A Beginner's Guide to Liberty

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Introduction by Richard Wellings

Liberty needs defending. In Western countries, including the US and UK, governments are taking more and more control over people's lives.

In recent years they have jailed suspects without trial, created large numbers of new 'crimes', cracked down on free speech, and even allowed torture. But the attack on liberty is wider than the gradual drift towards a police state.

The huge increase in taxes over the last century means that today a large part of every pound, dollar or euro earned is confiscated. And much of what is left is taken by regulations – the rising tide of controls that raise the price of the goods we buy. The number of activities that are not in some way directed or limited by governments is becoming smaller.

Political leaders have clearly failed to grasp the benefits of allowing us to live our lives as we choose. By releasing our talents and creativity, liberty brings unprecedented wealth, and promises a bright future built on new ideas. It also gives us protection from the abuses that have come too often from over-powerful states.

Yet the ignorance of our politicians is not unique. Universities may be teaching more students than ever before, but they rarely school them in liberty. Education is in fact dominated by ideas which promote an even bigger role for government.

A Beginner's Guide to Liberty is a small step towards correcting this bias. It is designed for educated people taking a first look at the arguments for liberty. While some general knowledge of economic and political issues is assumed, technical language has been avoided as far as possible. Each chapter looks at a key aspect of liberty and finishes with a short list of further reading for those interested in finding out more.

The guide begins by explaining the meaning of liberty and why the concept is so important. It goes on to look at how markets work, free trade, taxes and government spending, and property rights. These essays set out the benefits of liberty with great clarity and explain why actions that restrict liberty have such a negative impact. Later chapters – on why government fails, bans, welfare, and banking – build on this theme with their sharp focus on the harmful effects of state intervention.

The collection ends by looking at the proper role of government. The final chapter concludes that the sphere of politics should be strictly limited. Indeed, the book as a whole sends a clear message that present-day governments do far too much.

This implies that we do not live in truly free societies, even in the West. Indeed, many aspects of our lives are tightly controlled, whether we realise it or not. But the guide does far more than criticise politicians and officials for holding people back. Its expert authors point to a better alternative – an exciting, dynamic and prosperous world based on freedom. This can be achieved if supporters of liberty win the war of ideas. *A Beginner's Guide to Liberty* is part of that fight.

1 The importance of liberty by J. C. Lester

Liberty is a key concept in politics, economics and philosophy. It is particularly significant to *libertarians* and *classical liberals*, who believe liberty is necessary if people are to live prosperous and fulfilling lives, and who point to the terrible consequences when governments and politicians destroy it. The chapter begins by explaining the meaning of liberty, before exploring these arguments in more detail.

What is liberty?

The words 'liberty' and 'freedom' are not usually distinguished in any significant way and can generally be used interchangeably. They simply have different roots in the English language. 'Liberty' has its origins in the Latin 'libertas'. 'Freedom' comes from the Old English 'freodom'.

It is usually not necessary to discuss what we mean by a particular word. We can take it for granted that others mean the same thing as we do. But this is not always the case with the fundamental words that arise in moral, social and political contexts. One such word is 'liberty'. So it is necessary to give some kind of definition or even theory of 'liberty' before we can say clearly why it is important.

'Liberty' in its most general sense refers to the absence of constraints on something. Here we are interested in the absence of constraints on people by other people.

Liberty can be defined as not being interfered with, or not being imposed on, by others (non-invasive liberty). Not being attacked or robbed is part of liberty; attacking or robbing people is not part of liberty.

It follows that liberty means being able to do what you like with your own body (the principle of self-ownership) and your own property, as long as you are not thereby imposing on the body or property of others. You are free to harm yourself, for example by taking dangerous drugs, but if you harm someone else or damage their property without their consent, you are violating their liberty.

This sense of liberty is what libertarians, or classical liberals, mean when they advocate liberty. It is also the dominant idea of liberty within Western history and it applies to any society that is described as generally 'liberal'.

