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The Causes of Economic Growth

by Reuven Brenner

Peter Bauer, the noted development economist, is flanked by Walter Williams of George Mason University, Steve Hanke of Johns Hopkins, and Cato's James A. Dorn at a Book Forum for *The Revolution in Development Economics*, edited by Dorn, Hanke, and Alan Walters.

Politicians and economists promise growth, prosperity, and higher standards of living. What do they mean by those terms? Is there some objective measure by which to judge whether people in a particular society, or in the world, expect technological and political innovations (including fiscal ones) to be beneficial and lead to the creation of more wealth? How can we be sure that a financial innovation, a change in company strategy, or a change in government policy makes a society better or worse?

The answer is that changes in the total market value of firms (the market value of debt and equity) in a society added to the market value of its government's outstanding obligations would be the best estimate to use in making such judgments—once financial markets are deep and transparent. When this sum increases, it means that the society's ability to generate revenues and pay back debt—whether private or public—has increased. And the contrary: when this sum drops (measured in terms of a relatively stable unit, rather than a particular currency), people signal that either their government or companies' management is making and persisting with erroneous decisions. The reason is simple: Developed, relatively unhindered financial markets prevent persistence of mistakes. By so doing, they quickly redirect the use of capital and ensure that savings and capital are deployed more effectively.

When the aforementioned sum diminishes, where does the wealth go? That depends. The smaller the ability of capital and people to move, the more their diminished value can be viewed as a permanent loss. Those things that are expected to be solid—the effort and ingenuity of people—melt into thin air. More mistakes can be expected, and their effects can be expected to last longer. The decrease thus reflects diminished expectations of generating future revenues (since every mistake is a cost). Generating future revenues is what "growth" and the ability to pay back debt mean. When capital and people move, though, the wealth that disappears in one country reappears in others.

There are few better examples to illustrate those points than the wealth created by the various diaspora of history—Armenians, Chinese, Huguenots, and Jews—as well as the poor emigrants from Europe, who built the newer continents. (Few of the rich left Europe.) The emigrants were driven out of their homelands by politics and regulations. Let us briefly look at how the movement of the most gifted and energetic of those peo-

Continued on page 12

Reuven Brenner, the author of Labyrinths of Prosperity *and other books, holds the Repap Chair at the Faculty of Management at McGill University in Montreal and is an associate at the Duxx Graduate School of Business in Monterrey, Mexico.*

In This Issue

Moore, Pataki greet Whitman, p. 5

Crane on the Republican debacle 2
Cato goes to Tokyo 3
Gephardt v. Kemp v. Lugar 4
Say no to the IMF 7
Cato Studies: the assault on Microsoft, school spending, Internet censorship 10
Upcoming events 9, 11

The Decline and Fall of GOP Principles

The record of the 105th Congress, Republican controlled in both houses, is an abomination. Spending is up. No major program or agency has been significantly cut, much less eliminated. The tax code is more complex than ever, loaded down with new conservative social engineering initiatives. The balanced-budget agreement is an excuse not to cut taxes and, with the "surplus," an excuse to increase spending. The GOP has seemed intent on federalizing every crime on the books, indifferent to the Constitution's clear direction that crime is a state and local responsibility. Republican efforts to "privatize" Social Security are so lame as to be laughable. Regrettably, the list could go on. And on.

If you're looking for a reason for the lamentable track record of the Republican Congress, look no further than the party's leadership. January provided clear evidence of an utter lack of philosophical resolve on the part of that leadership. On January 5 House Speaker Newt Gingrich gave what his office billed as a major statement of his political agenda for the next decade in a speech to the Cobb County Chamber of Commerce. To his credit, the Speaker did call for reducing the total tax burden on the American people, now in excess of 40 percent, to 25 percent over the next dozen years. But he failed to offer a single specific spending cut to finance the tax cut. Hardly a profile in political courage.

Indeed, Gingrich has taken to talking of how we can "modernize" government, à la Al Gore's "reinventing government" diversion, as his approach to shrinking the state. Suggesting that there are areas of civil society that should remain outside the scope of the federal government does not appear to be part of the Speaker's strategy.

But by far the most egregious aspect of the Gingrich speech was his plan to save the public schools. Instead of looking for alternatives to the abject failure of the government monopoly school system in America, Gingrich defended the system. "I believe passionately and deeply in the public school system of the country," he said. His solution to miserable test scores and mounting violence in the nation's public schools was not choice and competition (although he pays lip service to choice when he's not making a "major" speech) but rather a breathtakingly statist, centralized command-and-control proposal. Employing a military analogy (as he is wont to do), he told his Cobb audience, "I think we ought to adopt Winston Churchill's principle of action this day. We ought to identify the schools now that are bad and say to them, 'What are you going to change in the next 30 days?' If they don't have a good answer we ought to replace the people in charge of them. We ought to do it everywhere. . . ."

That the Republican Speaker of the House could say something so ignorant, so at odds with both our constitutional form of government and the reality of how markets work, is simply astonishing. Politicians and bureaucrats, not parents, are to determine what a "good answer" is to the problem of bad schools. Some unnamed central authority (the federal government?) will "replace the people in charge" (with whom?). One can't help but conjure up images of communist authorities in the old Soviet Union demanding more production from steel functionaries at People's Smelter No. 10—"or you will be replaced!"

Close on the heels of the Speaker's "vision" for the future, House Majority Leader Dick Armey followed with an eight-page memo to his Republican colleagues predicated on the curious notion that Americans somehow want politicians, not to get the government out of their lives, but to provide "moral leadership" for the nation. Although we certainly hope that our politicians don't turn out to be crooks and scoundrels, to suggest that Americans believe that element of our society should presume to lead us on issues of morality shows a stunning misunderstanding of how we view politicians.

More fundamentally, Armey's memo reflects the Clinton-driven search for a kind of intimacy between the public and private sectors that is wholly alien to a constitutional structure of strictly limited government. It is disheartening to see one of the few politicians who used to take a principled approach to limited government succumb to the Congress-is-the-center-of-the-universe syndrome.

Finally, on January 27, Senate Majority Leader Trent Lott gave the GOP response to the president's state of the union address. An uninspired speech, obviously written by committee, Lott's response not only omitted any reference to specific program or spending cuts, it ignored (incredibly) the fact that the president had put into play 23 percent of the federal budget by calling for fundamental Social Security reform.

The speech called for more federalization of crime, getting rid of "fraud and abuse" (what a good idea), and "rebuilding the kind of government that works with you and for you," as though most Americans don't believe the government already "works" with us far more than it should.

One sentence in Lott's speech was particularly revealing. He said, "The only way to limit government and expand individual freedom is to eliminate the IRS as we know it today." Huh? The *only* way to limit government? How about abolishing the Departments of Education, Commerce, Energy, and Labor for starters? But the other interesting thing about that sentence is the habit Republicans have developed of using Clintonesque weasel words like "as we know it today." We said we'd abolish the IRS as we know it today and you'll be happy to learn that effective tomorrow the entire IRS headquarters will get a fresh coat of paint.

The federal government is a machine designed to increase its control over the lives of average Americans. It is constantly probing here, pushing there, and generally increasing its control. Without a philosophically sound, constitutionally based political party opposing that process, it is going to continue to do so with impunity. The philosophical leadership vacuum at the top of the GOP should be a source of major concern to all freedom-loving Americans.

Ed Crane

—Edward H. Crane

More than 250 attend conference in Tokyo

Cato, Keidanren Sponsor Deregulation Panel

Government decisionmakers often overlook a fundamental fact in their rush to intervene in the private sector: individuals and private organizations have tremendous ability to deal on their own with the shortcomings of a modern economy. Relying on private initiative moves us closer to the ideal of a free society while simultaneously providing a powerful incentive for improved economic performance," said Murray Weidenbaum, former chairman of the Council of Economic Advisers, at an April 6th conference in Tokyo sponsored by the Cato Institute and the Keidanren.

The conference, "Deregulation in the Global Marketplace: Challenges for Japan and the United States in the 21st Century," brought together several Japanese and American experts to discuss how the world's two largest economies can adopt more liberal tax, trade, and regulatory policies. More than 250 people attended the daylong event, which was supported by Federal Express and the United States–Japan Foundation.

Murray Weidenbaum of Washington University

Alan Reynolds of the Hudson Institute and Kensuke Koga, chairman of Nisshin Steel Company, considered recent governmental efforts to stimulate Japan's sluggish economy. Both speakers urged Japanese policymakers to introduce large across-the-board tax cuts. Reynolds said, "If Japan continues to embrace the tax and spending policies of continental Europe and Scandinavia, nobody should be surprised if economic performance becomes as disappointing as it has been in those areas. An economy that is taxed into oblivion will not help anyone—not the poor, and not even the politicians."

