—caused, prolonged, and dramatically worsened the crisis."[40] It is all worrisomely reminiscent of the government's role in extending and worsening the Great Depression—and evidence of how difficult it is to learn from our own mistakes.

Chapter 9

The 2009 Lurch Left

Throughout most of our history, Americans understood that our economy had occasional cyclical downturns, from which it would recover on its own, usually quickly. Those days seem to be gone for now. Today, many Americans expect the government to intervene quickly to restore robust economic growth when it lags.

This expectation probably results from a confluence of several factors. One is the dramatic expansion of government in virtually all aspects of our lives and the corresponding dependency on government generally. Another is the recent experience of 25 years of almost uninterrupted economic growth from 1982 through 2007, conditioning people to expect permanent prosperity as the norm. Yet another factor is the constant political promises to do whatever it takes to alleviate any discomfort perceived among the electorate.

The severe economic downturn of 2008–2009, together with the pervasive expectation of governmental salvation, has created a dangerous political dynamic. It has emboldened the

Obama administration and the Democrats who control Congress to attempt a sweeping expansion of the power of government to unprecedented levels of control over our economy and our individual lives. The economic crisis has created an opportunity for them to lurch America to the left, justified by the need to restore economic growth. As President Obama's chief of staff, Rahm Emanuel, said: "Never allow a crisis to go to waste."[1] The administration is clearly following Emanuel's advice. Their goals extend beyond the purely economic. They are intent, it seems, on turning America into a European-style welfare state.

President Obama's friend from their days together in the Senate, Oklahoma Republican Tom Coburn, wrote about the President's ambitions in April 2009:

> I believe President Obama has proposed the most significant shift toward collectivism and away from capitalism in the history of our republic. I believe his budget aspires to not merely promote economic recovery but to lay the groundwork for sweeping expansions of government authority in areas like health care, energy and even daily commerce.[2]

Unfortunately, the history of grand government interventions during economic emergencies suggests these policies will not promote the economic recovery we are being promised. Hoover's taxes and tariffs; Roosevelt's National Recovery Act; Nixon's wage and price controls; and George W. Bush's bailouts—all these policies were sold as ameliorative when they were counterproductive. These measures proved deleterious for one simple reason. In one form or another, all of these measures imposed economic policies by political edict instead of allowing economic activity to be determined by the individual decisions of free men and women interacting voluntarily in the marketplace. This substitution of centralized, politically driven economic controls in place of personal and economic freedom invariably diminishes prosperity.

The failure of economic central planning is an historical fact. It is been amply documented that prosperity and the alleviation of poverty is highly correlated to economic freedom and inversely correlated to governmental economic control. Despite this record, the Obama administration is embarking on an expansion of governmental economic control more sweeping, more expensive, and more intrusive than any other in our history with the possible exception of Roosevelt's first-term initiatives. This audacious agenda may well achieve its goal of turning America into a more collectivist, more government-dependent society, but it surely will not restore economic growth to what it could be.

Let us consider the most worrisome elements of the Obama administration economic plans and alternative policies that would do more to encourage economic growth.

Bailouts, Nationalizations, and Asset Purchases

Initiated by the second Bush administration, the serial bailouts of banks, insurers, finance companies, auto companies, and auto parts makers have continued under the Obama administration with no sign of letting up. As we have seen, the government's arbitrary, unbounded, and highly variable interventions in the financial services industry contributed to panic in the markets and the freezing up of credit, and discouraged private investment when it was needed most. Government bailouts in all of these industries are clearly unfair to taxpayers and competing businesses who do not receive a bailout. But they also impede a general recovery. When resources are pumped into failing business models to keep them alive on life support, those resources are necessarily diverted away from alternative, more productive uses.

This is true both for straightforward bailouts, like the government loans to the car companies in late 2008, and for more complex, indirect bailouts, like the various Treasury-led plans to purchase so-called toxic assets from financial institutions. First, we had the Treasury's $700 billion Troubled Asset Relief Program (TARP) which underwent a metamorphosis within a few weeks from a toxic asset purchase plan to a partially mandatory capital injection plan. Then, months later, it mysteriously returned to a toxic asset purchase plan. Then, we had the perhaps $1 trillion Public-Private Investment Program (P-PIP)—a plan to have private fund managers partner with the Treasury to buy toxic assets with heavily subsidized funding provided through FDIC guarantees. Both of these schemes were meant to relieve financial institutions of distressed assets in the hope that the cleansing would encourage more lending. There are several fundamental flaws with this approach.