Such liberty is not only desired by everyone but is generally also thought desirable for everyone, at least to a large degree. It allows everyone in a society to have complete freedom at the same time and it enables violations of liberty to be clearly identified. An aggressor, such as a thief or murderer, is not exercising his or her freedom. Indeed, those who resist an aggressor are protecting their own liberty, not limiting the liberty of others.

An important point is that theft is still theft and murder is still murder even when governments call their thefts 'taxation' and their murders 'war'. Over-powerful governments – with their endless quest to interfere, impose and control – are by far the biggest enemies of liberty.

Deciding for yourself

When governments restrict freedom it becomes harder for people to live their lives in the ways that they choose. Liberty is important because it allows us to flourish, to strive for our ambitions and follow our own paths in life.

Imagine, for example, you are a talented author, but the government censors the kind of books you want to write; or an entrepreneur, architect, filmmaker or inventor, prevented from realising your ideas by government controls.

To give another example – in many Western countries homosexual behaviour was largely or completely prohibited until quite recently. It is still illegal in many parts of the world. Using arrest and imprisonment – and even forced treatment in mental hospitals – governments have prevented many gay people from living fulfilling lives.

Liberty is clearly essential for the pursuit of our ambitions and to satisfy our personal needs. But it is not about being selfish. It also gives us the freedom to help others. Indeed, we can only be moral or immoral to the extent that we are free to choose our behaviour.

And when individuals are responsible for their own actions – free to experiment and live as they choose – we can learn from their mistakes and benefit from the new ideas that are developed. This is one reason why free societies are more vibrant and successful than those suffocated by the dead hand of government.

Economic freedom

In a free society people are at liberty to trade with others and a free market can develop (see chapters 2 and 3). The protection of private property encourages businesses to grow. They make profits by serving the wants of others, and because these profits are kept by the business, rather than confiscated by the authorities, they can be invested – creating even more wealth in the future.

Freedom also allows entrepreneurs to try out different ideas and adapt to changing conditions. Better technology can be developed which enables goods and services to be provided more cheaply. And new inventions can be introduced that transform lives for the better – for example, cures for terrible diseases.

The free market ensures that resources are guided into their most productive uses (and there is no known alternative to the economic calculation of the market). As a result, it leads to large increases in living standards. Liberty is therefore essential for the reduction of poverty.

But governments often act to restrict free markets for political reasons.

For example, politicians might impose high taxes (see chapter 4) or ban trade in certain goods (see chapter 7). Such intervention is generally destructive of both wealth and liberty. It destroys wealth by making it much harder for businesses to thrive, and reduces liberty by aggressively interfering with people and their property.

But isn't some degree of government intervention in markets necessary? Here there is disagreement among libertarians and classical liberals. Some argue that very low taxes are needed to fund a 'minimal state' – a small government which protects liberty by providing services such as defence and a court system. In contrast, others believe that even these services can be better provided voluntarily, through markets and charity, without the need for taxes.

Both viewpoints agree, however, that the levels of government intervention we see today cannot be defended in terms of the protection of liberty. High taxes and strict regulations are economically damaging and violate individuals' freedom.

Equality and social justice

Despite its benefits, governments often restrict freedom in an attempt to achieve 'social justice'. They try to impose some degree of equality (of income or wealth) or to prohibit discrimination with respect to a person's race, sex, disability etc. They may confiscate money from some people to give to others, such as the poor, or force businesses to employ members of certain groups.

But if 'social justice' means not having damaging and unnecessary social differences in society, then only liberty approaches giving us this. Indeed, the operation of the free market helps to remove such differences.

Over time, competition causes differences in income and profit to be reduced. Any remaining differences are necessary to reward people for working harder or developing valuable skills.

Businesses that discriminate against employees or customers without good economic reason are likely to be out-competed by businesses that do not. Free markets are therefore highly effective at addressing discrimination and inequality.