Jesper Koll of J. P. Morgan Securities Asia and Keikichi Honda of Sun Microsystems Japan examined the first wave of Japan's "Big Bang" financial reforms, which went into effect on April 1. They said that unwise regulatory policies are keeping Japanese banks from engaging in international lending.

George Melloan of the *Wall Street Journal* decried Keynesian public works spending that will do little to charge the economy and will likely divert attention from more fundamental institutional reforms that should be pursued.

Masaya Miyoshi of the Keizai Koho Center

Brink Lindsey, director of the Cato Institute's Center for Trade Policy Studies, told the crowd that tensions between the United States and Japan, while present, are fundamentally different than they were in the past. In the 1980s the United States feared Japan's economic strength; now it fears that Japan will collapse and take much of the world with it. He said that Americans are right to urge Japanese policymakers to cut taxes, resolve the debt crisis, and deregulate the financial sector but stressed that calls for increased public spending and enforcement of anti-monopoly statutes should be rejected.

The following day, Cato, the Japan Center for Economic Research, and *The Economist* hosted a luncheon event focusing on the demographic problems that the Japanese and American social security systems face. Cato's José Piñera and William A. Niskanen were among the speakers. Fidelity Investments and State Street Bank were corporate sponsors of the event.

Selected papers from the Cato-Keidanren conference are available on the Web site of the Center for Trade Policy Studies. The address is www.freetrade.org. ■

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Bauer honored at forum on development

Gephardt, Lugar, and Kemp Debate Tax Reform

✦**February 2:** At a Capitol Hill Policy Forum on **"Tax Reform for the 21st Century: Competing Visions,"** House Minority Leader Richard Gephardt (R-Mo.); Jack Kemp, codirector of Empower America; and Sen. Richard Lugar (R-Ind.) debated how Congress should reform the tax code. Gephardt favored lowering the tax burden on middle-income workers but argued that tax rates for corporations and upper-income individuals should remain approximately the same. Kemp proposed a flat-rate income tax. And Lugar reiterated his support for replacing the income tax system with a national sales tax. Gwen Ifill of NBC News moderated the debate. The event was the first in a series of debates on fundamental tax reform that the Cato Institute will sponsor throughout the country.

Sen. Richard Lugar and Rep. Dick Gephardt listen as former vice presidential candidate Jack Kemp defends the flat-rate tax at a Cato Policy Forum on Capitol Hill.

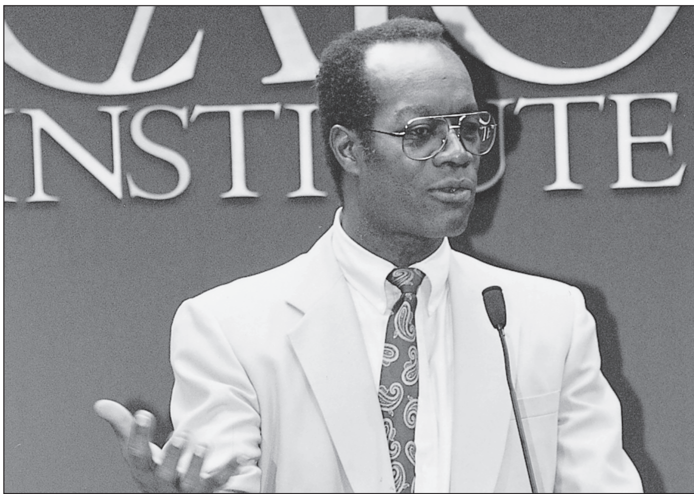
✦**February 6:** Robert E. Litan, director of economic studies at the Brookings Institution, and William A. Niskanen, chairman of the Cato Institute, discussed their new book ***Going Digital! A Guide to Policy in the Digital Age*** at a Book Forum at the National Press Club. Litan and Niskanen urged policymakers to follow four broad guidelines: markets should be allowed to address problems associated with digital technology; existing barriers to electronic trade and commerce should be removed; pleas of incumbent firms and technologies for protection should be resisted; and government intervention may be useful, but not essential, in very limited instances. For example, the harmonization of international legal rules might prove beneficial. Ira Magaziner, senior adviser for policy development at the White House, agreed that lawmakers should take a hands-off approach to the Internet and noted that the pace of technological innovation makes effective government regulation nearly impossible.

✦**February 11:** George B. N. Ayittey, professor of economics at American University and founder of the Free Africa Foundation, discussed his new book ***Africa in Chaos*** at a Book Forum. Ayittey said that the "mafia states" that now rule Africa are ahistorical—that traditional African culture was based on private property and the rule of law. If Africa is to develop economically, it must reject the current regimes and embrace policies that restore individual liberty.

✦**February 12:** At a Policy Forum on **"Why We Should Say No to the IMF,"** more than 150 people heard Sen. Lauch Faircloth (R-N.C.), Allan Meltzer of Carnegie Mellon University, and Ian Vásquez of the Cato Institute argue that the United States should not fund an International Monetary Fund bailout of several failing Asian economies. Faircloth predicted that Congress will not appropriate the full $18 billion that the IMF is requesting and opined that the world would be better off if the IMF were eliminated. Meltzer maintained that the IMF pursued imprudent policies toward Mexico after the peso crisis of 1994 and contended that IMF funding induces dangerous centralization of banking systems in developing countries. Vásquez explained that the IMF was largely responsible for the "lost decade" of the 1980s in Latin America and that IMF loans encourage unwise domestic policies and prop up corrupt regimes. He urged Congress to consider whether the IMF "serves any useful purpose at all."

✦**February 12:** Massachusetts, San Francisco, and Takoma Park, Maryland, are among a growing number of state and local jurisdictions that have enacted procurement laws that discriminate against companies that do business in Burma, a country with a notoriously bad human rights record. At a Policy Forum titled **"Are State and Local Sanctions against Burma Constitutional?"** attorney David Schmahmann argued that state and local sanctions violate the Constitution because they infringe on the federal government's delegated powers to set U.S. foreign policy and regulate foreign commerce. Frank Kittredge, president of the U.S. Foreign Trade Council, reported that his organization is challenging such sanctions in court.

✦**February 11–15:** The Cato Institute hosted its annual **Benefactor Summit** in Grand Cayman. Several Cato scholars spoke about their research. In addition, Ward Connerly of the American Civil Rights Institute discussed his efforts to eliminate racial and gender preferences in public institutions; Esther Dyson, chairman of EDventure Holdings, considered the future of digital technology and commerce; and P. J. O'Rourke, Mencken Research Fellow at the Cato Institute, delivered the Saturday evening dinner address, "Parliament of Whores: A Global Survey." Tom Palmer, director of special projects at the Cato Institute, and



George Ayittey of the Free Africa Foundation denounces "mafia states" at a forum for his book, ***Africa in Chaos***.

Economist Joseph Pomykala discusses his *Regulation* magazine article at a forum on bankruptcy law with Vern McKinley, Ed Hudgins, Dina Ellis, and Bob Weed.

Journalists surround Gov. Christine Todd Whitman after she and Gov. George Pataki spoke at a Cato Policy forum.

José Piñera was among the speakers at a Cato conference in Tokyo, cosponsored by the Japanese business association Keidanren and attended by more than 250 people.

Andrew Morriss of Case Western Reserve University lectured on history and legal theory. Approximately 170 people were in attendance.

✦**February 17:** Maurice McTigue, a former New Zealand cabinet member and representative in parliament, came to the Cato Institute for a **Roundtable Luncheon**. He discussed his country's efforts to deregulate private industry and privatize numerous state-owned enterprises.

✦**February 23:** The Cato Institute hosted a half-day conference, **"The Implications of Abandoning the Two-War Strategy,"** to consider whether the United States should rethink its military strategy. Currently, the military budget is based on the assumption that the United States may be required to fight two major wars almost simultaneously. But many speakers, including former senator Gary Hart, who delivered the keynote address, argued that that strategy doesn't make sense in the post–Cold War world. Ivan Eland, director of defense policy studies at the Cato Institute, stated that it is hard to envision two conflicts that would simultaneously threaten American security interests enough to warrant armed response. Moreover, asserted Philip Gold of the Discovery Institute, a large standing military runs afoul of America's tradition of limited, representative government. He maintained that the military should rely more heavily on reservists and less on active personnel. Other speakers included R. Adm. Eugene Carroll (Ret.) of the Center for Defense Information, Frederick Kagan of the U.S. Military Academy, Carl Conetta of the Project on Defense Alternatives, and Michael O'Hanlon of the Brookings Institution.