First, by the first quarter of 2009, the anemic volume of new lending was driven more by a lack of borrowers' demand than by an unwillingness, or inability, of lenders to lend. During recessions, businesses and consumers have the good sense to be cautious about incurring new debt. Prudent lenders tighten their credit standards since weak borrowers might not make it through the downturn. Thus, government purchases of troubled assets are no guarantee of new lending.

Second, many banks had no need to shed their bad assets. Thousands of regional and community banks held few or no toxic assets. And the many that did were in the process of earning their way out of trouble by the first quarter of 2009. The very low borrowing costs available to banks allowed them to generate strong net interest income earnings. These earnings, together with an easing of the mark-to-market rules (as recommended next) and the inflationary actions of the Fed (which would, over time, raise the prices of banks' collateral) made a government-sponsored asset purchase plan unnecessary for most banks. For insolvent banks, we should use the mechanism that was created specifically for dealing with failing enterprises:

bankruptcy. But let us first consider the reform of the mark-to-market accounting that would relieve the downward spiral of asset prices and bank capitalization.

Mark-to-Market Accounting

Forcing banks to mark illiquid assets to market for the purpose of determining the level of their capital has tended to aggravate their problems. But investors tend to prefer that bank assets get this treatment so that they will know the worst-case value of their investment. The sensible way to provide investors with the information they want and deserve without hurting banks is to require banks to report their assets based on mark-to-market values, as they do now, but for bank regulators to use discretion in applying alternative approaches for the purpose of determining regulatory capital.

On April 2, 2009, the Financial Accounting Standards Board (FASB) announced a relaxation of the mark-to-market rule by voting to allow companies to use "significant judgment" in determining when to apply the mark-to-market methodology for valuing certain illiquid assets, including mortgage-related securities.[3] This is likely to diminish the asset write-downs that have caused so much trouble and it prompted a significant rally that day in bank stocks. But it also raises doubts in the minds of investors about whether banks will use their newfound discretion to overstate the value of troubled assets. That is why the better solution would be to bifurcate this problem into a financial reporting matter and a distinct capital adequacy issue. We should continue using mark-to-market accounting for the former purpose, but regulators should use other, reasonable, well-established, conservative methods for the latter. This would help them avoid aggravating the very problem they are trying to resolve.

The Bankruptcy Alternative to Bailouts

When a firm is no longer able to pay its creditors, the firm may choose to go into bankruptcy or it may be forced into it by its creditors. Either way, this highly-evolved and specialized legal system allows for an orderly process by which creditors attempt to recover as much as they can of what is owed to them. Bankruptcy is not a death sentence. A bankrupt firm may try to renegotiate or restructure its debts, or it may have to liquidate its assets. In any case, the process generally ensures that those assets—be they mortgage-backed securities or auto factories—will be put to their best use. The creditors control the process and they have every incentive to preserve whatever assets have real value so that they can be repaid.

Sometimes that happens when firms emerge from bankruptcy with a more viable capital structure. Other times, the bankrupt business is sold, either in whole or in parts. Either way, taxpayer funds are not involved—except to the minimal extent of covering the court's administrative costs. This is the process that rationalizes the assets of failing enterprises, imposes discipline on operators and creditors, and treats taxpayers fairly instead of forcing them to invest in failing businesses.

If large American banks had gone into bankruptcy instead of being bailed out by taxpayers, several things would have happened. First, stockholders would have been virtually wiped out. This is unfortunate but it is the risk inherent in owning stocks. Taxpayers certainly should not be made to bear the one-way downside of failure. Second, depositors would have been made whole as their deposits have been guaranteed by the government. Finally, debt holders would have taken a loss to the degree that the bank's assets had declined in value. This outcome is entirely appropriate and avoids all the pitfalls of bailouts including moral hazard, political favoritism, and inherent unfairness.

Importantly, bankruptcy also provides certainty to investors who can learn the rules of bankruptcy and thereby understand the risks they take with a given investment. In the alternative, when government entities like the Treasury and the Fed subsidize, capitalize, nationalize, or euthanize failing businesses entirely at their own discretion with no known rules or guidelines defining the process, private capital flees.

Some will argue that bankruptcy is a long, cumbersome, drawn-out process that ties up the bankrupt firm for an indefinite period. Often this is true but not necessarily prohibitive. Companies can continue to operate during bankruptcy—airlines do it all the time! And if the bankruptcy of many large banks proved too cumbersome and disruptive to our economy, we could always consider expediting the bankruptcy process for banks.