In contrast, government efforts to achieve 'social justice' may be counterproductive as well as economically damaging. For example, if regulations make it harder for businesses to fire women, then they may hire fewer women in the first place – actually increasing inequality between the sexes. Similarly, giving generous payments to the unemployed can deter them from finding a job – actually increasing poverty.

Alternative views of liberty

This kind of government intervention is often encouraged by different views of liberty from the one outlined above.

For example, liberty may be seen as a ‘zero-sum game’. In other words, one person’s loss of liberty is always another person’s gain in liberty. If someone takes my car without my permission, for example, then I lose the liberty to use that car and the taker gains the liberty to use that car.

This view means that we have to balance the ‘liberty’ of a thief, or other aggressor, against that of his victims. Such liberty cannot be maximised for all, it can only be competed over or shared in some way. This creates problems. In particular, other principles – not liberty itself – are needed to decide what forms of liberty should be given priority and for which groups.

One common mistake is to see liberty as democracy and the right to vote. But a majority may vote for politicians that destroy freedom, for example, by stealing the property of a minority group or launching an aggressive war.

Do we consent to such violations of liberty by living in a country and participating in democracy? No. If we try to minimise any damage that our rulers do by voting for the least bad candidate, then that is not consenting to the harm the government causes. We do not consent to crime just because we live in an area where crime is known to exist.

Liberty can also be confused with equality of income or wealth. Socialists might say that poor people lack freedom because they do not have the resources to do what they want. This misunderstanding of liberty is very dangerous. It allows stealing from one group of people in order to transfer resources to another group of people – an act of aggression that violates the principles of self-ownership and private property.

When liberty dies

If governments try to impose such equality then genuine liberty is destroyed. Because people are very different in their skills, talents and desires, they must be strictly controlled to keep their wealth levels the same.

Politicians have often tried to create such 'equal' societies with disastrous consequences. In 'communist' Russia, for example, people were banned from running businesses and the economy collapsed. Anyone who objected to the wholesale theft of private property risked being imprisoned, tortured or murdered by the government. Eventually tens of millions of people were killed by their own government and millions more sent to prison camps.

Such atrocities are commonplace when liberty is sacrificed for political power; when politicians' goals override the freedom of individuals. One of the best known examples is Nazi Germany during World War II. Hitler's national socialist government launched an aggressive war, murdered Jews, gypsies and homosexuals, and forced young men to fight and die in the armed forces.

It is perhaps only when liberty dies that we really grasp its importance. Without liberty we are not free human beings pursuing our own goals and choosing our own lifestyles; we are little more than slaves of the state.

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2 How markets work

by Eamonn Butler

Markets are amazing. They unite the populations of the world in peaceful trade, co-ordinating the efforts of millions of diverse individuals. They enable us all to swap things we don't want for things we do. They steer resources to where they are most valued. They discourage waste and encourage fresh ideas. And they do all this without any governments or authorities needing to tell them how. It's amazing, but it's true. So how on earth do markets actually work?

The markets that people are most familiar with are where people gather in order to buy and sell things, like the collection of stalls you can find in any market square in Europe, selling everything from fruit and cheese through books and clothes to bric-a-brac and jewellery. Or the market I visited in Lanzhou, China, a street lined with rickety sheds from which people sold hot soup, and live fish, and pigeons, and buckets, and bicycle parts, and sunflower seeds and soap. Or specialist affairs, like the world's largest flower market in Aalsmeer near Amsterdam, or the huge camel market at Buraydah in Al-Qassim, Saudi Arabia.

At any of them, hundreds of people are involved in exchange – busily comparing the goods on offer, bargaining, buying, and selling. And this is just the visible tip of the iceberg. Many more markets exist all around us, not in a single place. There are markets for ships, shoes, sealing wax, stocks, shares, stamps, schoolteachers, shop assistants, and an alphabet full of millions of other goods and services too. Exchange is a part of our lives. But why do we do it?