✦**February 24:** Govs. George B. Pataki (R-N.Y.) and Christine Todd Whitman (R-N.J.) discussed **"Tax Cuts and Economic Revival in the Northeast"** at a Policy Forum. They reported that steep cuts in state income taxes combined with reductions in many spending programs have sparked economic activity and helped to stem an exodus of citizens and businesses to other states. In addition, both New York and New Jersey will run sizable budget surpluses in 1998.

✦**February 24:** Tibor Machan, professor of philosophy at Chapman University and author of numerous books, including *Individuals and Their Rights*, discussed his new Cato book ***Generosity: Virtue in Civil***

Continued on page 6

CATO EVENTS *Continued from page 5*

Society at a Roundtable Luncheon. Machan said that generosity can be considered a virtue only if it is chosen voluntarily and maintained that the modern welfare state snuffs out truly beneficent conduct.

✦**February 27:** Several members of the Cato Institute policy staff discussed the importance of market-liberal policies and fundamental reform of the tax and Social Security systems with Rep. Vito Fossella (R-N.Y.) at a **Policy Briefing**.

✦**February 28:** Rep. John Boehner (R-Ohio), chairman of the House Republican Conference, came to the Cato Institute for a **Policy Briefing** on a wide variety of issues.

✦**March 2:** The Cato Institute hosted a **Tribute to the Life and Works of Julian L. Simon.** Numerous speakers discussed how Simon—a distinguished senior fellow at the Cato Institute who died on February 8—had influenced their thinking and touched their lives with his remarkable scholarship and unflagging optimism and kindness. Those giving brief reflections included Rita Simon, Jack Kemp, Spencer Abraham, Peter Bruce, Helen Demarest, Stephen Moore, Adam Pilarski, Fred L. Smith Jr., Rick Sullivan, W. Allen Wallis, and Ben Wattenberg. A videotaped message from Nobel laureate Milton Friedman was also shown at the event.

✦**March 3:** The Cato Institute hosted a Capitol Hill Book Forum to release the new Cato book ***NATO Enlargement: Illusions and Reality,*** edited by Ted Galen Carpenter and Barbara Conry. Former senators Gary Hart and Gordon Humphrey and Cato chairman William Niskanen explained that NATO expansion would unduly increase American security obligations and alienate Russia. Carpenter added that the economic costs of NATO expansion have been greatly underestimated.

✦**March 5:** Peter Bauer, professor emeritus of economics at the London School of Economics and author of such classic works as *Dissent on Development* and *Reality and Rhetoric,* discussed the new Cato book ***The Revolution in Development Economics,*** which is dedicated to him. Bauer said that the International Monetary Fund is an unnecessary institution that too often stands in the way of genuine economic growth and development. Steve Hanke, professor of applied economics at Johns Hopkins University and one of the editors of *The Revolution in Development Economics,* emphasized that Bauer's work has profoundly influenced the way development economists look at the world.

✦**March 16:** Last year, during prosperous times, more than 1.3 million people filed for bankruptcy. To examine the reasons for that anomaly, the Cato Institute hosted a Policy Forum titled **"Bankrupt Bankruptcy Policies: Time to Restore Creditor Rights?"** Vern McKinley and Joseph Pomykala, authors of articles on bankruptcy policy in a recent issue of *Regulation*, said that, for too many people, filing bankruptcy makes economic sense.

Cato's William Niskanen and Ted Galen Carpenter are flanked by former senators Gordon Humphrey (left) and Gary Hart (right) at a Book Forum for *NATO Enlargement: Illusions and Reality.*

They urged Congress to toughen the requirements a person must meet before he can file for bankruptcy. Dina Ellis, an aide to Rep. George Gekas (R-Penn.), discussed a bill proposed by Gekas that would require debtors with substantial assets to meet a portion of their debts. Bob Weed of the National Association of Consumer Bankruptcy Attorneys maintained that current bankruptcy rules are adequate and just.

✦**March 18:** The Cato Institute hosted a **City Seminar** in Dearborn, Michigan. Among the speakers were Cato's Edward H. Crane, Jerry Taylor, Stephen Moore, and Michael Tanner. Michigan's governor, Republican John Engler, delivered the keynote address, "Education, Taxes, and Michigan's Future."

✦**March 24:** At a Policy Forum titled **"A Safe Haven No More? Fixing U.S. Asylum Law,"** Michele Pistone, author of a recent Cato Policy Analysis on asylum policy, argued that a new one-year filing deadline for immigrants seeking asylum from persecution will endanger the lives and freedom of thousands of refugees. Bo Cooper of the Immigration and Naturalization Service explained how INS reforms have addressed the problem. Mark Krikorian of the Center for Immigration Studies maintained that even tougher rules should be applied and that the United States should reconsider its entire approach to immigration policy.

✦**March 26:** Leon T. Hadar, an adjunct scholar at the Cato Institute and author of a new Cato study on U.S. trade sanctions against Burma, argued that the United States should repeal its existing trade sanctions at a Policy Forum on **"Rethinking Economic Sanctions."** Hadar maintained that sanctions do little to change the domestic policies of target countries and harm the competitiveness of American industry. Angela Ellard, trade counsel to the House Committee on Ways and Means, reported on a bill that would make it more difficult for the United States to impose nonretaliatory, unilateral trade sanctions. Alan P. Larson of the U.S. Department of State said that trade sanctions can, at times, be effective and maintained that they are a "vital part of our diplomatic arsenal."

✦**March 31:** Four participants in a Policy Forum considered the question, **"Should the United States Ratify the Comprehensive Test Ban Treaty?"** Robert Bell of the National Security Council and Tom Collina of the Union of Concerned Scientists maintained that the United States should sign the treaty because doing so would deter nuclear testing by nonsignatories. They also maintained that the United States does not need substantial demonstrations of its nuclear arsenal to determine that it is safe and reliable. Robert Barker, former assistant to the secretary of defense, and Marshall Billingslea of the Senate Foreign Relations Committee said that the treaty will do little good because at least two countries—India and Pakistan—will not comply with it and will not sign it. Moreover, they contended that the treaty could do real harm, because, contrary to what Bell and Collina said, the United States must test its nuclear arsenal to determine its effectiveness. ■

Why We Should Say No to the IMF

On February 12 the Cato Institute held a Policy Forum, "Why We Should Say No the IMF." The speakers were Sen. Lauch Faircloth (R-N.C.); Allan H. Meltzer of Carnegie Mellon University; and Ian Vásquez, director of the Cato Institute's Project on Global Economic Liberty. Excerpts from their remarks follow.

Lauch Faircloth: Before I begin, I would like to thank the Cato Institute for the great work it has done in exposing the problems with the International Monetary Fund.

Sen. Lauch Faircloth: The Mexican bailout led to the Asian crisis

I'm sure all of you are familiar with the bailouts of South Korea, Indonesia, and Thailand. But I don't know if you realize that those bailouts are possibly the beginning of something much larger. In my opinion, we are witnesses to the dawning of a new era of international bailouts. Today we have South Korea, Indonesia, and Thailand. But what about tomorrow? Will we bail out Russia, Brazil, or China? Although things are getting better in those countries, all three are in quite bad shape. If the IMF is going to send money to South Korea, why not send it to Russia as well?

In the West we praise the free market, but we no longer have a free market in international finances. The legacy of the Clinton administration is what I like to call the "Rubin Doctrine." Simply put, the Rubin Doctrine says that in developing countries we ought to privatize profits and socialize losses. That is a recipe for disaster, and it is unjust.

The Rubin Doctrine was implemented during the Mexico peso crisis of 1995. The price of that supposed one-time rescue has been very great, because it set a very expensive precedent. By bailing out Mexico, we essentially told people in developing countries that they need not worry about engaging in risky financial practices. If businesses fail or loans are unpaid, taxpayers in developed countries will clean up the mess and pick up the bill. In short, I would argue that our actions toward Mexico encouraged unsound business decisions in Asia and, in many respects, laid the foundation for the Asian crisis.

Unfortunately—and please excuse me for a slight digression—we see the same thing happening at the micro level in the United States. We have had a 300 percent increase in bankruptcies in this country since 1980. People are not required to work out their problems with creditors. Instead, you can simply declare bankruptcy. What bankruptcy now amounts to is saying, "Excuse me" and then starting over. What we did in Mexico—and what we are doing in South Korea, Indonesia, and Thailand—is essentially the same. The governments of those countries are shouting "bankruptcy," and we are going to rush in with funds before any attempt is made to work out the problems with creditors.