University of Chicago Business School Professor Luigi Zingales has proposed an intriguing idea for a new, prepackaged bankruptcy that would allow insolvent banks to restructure their liabilities overnight, according to well-defined, prespecified terms.[4] This plan would require changing existing bankruptcy laws and would need to withstand careful scrutiny of bankruptcy experts, but it would have three significant virtues: speed, simplicity, and free for the American taxpayer.

Whether we develop new proceedings or not, we should end the serial bailouts of 2008–2009 and use bankruptcy as it was intended.

Spending Excesses

Between the $787 billion "stimulus" spending bill of February 2009,[5] the $410 billion omnibus spending bill of March 2009,[6] the $3.6 trillion budget proposed on February 26, 2009,[7] the huge bailouts, and seemingly endless guarantees, the federal government has committed the American taxpayer to literally trillions of dollars in new, actual, and contingent liabilities—in less than six months! The spending is a staggering leap as a share of GDP from a forty-year average of 20.7 percent to over 28 percent—assuming the economy grows. The corresponding

2009 deficit marks a postwar high of 12.9 percent of GDP—more than double the previous postwar high of 6 percent set in 1983.[8] If the Obama budget is adopted, it will result in a tripling of the nation's accumulated debt in just a few years. The guarantees of deposits, Fannie Mae and Freddie Mac securities, hundreds of billions in mortgage-backed securities, even automotive warranties collectively impose the biggest increase in contingent liabilities on the American taxpayer in history.

All of this deficit spending will impose a huge burden on the American people. As Stanford University Professor Michael Boskin pointed out, the Obama administration's spending increases, above and beyond the increases already anticipated under prior law, will add $6.5 trillion to the U.S. debt. If just this incremental burden were to be spread evenly among all income tax-paying families, each would have to pay an additional $163,000 in taxes all at once.[9] If these payments were spread out, the interest costs would add dramatically to that figure. This looming tax bill arises from the explicit obligations of the federal government alone. The dismal financial condition of state governments threatens to compound the problem with large implicit obligations.

After all, most of the fifty states are running structural budget deficits. Their ongoing statutory and discretionary spending commitments are larger than their revenues. Most also have very large underfunded pension and retiree health care obligations. They are generally required to balance their budgets, but in 2008 and 2009, many have resorted to onetime fixes, like raiding rainy-day funds, and, worse, taking federal government bailout money. As Michael Flynn and Adam B. Summers document, the states got themselves into this fix through profligate spending during good times:

> In the five years between 2002 and 2007, combined state general-fund revenue increased twice as fast as the rate of inflation, producing an excess of $600 billion.

> If legislatures had chosen to be responsible, they could have maintained all current state services, increased spending to compensate for inflation and population growth, and still enacted a $500 billion tax cut. Instead, lawmakers spent the windfall.[10]

When the economy weakened in 2008, state revenues began to collapse. Rather than cutting back on the excessive spending that caused their deficits, the states ran to the federal government, hat in hand. The Obama administration was only too happy to bail them out. The February 2009 "stimulus" spending bill contained well over $150 billion for state governments—and with very problematic strings attached.[11]

The worst part of the federal bailout of the states is that, in many cases, it aggravated their structural deficits. Portions of the monies, such as unemployment fund bailouts, even required many states to expand eligibility for unemployment benefits—thus creating larger long-term liabilities—as a condition for getting the funds. In addition to rewarding irresponsibility, bailing out profligate state governments is badly flawed policy in two other ways. First, the federal bailout of the states dramatically reduces political accountability. State legislators and governors can hide their irresponsibility behind federal funds instead of facing the voters for their profligacy. Second, by not forcing the states to confront and correct their fiscal imbalances, the stimulus is only delaying their day of reckoning. When the federal monies run out, the states will be in an even bigger mess and will surely head back to Washington for the next round of bailouts. All of which leads back to the fiscal time bomb the Obama administration has set ticking.

Excessive borrowing during a credit bubble clearly contributed mightily to getting us into the recession of 2008–2009. The Obama administration and a cooperative Congress apparently believe that massive additional borrowing and spending will get us out. They could not be more wrong.

As we have seen, government spending does create economic activity. But since it necessarily diverts money from the private, productive sectors of our economy, it destroys at least as much activity as it creates. Worse, the accumulated debt that funds this spending spree is reaching uncharted territory and threatening serious problems.