In the wake of the Mexican crisis, Robert Rubin and the IMF conceived of the idea—an all-time bad one—of establishing a new fund that would be used exclusively for bailouts of failing economies. The problem with that "solution" is that it does nothing to prevent future problems from occurring. It only creates a pot of money that is available for future bailouts. And when you have a pot of money at the ready, you encourage people to use it, either directly or as an insurance fund.

I am convinced that the IMF is more interested in perpetuating itself and creating a constant need for its existence than in truly aiding developing countries. The IMF has no interest in seeing any developing country become debt free, or developed for that matter.

So where do we go from here? The Clinton administration is asking Congress to appropriate $18 billion for the IMF. Does the IMF need more money? Absolutely not. Congress has a choice. It can link arms with the Treasury Department and continue down the bailout road, or it can correct the course. Congress can set its own policy and avoid future bailouts. I do not believe, and I speak as just one senator, that Congress will appropriate the full $18 billion that the IMF is requesting. More fundamentally, Congress should demand that the IMF reform itself immediately.

Let me suggest some much-needed changes that should be made. First, the IMF should be required to develop a plan to reduce or eliminate all of its loans over a 5- or 10-year period. Second, the IMF should be charged with obtaining the following from each country: full fiscal transparency, open markets, and an end to crony capitalism. Third, the G-7 nations should develop an international bankruptcy code. Fourth and finally, we should think about new leadership at the IMF.

I would like to see the IMF eliminated. But, at the minimum, Congress should demand serious structural reforms that would bring an end to the IMF's failed bailout policies.

Allan H. Meltzer: Let me begin by stating a fundamental truth: capitalism without failure is like religion without sin. It doesn't work. Bankruptcies and losses, even the threat of bankruptcy, concentrate the mind on prudent behavior. Prudence was the missing element in the Mexican crisis of 1995, as it is in the Asian crisis of today. In its absence, bankers and other lenders take excessive risks. They have no incentive to learn about the number of outstanding loans, how much borrowers have borrowed short to lend long, or how much currency risk has been assumed. The lenders don't care much, because they collect no matter what happens.

The IMF's programs contribute to the large wedge between the social risk—the risk borne by the troubled country—and the private risk borne by bankers. That is one source of moral hazard, and one reason we have a crisis-prone system. A common rebuttal to my claim is that Mexico repaid its loans to the U.S. government and the IMF. But that

Continued on page 8

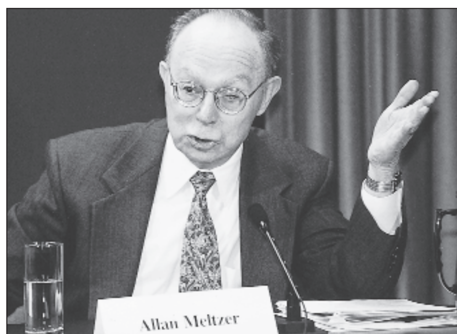
“Capitalism without failure is like religion without sin. Bankruptcies and losses concentrate the mind on prudent behavior.” —*Allan H. Meltzer*

IMF *Continued from page 7*

argument misses the point. If banks and financial institutions had taken losses in Mexico, they would have exercised elementary judgment about risks in Asia.

Some bankers and Treasury officials defend more money for the IMF by citing loans to Mexico as a success for U.S. Treasury–IMF intervention. That is an extraordinary claim. It looks only to the repayment of the loan, achieved mainly by borrowing abroad. It ignores the effect on the Mexican economy.

Consider the record. The U.S. Treasury and the Federal Reserve have been “helping” Mexico since the 1930s. The IMF has been at it since the 1970s. Successive Mexican governments have learned that if they face a crisis, one or both of those institutions will lend them money to make the immediate crisis appear less onerous. Investors have learned that they get bailed out, so they continue to invest. I believe that goes a long way toward explaining why Mexican policy has been erratic and undisciplined at times. The Bank of Mexico and the government take excessive risks and incur large losses for Mexican taxpayers.



Allan H. Meltzer: IMF bailouts increase the risk of future crises

The results have been disastrous for the Mexican economy and people. Despite enormous growth in the world economy in the past 20 years, Mexican real income was the same in 1996 as in 1974. The Mexican people have been on a bumpy road to nowhere. In the same period Mexican debt in constant dollars increased from $40 billion to $160 billion. Much of that is the price Mexico paid for U.S. and IMF assistance. Without the IMF and the U.S. Treasury, Mexico would have pursued better policies, would have accumulated less debt, and, I believe, would have made more progress.

It is frequently asserted that moral hazard is not a problem because no government chooses to subject its economy and its people to the type of losses Latin America experienced in the 1980s, Mexico witnessed in 1995, and Asia faces now. I believe that is true but irrelevant. The issue does not arise in that way.

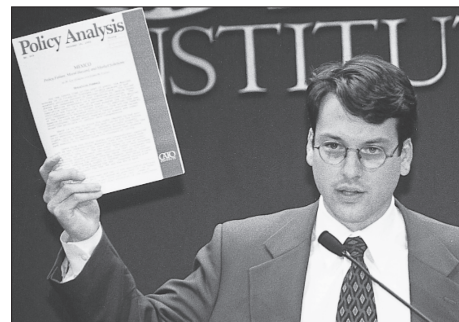
A country may find it necessary to choose between offering guarantees to foreign lenders and facing large withdrawals of foreign loans. Mexico, Korea, and other countries have faced precisely that choice. The government may choose to guarantee the loans by issuing dollar-denominated securities, such as the Mexican *tesobonos,* or by promising to accept responsibility for private debts denominated in dollars, as the Korean government did. When the government offers the guarantee, it believes the default risk is manageable, just as the U.S. government believed that the risk in the savings-and-loan system was manageable. It is not necessary for the government to plan a debacle; a debacle is always a possibility. A finance minister faced with such a choice will almost always prefer to avoid the crisis now, at the risk of a larger future crisis.

The opportunity to take the (possibly small) risk of a later crisis instead of a certain, smaller, current crisis is the second source of moral hazard. To reduce the risk of future crises, it is necessary to reduce the chances of a finance minister’s having to make the choice I described.

IMF and U.S. Treasury lending to Asian countries continues that dangerous process. It has increased the risk of large future crises. Too much of the world has become “too big and too indebted to fail.” Neither the IMF, nor the development banks, nor the U.S. and Japanese governments can pay for all the errors, mistakes, and imprudent actions they help to create.

“Too big to fail” was a flawed idea when applied to U.S. savings-and-loans and to Swedish, Japanese, Latin American, and other banks. It is no less flawed when applied to U.S., Japanese, and European banks and financial institutions that have lent in Asia.

Secretary Rubin was right when he said in September 1997, “What we don’t want to have is a situation where people can do unwise things and not pay a price.” But that is the system that he and the IMF have created and sustained.



Ian Vásquez: The IMF uses crises to expand its influence

Ian Vásquez: The IMF has a dismal record of helping poor countries achieve self-sustaining growth or, for that matter, helping poor countries introduce market-oriented reforms. Despite its performance, the IMF has proven to be a remarkably resilient institution. For example, when the pegged exchange rate system ended in the 1970s, so did the original mission of the IMF. But the IMF has used successive world crises—such as the “oil crisis” of the 1970s, the Third World debt crises, the collapse of communism, and, most recently, Mexican-style crises—to expand its influence and resources.

In theory, the IMF makes short-term loans in exchange for policy changes. But that has not helped countries move to the free market. Instead, a review of IMF loans reveals that the IMF has created loan addicts. Cato has found that 11 nations have been relying on IMF aid for at least 30 years, 32 countries have been borrowing for between 20 and 29 years, and 41 countries have been using IMF credit for between 10 and 19 years. That record leads one to be highly skeptical of the “conditionality” or “temporary nature” of the IMF’s short-term loans.

In the case of Mexican-style bailouts, I have three objections to IMF intervention. The first one, which has been mentioned by the previous speakers, is the moral hazard problem. It is not a small detail. We’ve seen moral hazard in the past and we’re seeing it

Continued on page 15

Annual Conference on Technology & Society

Washington D.C. vs. Silicon Valley

Milton Friedman

November 19-21, 1998 @ Fairmont Hotel, San Jose, California

T. J. Rodgers

Eric Schmidt

Scott Cook

Bill Melton

An exciting new program from Cato University

Cato University is launching a series of holiday weekend seminars on the foundations of a free society. Each seminar will begin with a Friday evening dinner and speech, offer lectures and discussions Saturday and Sunday, and conclude with a Sunday evening dinner and speech and Monday morning departure. (The July 4 seminar will begin Thursday evening, July 2, with departure on Sunday, July 5.) The cost of $795 includes three nights in a hotel, all meals, and all lectures. The Cato University seminars are open only to Cato Sponsors.

Seminars in Economics and History

Independence Day weekend, July 2–5 • San Diego • Rancho Bernardo Inn

Faculty:
Russell Roberts, Washington University, Author, *The Choice: A Fable of Free Trade and Protectionism*
Stephen Davies, Manchester University
James K. Glassman, *Washington Post*

Labor Day weekend, September 4–7 • Chicago • Intercontinental Hotel

Faculty:
Stephen Landsburg, University of Rochester, Author, *Fair Play: What Your Child Can Teach You about Economics, Values, and the Meaning of Life*
Stephen Davies, Manchester University
Nathaniel Branden, Author, *Taking Responsibility*

Seminar in Philosophy and Law

Columbus Day weekend, October 9–12 • San Francisco • Radisson Miyako

Faculty:
Randy Barnett, Author, *The Structure of Liberty*
David Kelley, Author, *A Life of One's Own*
David Friedman, Santa Clara University, Author, *The Machinery of Freedom*

For more information, check out the Cato Web site at www.cato.org, or call Michelle Rider at (202) 218-4606

The Kansas City school spending debacle

Case against Microsoft Will Chill Innovation

The U.S. Department of Justice, which began its antitrust investigations of Microsoft seven years ago, is currently attempting to force the company to offer two versions of its Windows operating system—one with its Internet browser and one without—even if both are identically priced. In "Microsoft and the Browser Wars: Fit to Be Tied" (Policy Analysis no. 296), Robert A. Levy, senior fellow in constitutional studies at the Cato Institute, writes, "If DOJ prevails in its attack against Microsoft, we will have sanctioned government scrutiny of any company that integrates previously distinct technologies, and we will have politicized competition by enlisting the public sector in pursuit of private, parochial interests." Levy concludes that today's high-tech economy—where innovation proceeds at an astonishing pace—makes our antitrust laws increasingly irrelevant. "The pace of innovation in information technology is so rapid today that a firm like Microsoft will simply lose its customers if it does not offer the very best products; a dynamic market makes it almost impossible to sustain monopoly power. This kind of government meddling will do nothing but chill innovation."

✦More Money Won't Help Public Schools

Proponents of public education have long contended that lack of funding is a principal reason for the poor performance of many government schools. However, as Los Angeles writer Paul Ciotti reports in "Money and School Performance: Lessons from the Kansas City Desegregation Experiment" (Policy Analysis no. 298), it is unlikely that increased funding will help public schools. In 1985 a federal judge invited the Kansas City, Missouri, School District to come up with a cost-is-no-object educational plan. The district responded by spending as much as $11,700 per pupil per year. The district used the money to build new facilities and to hire more teachers, dropping the student-teacher ratio to 12 or 13 to 1, the lowest of any major school district in the country. Despite such extravagant spending, the results were dismal. Test scores did not rise, and racial integration, one of the principal goals of the reform, was not achieved. Ciotti concludes, "The Kansas City experiment suggests that, indeed, educational problems can't be solved by throwing money at them, that the structural problems of our current educational system are far more important than a lack of material resources, and that the focus on desegregation diverted attention from the real problem, low achievement."

✦Banning ATM Surcharges Would Hurt Consumers

Many officeholders have asserted that banks should be prohibited from charging their customers for using automated teller machines. But, as John Charles Bradbury writes in "ATM Surcharges and the Expansion of Consumer Choice" (Briefing Paper no. 36), such a move would harm the very people it was intended to help: consumers. ATMs are expensive to operate. The Federal Reserve Board has estimated that, on net, an ATM costs an average bank more than $10,000 a year. If banks weren't allowed to charge customers for the convenience of using an ATM, losses would be even more significant and many banks would likely scale back their ATM service. Bradbury, a doctoral student in economics at George Mason University, concludes, "ATM surcharges allow banks and other ATM operators to deploy machines in more convenient locations than might otherwise be possible. Prohibiting ATM surcharges would only harm consumers by slowing the expansion of ATMs and reducing the number of ATMs currently deployed without making anyone better off."

✦Don't Censor the Web

In 1978 the Supreme Court introduced a new rationale for regulation of broadcast media: the "pervasiveness" doctrine. The Court upheld Federal Communications Commission regulation of indecent radio broadcasts on the grounds that they enter homes when children might be listening. In "The Specter of Pervasiveness: *Pacifica*, New Media, and Freedom of Speech" (Briefing Paper no. 35), Jonathan D. Wallace, an attorney and coauthor of *Sex, Laws, and Cyberspace,* argues that the pervasiveness doctrine is "a dangerously broad and vague excuse for speech regulation." If applied consistently, the pervasiveness doctrine would threaten the free-speech rights of print media, as well as broadcast media. Moreover, writes Wallace, as "the Internet expands into one-to-many voice or video communications, courts might decide to treat it as the legal equivalent of pervasive radio or TV broadcasts." He concludes that the "Court should guarantee that the principles of property rights and individual responsibility pervade our lives and stop worrying whether the media do."

✦Lift Sanctions against Burma

The United States has imposed unilateral trade sanctions against Burma in an effort to force that country to improve its human rights record. But such sanctions have been a comprehensive failure, writes Leon Hadar in "U.S. Sanctions against Burma: A Failure on All Fronts" (Trade Policy Analysis no. 1). Hadar, an adjunct scholar of the Cato Institute, maintains that sanctions "have denied Burmese citizens the benefits of increased investment by American multinational companies—investment that brings technology, better working conditions, and Western ideas." Moreover, sanctions have alienated our allies in the region and cost the U.S. economy millions of dollars in lost wage premiums in the export sector. "As an alternative to the failed policy of sanctions," writes Hadar, "the United States should allow U.S. companies to freely trade with and invest in Burma."

✦NATO Expansion: A Threat to Peace

Expanding NATO eastward could provoke war with Russia, argues Stanley Kober in "NATO Expansion Flashpoint No. 3: Kaliningrad" (Foreign Policy Briefing no. 46). Kober, research fellow in foreign policy studies at the Cato Institute, reports that the admission of Poland, Estonia, Latvia, and Lithuania to NATO would separate the Russian enclave of Kaliningrad from the rest of the country. "That," Kober writes, "would create a 'mirror image' of West Berlin during the Cold War—with the thorny problem of military transit rights and other potential quarrels." The probable Russian response to the isolation of Kaliningrad, predicts Kober, "would be greater reliance on nuclear weapons (including adoption of a first-use policy) and renunciation of the Founding Act on Mutual Relations,

Cooperation and Security between NATO and the Russian Federation. Expansion of the alliance, therefore, risks provoking a new and even more dangerous version of the Cold War."

✦Eastern Europe's Flawed Democracies

The North Atlantic Treaty Organization was always portrayed as more than a traditional military alliance. From its inception—and especially since the collapse of the Soviet Union—NATO has cultivated the image of an alliance of democracies. By admitting the Czech Republic, Hungary, and Poland to the alliance, as the Clinton administration has proposed, member countries would severely tarnish that image, reports Thomas Magstadt in "Flawed Democracies: The Dubious Political Credentials of NATO's Proposed New Members" (Policy Analysis no. 297). Magstadt, an adjunct scholar of the Cato Institute who has spent the past four years in the Czech Republic, writes, "All three countries have alarmingly weak civil societies and less than robust democratic political cultures." If any of them is admitted, "NATO might have to face the embarrassment (or worse) of dealing with a member that has regressed into authoritarianism."

✦Liberalize Asylum Laws

The United States has traditionally been a refuge for oppressed people from around the world. Unfortunately, legislation has recently been passed that threatens that noble tradition. In "New Asylum Laws: Undermining an American Ideal" (Policy Analysis no. 299), Michele Pistone, an advocacy fellow at the Center for Applied Legal Studies at Georgetown University, writes, "Human lives are being put in danger by the 1996 Immigration Reform and Immigrant Responsibility Act." The act imposed a one-year filing deadline that, Pistone explains, many "genuine asylum seekers will not be able to meet because of the circumstances they face, including the trauma of torture, the threat of death, and fear for family members who remain in their home country." Pistone concludes, "The current anti-immigrant trend should not be permitted to diminish the valued role of the United States as a haven for democracy and fundamental freedom." ■

Regulation looks at deregulation around the world

Greenspan in *Cato Journal*

The new issue of the *Cato Journal* (vol. 17, no. 3) features a number of papers that were presented at Cato's 1997 monetary conference, "Money and Capital Flows in a Global Economy." Alan Greenspan's article "The Globalization of Finance" and Walter Wriston's "Dumb Networks and Smart Capital" highlight the issue.