Using realistic assumptions about the economy and assuming a low rate of failure on the guaranteed assets, the federal government may have to borrow as much as $7 billion per day for much of 2009 to fund all its commitments. It is not at all clear that so much borrowing will be possible. In March 2009, the British government attempted to issue a large sum of its own government bonds. They experienced a failed auction—one in which there were not enough buyers to absorb all the debt the government wanted to issue. This could happen in the United States, and the consequences would be dreadful.

In addition to forcing interest rates much higher in order to try to lure buyers, a failed Treasury auction would probably result in the Fed buying some portion of newly issued bonds with newly printed dollars. This monetization of our debt would almost certainly cause a rout of the dollar and lead to potentially devastating levels of inflation. Foreign holders of dollar reserves would start to doubt the U.S. dollar as a reliable store of value. If several of them decided that the Euro or the Yen would be a safer investment, the dollar could lose its status as the world's primary reserve currency. The cost to our economy in the form of higher interest rates and less foreign investment would be devastating.

Tighten the Federal Belt Instead

We simply cannot let this happen. Federal spending has to be reined in. Given the large spending increases of the George W. Bush administration and the record spending explosion of the Obama administration, there is no shortage of places to cut.

Obsolete programs, earmarks, subsidies, price supports, and bailouts and handouts to corporations and state and local governments are all excellent candidates for significant reductions and, in many cases, outright eliminations. Much of the February 2009 "stimulus" spending bill funds will not be spent until future years. It is not too late to stop much of that spending.

Across-the-board spending cuts in most parts of government would work nicely too but are very difficult to achieve politically. Voter outrage may change that political dynamic. Grassroots protests began springing up in March of 2009. When TV business news host Rick Santelli spontaneously expressed his outrage on the floor of the Chicago Mercantile Exchange and suggested that Chicagoans have a modern-day tea party to register their objection to all the government spending, he touched a chord with millions of Americans and set off a series of "Tea Party" protests across the nation.

Many Washington-based think tanks and advocacy groups such as The Heritage Foundation, The Cato Institute, Citizens Against Government Waste, and the National Taxpayers Union have long lists of specific spending reduction recommendations. It is time the politicians started following their advice.

Tax Hikes

Higher taxes can only diminish the prospects for an economic recovery. And yet, as the economy suffers its worst recession in twenty five years, that is exactly what President Obama is insisting on. His first budget called for as much as a 13 percent hike in income tax rates on those earning over $250,000; a 33 percent increase in capital gains taxes on those earning over $200,000; and higher taxes in the form of reduced deductions for charitable contributions for those earning over $200,000.[12] And those are just the explicit tax hikes. Implicit in his budget is a massive tax hike on all Americans in the form of a "cap-and-trade" scheme meant to reduce the industrial output of carbon dioxide.

The Obama administration argues that these tax hikes are needed for two reasons: fairness and to reduce the deficits. The former is really just a euphemism for class warfare. As for reducing the deficit, it is abundantly clear that the current deficits are the result of massive new spending increases—not too-low tax rates.

Cut Taxes Instead

Instead of counterproductive tax hikes, the federal government should do the opposite. Congress should rein in the spending described above and lower taxes instead. Consider the stimulus Congress could generate if, instead of a $787 billion (plus tens of billions of dollars in corresponding interest payments) spending bill, it cut taxes by a comparable amount. Total corporate income taxes for all American companies generate something on the order of $300 billion per year[13]—in recent good years. For little more in lost revenue than was spent in that single bill, Congress could have eliminated all corporate income taxes for nearly three full years. America would have become by far the most tax-advantaged country in the world. We would have attracted a flood of new capital investment, new start-up ventures, and expansions of existing businesses.

Alternatively, federal payroll taxes will generate about $891 billion in revenue in fiscal year 2009 and $926 billion in fiscal year 2010.[14] We could have reduced both the employee and the matching employer tax on workers by nearly 50 percent for two years. That would have provided an immediate take-home pay raise for every single worker in America and lower the cost of hiring new workers for every employer. This strikes me as a lot more economically stimulative than building more bridges to nowhere.

If Congress and the President cannot bring themselves to enact the sweeping tax reductions that would surely prompt a surge in economic growth, they should at least take some more modest measures that will help. They should start by making the 2003 income tax cuts permanent for all income brackets, eliminating capital gains taxes entirely, and lowering the top corporate income tax rate to 25 percent. These steps would reduce federal revenue very modestly and briefly, but would encourage a significant upswing in economic activity.