Cato adjunct scholar Steve H. Hanke, recently in the headlines for his advice that Indonesia should adopt a currency board to stabilize the rupiah, argues that the International Monetary Fund not only failed to predict Asia's economic crisis but then offered the wrong medicine. Charles W. Calomiris of Columbia University argues that the expectation of bailouts by the IMF increases the fragility of the world economic system. Other authors include Anna J. Schwartz, Francisco Gil-Diaz, and Allan H. Meltzer.

Regulation has also just published a new issue (vol. 21, no. 1) that includes case studies on successful deregulatory efforts around the world. Adrian T. Moore takes a look at Mayor Stephen Goldsmith's efforts to reduce red tape and regulation in Indianapolis. Former cabinet official Maurice McTigue discusses "Reforms in New Zealand," and Carroll Rios de Rodriguez reports on "Privatized Mail in Guatemala."

In other articles Cato's director of science and risk studies, Michael Gough, casts a critical eye on a recent study purporting to find unexpectedly large dangers from pesticides. Stephen Huebner of the Center for the Study of American Business warns of bad policy being promoted under the rubric of "environmental justice." Jerry Taylor examines the Kyoto conference and its aftermath. Other topics include unemployment compensation, health insurance portability, and Internet gambling.

Both publications are available from the Cato Institute, and articles from both can be found on the Web at www.cato.org. ■

Cato Calendar

Collateral Damage:
The Economic Cost of U.S. Foreign Policy
Washington • Cato Institute • June 23, 1998
Speakers include Richard Cheney, Clayton Yeutter, Gary Hufbauer, and Ted Galen Carpenter.

Cato University Economics and History Seminar
San Diego • Rancho Bernardo Inn • July 2–5, 1998
Speakers include Russell Roberts, Stephen Davies, and James Glassman.

Cato University Economics and History Seminar
Chicago • Intercontinental Hotel • September 4–7, 1998
Speakers include Steven Landsburg, Stephen Davies, and Nathaniel Branden.

Cato University Law and Philosophy Seminar
San Francisco • Radisson Miyako Hotel • October 9–12, 1998
Speakers include Randy Barnett, David Kelley, and David Friedman.

Money in the New Millennium: The Global Financial Architecture
16th Annual Monetary Conference
Washington • Cato Institute • October 22, 1998
Speakers include William Poole, Jeffrey Sachs, and Steve Hanke.

Washington, D.C. vs. Silicon Valley
2nd Annual Conference on Technology and Society
Cosponsored with *Forbes ASAP*
San Jose • Fairmont Hotel • November 19–21, 1998
Speakers include Milton Friedman, Scott Cook, Eric Schmidt, T. J. Rodgers, and William Melton.

“Historians and economists (subsidized by governments) are very good at creating and perpetuating myths that justify increasing the power placed in the hands of government.”

GROWTH *Continued from page 1*

ple led to many of the world's economic "miracles."

Facts behind Miracles

The Cinderella stories of poor or impoverished societies suddenly leapfrogging others have provoked admiration, envy, and intense discussions about why the outdone stumbled, and the humbler rose. The riches of oil-producing Middle Eastern countries did not provoke such discussions because those countries fit the "finding treasure" pattern. But how do societies do it when they not only lack any particular natural resources but even suffer from disasters? Can other countries emulate them and achieve similar high growth rates?

The miracle of 17th-century Europe was neither Spain nor Portugal—both of which fit the "finding treasure" mold—but below-sea-level Amsterdam and Holland, whose riches were created despite natural obstacles. Later there was West Germany, rising miraculously from the ashes of World War II. There were some Asian miracles that deserve our attention, such as those of Hong Kong and Singapore. And there was the almost forgotten example of Scotland, which teaches a particular lesson.

What's common to all those miracles? The Dutch were the first European republic, both tolerant toward all religions (when the rest of Europe was still severely discriminating against many) and with sound rights to property, which opened opportunities for relatively unhindered trade and financial innovation.

But it would be misleading to say that "the Dutch" did it. The openness of the new republic attracted to Amsterdam well-connected and educated immigrant merchants and moneymen (bankers from northern Italy); Jews and Huguenots, discriminated against elsewhere in Europe, were prominent among them. They helped turn Amsterdam into the financial and trading center of the 17th-century world. It had the world's first stock market, where French, Venetians, Florentines, and Genoese, as well as Germans, Poles, Hungarians, Spaniards, Russians, Turks, Armenians, and Hindus traded not only in stocks but also in sophisticated derivatives.

Much capital active in Amsterdam was foreign owned, or owned by Amsterdammers of foreign birth. There was "globalization" during the 17th century, even if nobody bothered to use the term. The difference between then and now, of course, is largely the speed of information flows. Max Weber didn't bother to look at migratory patterns when he came up with his speculation that somehow religion—the Protestant ethic—had much to do with Amsterdam's spectacular success. Although Weber's idea has been quoted frequently enough to pass for fact, it wasn't true in Amsterdam or in any other prosperous trading cities or states. Educated and ambitious trading immigrants, with networks around the world, turned 17th-century Amsterdam into a "miracle." And the same factors have been behind other miracles as well.

The histories of Hamburg, Hong Kong, Singapore, Taiwan, and West Germany have much in common with Amsterdam's, but shared religion is not a factor. In each of those places, the state provided an umbrella of law and order, exacted relatively low taxes, and gave people a stake in what the business society was doing—thereby attracting immigrants and entrepreneurs from around the world.

Sir Stamford Raffles designed Singapore as a port at the beginning of the 19th century, and backed it with an administrative and legal system and an educational system that was open to the whole multiracial population. Trade and security brought prosperity to the penniless immigrants from Indonesia and, in particular, China. Taiwan (after the 17th century), Singapore, and Hong Kong offered immigrants opportunities denied them in China, which was dominated at first by warlords and a status-conscious bureaucracy and later by a communist bureaucracy. Hong Kong benefited from waves of immigrants from China, in particular from the inflow of Shanghai merchants and financiers when Mao Zedong "liberated" China in 1949—much as Amsterdam rose to prominence when merchants and financiers fled the Iberian peninsula in earlier centuries, when the Huguenots fled France, and when Jews fled from many parts of Europe.

Hong Kong's textile and shipping industries were initiated by immigrants from Shanghai. Those people also established a network of merchants, traders, moneymen, and manufacturers—as Jewish, Italian, Armenian, Parsee, and other immigrant groups did throughout history in various parts of the world.

The Marshall Plan

The post–World War II West German miracle fits this pattern too, though in popular memory its success is associated with the Marshall Plan. The impact of that aid has been greatly exaggerated. Historians and economists (subsidized by governments) are very good at creating and perpetuating myths. At times the myths are about nationalism, falsely suggesting that economic miracles have been due to the genius of people living within arbitrary national borders. At times they are about the extremely beneficial roles of foreign aid. Both types of myth conveniently justify increasing the power placed in the hands of government.

Economists have estimated that, from 1948 to 1950, Marshall Plan aid was between 5 and 10 percent of European gross national product, although those numbers are dubious. European statistics from that period vastly underestimate national incomes because of extensive black markets due to price regulation and confiscatory taxation. There were, after all, no miracles in Europe after World War I, when loans and aid to Europe were also estimated to amount to roughly 5 percent of its GNP. True, the world moved toward lower tariffs after World War II, which it did not after World War I. The correct inference would seem to be that miracles are linked with lowered tariffs rather than foreign aid.

So what fueled the West German miracle? From 1945 to 1961, West Germany accepted 12 million immigrants, for the most part well trained. About 9 million were Germans from Poland and Czechoslovakia. Others fled East Germany's communist paradise. Although the movement of that human capital did not appear on the books at the time, its importance can be inferred from the significantly higher ratio of working persons to total population in West Germany than in other countries in the 1950s and 1960s: 50 percent in Germany vs. 45 percent in France, 40 percent in the United Kingdom, 42 percent in the United States, and 36 percent in

“The West German economic miracle was due, not to foreign aid, but to migration of skilled people and significantly lower tax rates.”

Canada. And when the European inflow stopped, new waves of skilled young employees arrived from Mediterranean lands. In other words, the West German miracle was due, not to foreign aid, but to the same features that brought about earlier and later miracles elsewhere: migration of skilled people and significantly lower tax rates.

The Scottish Miracle

The Scottish lesson, rarely mentioned in history books, shows what else can be behind economic miracles. Scotland in 1750 was a very poor country. The land was of poor quality, and illiterate people engaged in near-subsistence agriculture; there were no navigable rivers; barren mountains and rocky hills hindered communications. The main export at the time was processed tobacco. Yet, less than a century later, Scotland stood with England at the forefront of the world’s industrial nations; its standard of living was the same as England’s, whereas in 1750 it had been considerably lower. How did the Scots do it?

The Union of 1707 made Scotland part of England. It came under England’s system of taxes, laws, and currency and was allowed access to English markets. The union also abolished the Scottish parliament, leaving Scotland without a distinct administration until 1885. That turned out to be the biggest blessing (reminding one of Hong Kong’s later success under distant British rule), as it prevented the banking system and financial markets from becoming an instrument of government finance. The result was a financial market that developed in response to the demands of the private economy.

By 1810 there were 40 independent banks. The orthodoxy of the times held that banks should lend only if the loans were backed by the security of goods in transit or in process, and for no more than 90 days. In contrast, the Scottish banks were free to lend for unspecified periods of time with no tangible securities. The credits of Scottish banks thus became the precursors of junk bonds.

Bills of exchange, the main assets of banks in other countries at the time, were the least important for Scottish banks. The largest volume of loans was made to manufacturers and merchants who received credit backed only by their own signatures with two or more people as sureties. The banks flourished with tiny reserves and made irregular financial reports.

The Scottish financial historian A. W. Kerr captures the specific feature of the country’s financial markets: “The comparative immunity from legislative interference which characterizes banking in Scotland until the year 1844 has been an unmistakable blessing to the country, and has saved the banks from those vexatious and unnecessary distinctions and restrictions which have hampered and distorted English banking. In Scotland, banking was permitted to develop as the country advanced in wealth and in intelligence. Nay, it was even enabled to lead the nation on the path of prosperity, and to evolve, from practical experience, a natural and healthy system of banking, which would have been impossible under close state control similar to that followed in other countries.” The country showed how, starting from scratch, to become prosperous quickly through trade and finance, unhindered by tariffs but covered by a reliable English political and legal umbrella. (Adam Smith was a Scotsman, you know.)

Contrast Scotland in that period with France, where a great majority of requests for charters for financial institutions were rejected until 1857. Only a severe depression that year led to the liberalization of procedures. Yet even in 1870, banking services in France were not what they had been in Scotland at the beginning of the century, and regulations denied small industrialists access to credit.

Scotland stands out, not only for its unique banking system, but also for the emphasis it put on education. In a piece titled “The Output of Scientists in Scotland,” R. H. Robertson presents the relevant statistics. The output of “outstanding Scottish scientists” was at its height between 1800 and 1850 and diminished rapidly after 1870. The reason? The most brilliant Scots migrated—and there was no more Scottish miracle.

Scotland’s relative decline in the 20th century has been correlated with the increasing assimilation of Scottish education and banking practices to those of England (the assimilation of banking starting slowly in 1845). If a large fraction of a region’s most energetic and brightest people are allowed to migrate, and the access to credit of those who remain is constrained, what can one expect but decline?

There are other lessons to be drawn from the Scottish case. Savings were certainly not a precondition for the prosperity of the Scots. They did not have any to speak of. Nor did they receive foreign aid. But once opportunities were open and financial markets developed relatively unhindered, not only did the Scots save, but their savings were put to good use. In Scotland savings moved to private enterprises, whereas in England and elsewhere they went to governments. No state interference was needed to encourage the Scottish entrepreneurial spirit. In contrast to the previously mentioned miracles, there was no large-scale movement of talent from around the world to Scotland. However, the miracle did end with the emigration of Scottish talent, more regulated financial markets, and higher taxes.

What Are the Lessons?

Human creative sparks are always there, probably randomly distributed around the world. Prosperity, though, is due not to new ideas but to the commercialization of new ideas. And the incentives to commercialize ideas depend on taxation and access to financial markets.

The great advantages of private financial markets are that they decentralize decision-making and prevent persistent mistakes. Thus, when small-scale enterprises meet financial tests, they expand. If they fail, the loss to society is much smaller than it is in the case of failed grandiose government-sponsored projects—which frequently are not allowed to fail.

Continued spending on such projects is justified by a large army of government-sponsored economists, the priesthood of our times, who never fail to come up with half-baked theories of market failures to be remedied by smart, altruistic government regulators and bureaucrats. The result of this myth creation is that good money is thrown after bad.

Economists in the future may estimate exactly how much of the spectacular performance of the U.S. economy since World War II can be attributed to the large movement to America of extremely skilled, ambitious, well-connected people from around

"If and when the rest of the world retains its talented people, the United States will no longer be able to count on attracting them to cover up its costly policy mistakes."

the world, a world that until 10 years ago was hostile to initiative and hope. Then we will know how much the transfer of that unmeasured human capital helped cover for many costly and mistaken U.S. government policies. What should be clear from the historical evidence is that when and if the rest of the world retains its talented people, the United States will no longer be able to count on attracting them to cover its costly mistakes.

Governments have a number of options for increasing growth rates. One is to offer a package of taxes and benefits that would attract more talent and capital from abroad. Because such policy may discourage growth elsewhere, it could lead to retaliations. A better alternative would be to encourage more domestic entrepreneurship. That can be done by lowering both income and capital gains taxes, which would rapidly both increase the sums of money people would be ready to invest as venture capital and speed up the redirection of funds toward financing entrepreneurial ventures. Both effects would lead to greater efficiencies—squeezing out mistakes (and thus costs) that prevent higher growth rates.

How best do we put numerical values on wealth creation? Certainly not by government statistics that reflect mismeasured, backward-looking aggregates. The most reliable measure is instead the significant changes in the value of market securitizations—measured in a relatively stable unit of account, gold, rather than a floating paper unit. That is because the opinions of a wide variety of people who back their opinions with money have proven to be a better predictor of where things are heading than are the opinions of all those who do not.

Changes in the aforementioned value are not a perfect indicator of things to come. Nothing is. But they are a better and more reliable measure of wealth creation than are the alternatives. The one important caveat is that financial markets must have the proper depth. That is, security markets must be able to reflect expectations about the policies of government and the central bank, whose laws, policies, and regulations affect the management of companies. When there are few sources of information in a society, or if information is controlled and the players' hands are tied, the stock exchanges will not fulfill their roles. Without proper depth, they will become decapitalized.

Societies that, for political reasons, put impediments in the way of information—as China did when Xinhua, the state-run central news agency, set restrictions on all aspects of Dow Jones's business in the country—will see the same wild fluctuations on their stock exchanges that New York's exchange saw a century ago, before the Dow Jones newsletter and the innovation of annual reports. When that happens, neither security markets nor official statistics will tell us much about what is happening to growth and wealth creation. Remember: on paper, countries were growing wonderfully under communism, but those of us who grew up under communism all knew that political statistics about growth were all one great lie.

The Pseudoscience of Macroeconomics

Though the pseudoscience of macroeconomics was a myth and not a lie, it left in its wake devastating wreckage, unpleasant surprises, and a confusion of confusions. Why did it become a myth? The emphasis on national aggregates hid the reality that in one country things that people wanted were being measured, whereas elsewhere things that the rulers and the establishment wanted were being measured. The fact that behind the aggregate counting there was, initially, a strong assumption that the relation between governments and citizens is, as in a private transaction, based on an exchange of services, was soon forgotten. The macroeconomic models, summarizing the working of the economy in a few simple-minded equations, have led to the same predictions whether "production" and "output" refer to something disastrous or something positive.

Since employment by governments and governments' "output" have been added, respectively, to employment and to whatever was produced in the nongovernment sector—and since there are good reasons, although not macroeconomic ones, for governments to intervene at times to do constructive things—it is no wonder that government expenditures were found to create both jobs and output. By using those numbers unquestioned, economists transformed, with the help of extensive government subsidies to bureaus of statistics and to academics, a self-serving political idea into a neutral-sounding "scientific" debate about numbers and statistical methods, keeping political institutions out of sight. Macroeconomics thus became a nonthreatening theory that could be taught at many universities around the world.

The students became teachers and continued to try to understand the myth of macroeconomics and the illusion of comprehensible national aggregates. By the time some of them noticed that the emperor had no clothes, they may have faced the dilemma of the astronomer Kepler, who, although not believing in astrology, wrote treatises about it because the monarchs paid for them.