Government-Dictated Industrial Policy Will Fail

The more a country tries to centralize and plan its economy, the more it will fail. History has proven this lesson time and again. The former Soviet Union, Cuba, and North Korea have demonstrated how completely economies fail when they are entirely government-controlled. Most western European countries have proven that significantly centralized economic planning constrains economic growth. And countries from Hong Kong and Singapore to New Zealand and the United States have shown that relatively free, unplanned economies that allow men and women and businesses to allocate their own resources spontaneously as they see fit, invariable outperform the rest. So what has President Obama begun to do in the first days of his administration? A step-up in central planning.

When the Obama administration inherited General Motors as a ward of the state, policymakers had to decide whether they would continue to prop up this crippled giant with taxpayer funds while encouraging the structural changes needed to make it viable, or allow it to go into bankruptcy with the liquidation of the firm as a possible outcome. Their first choice was the former, which was unfortunate enough. Then President Obama decided to moonlight as chairman of GM's board.

On March 29, 2009, shortly after the administration rejected GM's restructuring plan and sent the company back to the drawing board with a new 60-day deadline, President Obama took the extraordinary step of firing GM's Chairman and CEO, Richard Wagoner. The actual dismissal was carried out by Ed Montgomery, the administration's "car czar," but it was widely reported without refutation that the decision came from the White House.[15] The next day, President Obama, commenting on GM, made it clear that the company must fundamentally restructure itself to become financially viable and that restructuring must include a greater emphasis on producing the small, fuel-efficient cars he favors.[16] It evidently escaped the president's notice that those cars are not the ones preferred by the American driving public.

Thus, we have the president of the United States, whose primary professional experience was limited to community organizing and academia, deciding who shall run General Motors and what kind of cars it shall produce. One has to assume that Chrysler will be in for similar instructions. And the central planning is not limited to the car makers.

Following the partial nationalization of several banks, Treasury Secretary Tim Geithner announced that he will fire bank CEOs and board members if and when he deems it necessary.[17] As a result of all this interference, executive compensation and lending practices have become highly politicized. In addition, the government, through the Fed, is setting prices for mortgages and mortgage-backed securities. More broadly, the Obama administration has great plans to increase the government's control of health insurance, energy production, and carbon emissions.

All of these policies will cost our economy dearly. The political administration of American businesses is a recipe for disaster. No president, senator, congressman, bureaucrat, or any combination of the preceding should use their political power to run a business. No one can ever know how to allocate resources for an industry, much less an entire economy. As Fredrik A. von Hayek spent a career teaching, it is not possible for any individual or group of individuals to have or to process the nearly infinite amount of information that affects an economy. Only the unordered, spontaneous activity of people in a market, responding to that great aggregator of all information—the price mechanism—can allocate resources where they are truly needed and valued. The further we go down this road of government control of our economy, the weaker and slower any economic recovery will be.

Denying Workers' Freedom

Organized labor has been in decline in the American private sector for 20 years. In 1983, 16.8 percent of the private-sector workforce was unionized. In 2007, that figure was 7.5 percent.[18] The higher costs—not necessarily in wages but typically in reduced productivity resulting from less flexible work rules—often make unionized companies less competitive than nonunionized firms. Over time, more competitive companies have a better survival rate, hence the decline in union proportions. Labor leaders have been desperate to reverse this decline for years. Since they cannot, or will not, change the fundamental reasons for the decline, they decided to change the rules governing the organizing process. But this requires political allies able and willing to make those changes. Enter the Obama administration, a Democrat-controlled Congress, and the Employee Free Choice Act (EFCA).

George Orwell himself could not have come up with a better name for this bill. EFCA would allow unions to circumvent secret ballot elections when trying to organize a given workplace. Instead, as soon as a union obtains public signatures from 50 percent of a company's workforce, that union is installed. The process is known as "card check." Far from giving workers a "free choice," card check would leave workers vulnerable to browbeating, intimidation, and retaliation if they choose not to sign. This is exactly why the labor bosses want this law, and rank-and-file workers do not.

In addition to this offensive infringement on workers' right to a secret ballot, the bill would impose binding arbitration to resolve contract disputes. This is another big sop to Big Labor, creating an incentive for union officials to make unreasonable demands. Knowing a pro-union arbitrator would likely rule in the union's favor, the demands could be met or approximated without the unions having to risk a strike or lockout.