Economists have had either to do as he did and disguise their true beliefs or to drop out of the "scientific" enterprise. The mediocre economists have stayed and sustained the enterprise unquestioningly, writing most of the "scientific output," checking it, publishing it, and insisting that everyone should go through channels controlled by them. That is how false ideas have always been turned into "science."

To conclude, the broadest historical evidence suggests that prosperity would be hindered less if governments just created the institutions that make it possible for entrepreneurship and financial markets to flourish. We can be confident that the idea that governments can frequently do more than that is a consequence of government-subsidized myth creation. ■

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New staff in development, government affairs

William Niskanen, José Piñera Honored

Cato chairman William A. Niskanen has been selected as president of the Public Choice Society. Previous presidents have included Nobel laureate James Buchanan, Gordon Tullock, and Mancur Olson. Niskanen has published numerous works on public choice theory, including the acclaimed 1971 book *Bureaucracy and Representative Government*. Later this year Edward Elgar will publish *Policy Analysis and Public Choice: Selected Papers by William A. Niskanen*. The book will be divided into two sections. The first will detail Niskanen's contributions to public policy analysis and include essays on defense spending, trade policy, crime and drug policy, and welfare and the culture of poverty. The second section, addressing public choice and political economy, will feature essays on the liberal economic order, progressive taxation, and bureaucracy.

✦José Piñera, co-chairman of the Cato Project on Social Security Privatization, received the Liberty Award for Opportunity from Americans for Hope, Growth and Opportunity at a dinner at the Waldorf-Astoria in New York on April 15. Piñera, the architect of Chile's privatized pension system, was honored for showing "the way to unleash opportunity for all citizens to build up a real nest egg for their retirement and strengthen the economy at the same time." More than 900 people attended the event, which was emceed by Cato Mencken Fellow P. J. O'Rourke.

✦Executive vice president David Boaz's books *Libertarianism: A Primer* and *The Libertarian Reader* have been issued in paperback by the Free Press. In addition, a Japanese edition of *Libertarianism* will soon be published by Yosensha, and Blackstone will release an audiocassette version of the book later this year.

M. Christine Klein

✦M. Christine Klein has joined the Cato Institute as director of sponsor relations. She will be the primary contact at Cato for Sustaining, Patron, and Benefactor Sponsors. She has previously been an attorney with the Richmond firm of McGuire, Woods, and Battle. Nicole Gray, former director of sponsor services, has left Cato to join School Choice Scholarships, a private voucher program in New York.

Nicole Gray

Peggy Ellis

Derrick Max

✦Derrick Max has joined Cato as director of government relations, with primary responsibility for liaison with the House of Representatives and the governors. He has worked at the American Enterprise Institute and the House Committee on Education and the Workforce, and most recently for Sen. Tim Hutchinson (R-Ark.). He replaces Peggy Ellis, who left to become director of congressional and public affairs for the Republican National Committee. ■

IMF *Continued from page 8*

today. Mexico has experienced currency crises during every election cycle of the last 20 years because of its poor monetary and fiscal policies. In each crisis, the U.S. Treasury and the IMF have come to the rescue, with bailouts of increasing amounts. Had the IMF not bailed out Mexico in 1995, the Asian crisis of today would be far less severe.

The second reason I oppose IMF bailouts is that they are expensive, bureaucratic, and fundamentally unjust solutions to currency and debt crises. Just as profits should not be socialized when times are good, losses should not be socialized during difficult times. It is not just that citizens bear the debt burden that is attached to IMF loans. IMF bailout money goes to governments that have created the problems to begin with and have proven unwilling or reluctant to introduce necessary reforms. Giving money to such governments helps to sustain bad policies and delays necessary reforms.

But what about strong conditionality? Allan suggested that conditionality has little credibility. I agree. Conditionality has not worked well in the past, as the record of long-term dependence shows. But besides its poor record, there's a good reason why the IMF's attempts to impose conditions have little credibility. A country that does not stick to IMF conditions risks having its IMF loans suspended. When loans are cut off, governments tend to become more serious about introducing reform. Note that it is the elimination—not the provision—of credit that induces policy changes. Unfortunately, once policy changes are forthcoming, the IMF feels the need to resume lending. Indeed, the IMF has a bureaucratic incentive to lend. It simply cannot afford to watch countries reform on their own because that would risk making the IMF appear irrelevant. The resumption of financial aid starts the process all over again and prolongs the period of stagnation.

The third reason that I oppose IMF bailouts is that they undermine superior, less expensive market solutions. In the absence of an IMF, creditors and debtors would do what creditors and debtors always do in cases of insolvency or liquidity: renegotiate their debts or enter into bankruptcy proceedings. Both parties would have an incentive to act because the alternative would mean a complete loss. There is no reason why international creditors and borrowers should be treated any differently than domestic lenders and debtors.

Congress should vote for a freer and more stable global economy by denying the IMF the funds it has requested for future interventions. Then it should begin considering whether the IMF serves any purpose at all. ■

"To Be Governed..."

✦He's so serious he's willing to take money from Californians who *aren't* rich Hollywood directors

Funny man Rob Reiner is serious about his belief in early childhood development. How serious? He's leading a campaign for state funding.

—*Los Angeles Times,* Feb. 25, 1998

✦Careful thinking from the IMF

"[Capital] controls can be a good thing, provided they come second to the paramount objective of liberty. . . . Freedom of movement of capital is fundamentally good and positive for the world, provided it applies to economies in good shape."

—Michel Camdessus, managing director of the International Monetary Fund, in *National Journal,* Feb. 14, 1998

✦From whose point of view?

Vice President Gore called The Washington Post's executive editor, Leonard Downie Jr., on Friday. "I've never called to complain" about Post coverage before, Gore began.

"But I thought about it and thought about it, and I decided I just had to call because you've printed a picture of the Earth upside down" on the front page of the paper, Gore said.

—*Washington Post,* Mar. 16, 1998

✦Where is the Racial Classification Appeals Board now that we need it?

[San Francisco Mayor Willie] Brown said he remains committed to finding a lesbian Latina for [an open seat on the Board of Supervisors]. . . .

School board member Juanita Owens, a lesbian who some people believe is African American but is of Portuguese and Native American descent, may have been eliminated for similar reasons.

—*San Francisco Examiner,* Mar. 23, 1998

✦We're shocked, *shocked* to discover hypocrisy in the White House

Mike McCurry, chief spokesman for President Clinton, is pretty engaged these days. . . .

Nonetheless, McCurry, a Princeton University graduate, found time to enter the [NCAA basketball] pool organized by White House reporters.

"Of course, we frown upon ill-gotten gains from wagering," McCurry said. "But I've already filled out my sheet."

—*Washington Post,* Mar. 12, 1998

✦It's a struggle for the FEC, too

Singapore . . . recently ruled that political parties can no longer make television campaign advertisements. . . .

"It is not our objective to increase the level of censorship," said George Yeo, head of the Ministry of Information and the Arts. "Just maintaining the existing level of censorship is difficult enough."

—*Washington Post Magazine,* Mar. 29, 1998

✦Flushing our liberties away

For years, Rep. Joe Knollenberg (R-Mich.) has led the charge against 1.6-gallons-per-flush toilets, those water-savers that conservationists like so much. . . .

"I don't think people want Congress in people's bathrooms," he said.

What does he know? For years Congress has been poking around in people's sex lives (abortion); their TV habits (the V-chip); their religion (school prayer); and their wallets (income tax). What's to keep Congress from getting into toilets?

—Guy Gugliotta in the *Washington Post,* Apr. 2, 1998

✦First in war, first in peace, first in socialism

The urban scholars from foreign capitals studied Washington and yesterday pronounced the city strange—yet familiar.

"The thing that struck me the most," said Vyacheslav Glazychev, of Moscow, is that I found the most Soviet and the most socialist city in the world is Washington, D.C."

—*Washington Post,* Mar. 17, 1998

✦Well, except for the tax part

Coffee and orange juice are part of your morning. But so is *Morning Edition.* You have to pay for coffee and orange juice. We only ask you.

—Annual pledge drive, WAMU-FM, Mar. 30, 1998

✦Charity doesn't begin in this home

Vice President Gore and his wife, Tipper, . . . who paid $47,662 in taxes on income of $197,729, gave away $353 to charity last year.

—*Washington Post,* Apr. 14, 1998

✦The rule of law

Unless you do something that makes it hurt, [the tobacco companies are] never going to do what we want them to do.

—C. Everett Koop on NPR's *Morning Edition,* Apr. 1, 1998

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