EFCA was organized labor's number one priority for the first Obama administration and President Obama promised them he would deliver. Doing so could only drag down the economy further. The innovations and productivity improvements that generate growth and are the only sustainable source of higher wages require flexible and competitive workforces. Unions generally reduce flexibility and try to prevent competition. Having seen the results unions got for their members in the American steel, automobile, and other industries, workers are understandably cautious about joining unions.

Workers who are respected as valuable assets to a business generally prefer not to form unions. Those who are not treated well will join unions either through card check or a secret ballot. The last thing American workers and the American economy need in 2009 is unionization by intimidation.

Slouching Toward Protectionism

Periods of economic stress invariably generate protectionist sentiments, and the recession of 2008–2009 is no exception. During the American presidential campaign, both Senators Hillary Clinton and Barack Obama adopted populist, anti-trade rhetoric. When Congress passed President Obama's stimulus spending bill, protectionist "buy-American" language was included. This unfortunate tendency is not limited to the United States. By March 2009, seventeen of the G-20 countries had adopted 47 different restrictions on trade, according to the World Bank. In Russia, tariffs were increased on used cars. In China, tougher standards were imposed on food imports. India banned Chinese toys. Argentina imposed harsher licensing requirements on auto parts, textiles, and leather goods.[19]

A global trade war could have devastating effects on an already weakened global economy—not to mention raise prices for American consumers just when their budgets are being squeezed by a recession. This is not the time for saber rattling and protectionism. This is the time for the United States to play a leadership role in demonstrating its commitment to free international trade.

American Leadership for Free Trade

Free trade agreements have been negotiated with South Korea and Colombia. But Congress, happy to acquiesce to the demands of organized labor, has refused to approve them.

The direct economic benefits, mostly in the form of greater sales of American goods into Colombia, and both greater sales to and lower-priced goods from South Korea, would be modest but significant. More importantly, by approving these agreements, Congress would go a long way toward stopping the slide to global protectionism that, if unchecked, can only prolong and worsen the recession underway.

Cap and Trade (or Cap and Tax)

One of the most ominous parts of President Obama's 2010 budget proposal is the $629 billion placeholder he has for the cap-and-trade tax revenues from 2012–2019.[20] The specifics have yet to be worked out but the general idea is well-known. If it is implemented, it will impose devastating costs and significantly retard economic growth.

In an effort to reduce total CO_2 emissions, cap and trade would establish quotas for permissible CO_2 output for every industrial companies in America. The quotas would be set at some level, likely below the current output, and tradable permits would have to be purchased from the government, by the emitting businesses. As natural business growth would necessitate increasing CO_2 emissions, businesses would have to purchase ever more permits to legally enable that growth.

This would be a huge, new, deadweight cost to our economy. The businesses get nothing of real economic value for the high price they would have to pay for the CO_2 permits. Utilities, manufacturers, shipping companies, and anyone who makes or moves just about anything would be forced to incur a new, expensive, and probably unpredictable cost. They would have no choice but to pass the costs on to their customers in what would amount to a giant, indirect tax on consumers. This hidden tax would raise the price of virtually all goods and many services, thus reducing demand and diminishing economic growth. And those are just the direct consequences of a cap-and-trade scheme.

Since European companies can largely evade their cap-and-trade regimes, and developing countries like China and India are unlikely to inflict such a burden on their own economies, an American cap-and-trade program will put American companies and workers at a competitive disadvantage with much of the rest of the world. Obama's energy secretary Steven Chu admitted as much and threatened one of the most dangerous side effects of a cap-and-trade regime—protectionist trade policies that would tax American consumers on imported items not subject to a comparable cap-and-trade program in their country of origin. Secretary Chu said, "If other countries don't impose a cost on carbon, then we will be at a disadvantage . . . [and] we would look at considering perhaps duties that would offset that cost."[21]

Any country subject to these kinds of punitive tariffs will surely retaliate, likely setting off a trade war that could be devastating.

Higher costs for virtually everything we consume, lower growth, and a deterioration in the international trading environment are some of the inevitable results of a cap-and-trade program. In return, we get a very modest reduction in the rate of growth of CO_2 in the atmosphere. According to the best estimates of climate scientists, this slightly slower growth in CO_2 levels would have a minimal impact on the global climate several decades from now.[22]

Given its negligible benefits, we should not impose on ourselves the huge costs of cap and trade, and the lower standard of living it would cause. Instead, we should increase our use of nuclear power, the generation of which produces no CO_2 at all, and technologies that would enable us to remove CO_2 from the atmosphere on an industrial scale. The former is safe, clean, economically competitive to alternatives, and available to be significantly scaled up. The latter will require technological breakthroughs but, in time, would likely yield better results at a fraction of the cost of cap and trade.

Conclusion

These are just some of the most worrisome policies being proposed and pursued by the Obama administration in early 2009. They all stem from a misplaced confidence in the ability of politicians to manage the economy. They seem unaware of, or indifferent to, the role the government played in creating the recession of 2008–2009. If these policies continue, they will likely prolong and worsen the already severe recession.

Particularly frustrating are the obvious parallels to the mistakes made by Presidents Hoover and Roosevelt during the Great Depression. Of the five major blunders (aside from the monetary policy errors) that worsened the

Great Depression—burdensome regulation; excessive federal spending; tax hikes; diminishing labor flexibility; and protectionism—the current president and Congress seem inclined to repeat them all.

The combined actions of the elected government and the Federal Reserve seem to be pointing toward a general policy of nationalization of troubled industries and monetization of excessive debt. This combination has never ended well for other countries, and it would not end well for ours.

In mid-2009, it is not too late to change course. With the exceptions of Fannie Mae, Freddie Mac, and AIG, which have been almost entirely nationalized, most of the rest have been partial nationalizations which could still be undone. Tax hikes, labor law changes, cap-and-trade, and protectionist measures have been proposed, but not yet adopted. The worst of the spending excesses driving the debt burden have been authorized, but the money has not yet been spent. The Fed has begun to monetize some of the national debt, but only on a relatively modest scale.

If we remember and apply the policies that have always led to prosperity they will lead us back now. Respect for property rights, sound money, low taxes, and reasonable regulation are the preconditions for a vibrant economy. When these policies are followed, economic downturns are usually brief, shallow, and self-correcting.

Governments can redistribute and destroy wealth; they cannot create it. Neither can they conjure up growth from thin air—or by printing money. Shuffling paper assets and money among and between people does not create wealth. People create wealth. People create economic growth. They do so voluntarily, spontaneously, and cooperatively when the above-stated policies enable them to do so. They create wealth and growth simply by creating. Productive activity—men and women producing goods and services that others value—is the source of all wealth. The more we restore the natural incentives to produce, the more production we will get, the more jobs will be created, and the more opportunities we will offer.

Epilogue

In these pages I have tried to remind us of the enduring principles that promote economic growth. These principles—property rights, free markets, low taxes and government spending, and a stable currency—have been understood for centuries and proven successful repeatedly in many places and times. While providing legal protection for property and maintaining a stable currency are proper domains for government, most of the rest of prosperity depends on limiting government and preserving personal and economic freedom.

As I write this, economic freedom is under unprecedented attack by the federal government. The property rights of investors have been trampled; financial and automotive markets have been partially nationalized; energy and health care are threatened with massive regulations; taxes are going up; and spending has exploded. Fortunately, this breathtaking expansion of government powers has not escaped the attention of the American public.

Voters disapprove of taxpayer-funded bailouts of failing businesses by large and increasing margins. Spontaneous "TEA (Taxed Enough Already) parties" have emerged, drawing hundreds of thousands of citizens across the United States to protest excessive bailouts, spending, and government debt. And Ayn Rand's classic book, *Atlas Shrugged*, has experienced an astonishing sales revival. First published in 1957, it was ranked as the number one literary best seller on Amazon.com in April 2009. The book's warning that governmental hostility toward society's productive people can wreak havoc on an economy and society is clearly resonating with readers who fear the novel's parallels to today's events.

Since at least the Great Depression, one of the major themes of American politics has been the ongoing struggle over the size and role of government. On the center-right are those who wish to limit the power of government and preserve personal freedom and responsibility. On the left, there are others who prefer to expand the power of government—accepting the corresponding diminution of personal freedom—so that it can increase the realms of collective responsibility and reduce inequalities of outcomes. The collectivists on the left are, for the moment, in power politically. They are smart, ambitious, and creative. But it is not clear that the American people share their rejection of the American tradition of individualism.

I hope that this book will help to persuade readers not only of the principles needed for prosperity but also of the importance of defending those principles from attack.

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About the Author

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