Exchange adds value

Simple. We exchange things because it enables us to get something that we value more in return for something that we value less. Even kids know this. They swap toys they are fed up with for ones that other kids have and which interest them more. They swap football cards and stickers. And the great thing is that both sides benefit from these trades. The toy that you are fed up with might be the bee's knees to some other kid. The Manchester United striker that you have two of might be exactly what the other kid has been searching for – while their spare Liverpool goalie might be the object that you covet most in all the world.

You both gain from this deal, getting something you value more than the thing you give up in return. Nobody would enter an exchange unless they did. It is not that one side has been tricked or forced into accepting something of lower value. Value is in the eye of the beholder. It is a personal, *subjective*, opinion of the things you trade. It is not some public, *objective*, measurable quality of things, like their size or weight.

Different people may value the same thing very differently. Someone under the hot sun of Buraydah might value a pitcher of water more than a diamond, while someone in rainy Aalsmeer might make the opposite calculation. Indeed, the more that people *disagree* on value, the easier it is for them to trade.

Markets harmonise different purposes

That is quite a boon in terms of world peace. We do not have to agree with people's politics, or culture, or religion to trade with them. All we have to do is *dis*agree on value, which is quite easy – particularly in view of how diverse are the world and its products. Dates and wine do not grow well here in Britain, but I can buy them from Iraq and Chile, without having to agree with the producers on anything except the price.

In the schoolyard, the price of a Liverpool goalkeeper is one United striker. But in most markets, when we speak of 'price', we usually think of money prices. Money is nothing special. It is not a measure of something's value. It is simply a good that people will accept in exchange for an item, knowing that it can be easily exchanged later for something that they want. It saves hungry barbers searching around for bakers in need of haircuts: they can cut someone's hair for cash, and then use the cash to buy bread from another person later on.

How price communicates

Yet money prices *do* reveal what it is that people value, and how scarce it is. Suppose that some new, must-have invention requires tin in its manufacture. Everybody wants the new gadget, so producers crank up their output to take advantage of the soaring demand and make some money out of it.

To raise output, they need to buy more tin. They order more from the metal dealers, who order more from the miners. It may be hard to raise mine production overnight, but the miners and the dealers will discover that they can raise their prices, and the gadget producers are still willing to pay them, so strong is the consumer demand. Indeed, they can continue raising prices until consumers eventually baulk at the cost of the new gadgets – or until someone else invents a version that uses less tin.

In the meantime, the rising price of tin sends a powerful signal to the whole market: people are placing a higher value on tin; it has become scarce; more tin is needed; and if you use tin, use less or look for some cheaper alternative.

In response to this price signal, miners will try to increase the production from their mines, or will explore for new deposits. Dealers will try to move their stocks faster, so less of the metal sits idly in their warehouse stores. Gadget producers will research ways of using less tin, or seek out cheaper substitutes. And other inventors will look for ways of satisfying the public's demand with something that does not rely on so much high-cost metal.

Price, then, is a vast telecommunications network linking the whole community, telling everyone how to respond to the new demand. And not just people in the tin market. If other manufacturers find they can save money by switching from tin to chrome, say, then their new demand for chrome will see its price rising too. Users of chrome in turn will look for cheaper substitutes: and so the effect goes on, rippling out through every market.

As a result of consumers wanting a new gadget that uses tin, the whole structure of economic production is altered. And it all happens automatically, in response to signals provided by price. It does not need any authority telling people that we need to produce more tin, or chrome, or all the rest, or cut down on their use. Thanks to the price signals that ripple out, people automatically adjust their plans and co-ordinate their actions to fit in with the demands and the plans and the actions of others.

This is good news for consumers, because it draws scarce resources – like tin – to the places where they are most valued. If producers can capture high prices from supplying a valued resource to customers, then more producers will spend more effort doing just that. Automatically, each and every resource will be steered to where consumers most want them.

Likewise, it is good news for the planet, because if people can respond to price rises by using fewer scarce resources, they will: producers have every incentive to use the cheapest mix of inputs they can find to create products of the quality that consumers want to buy.

A spontaneous arrangement

This arrangement, based on voluntary exchange and the prices that emerge through it, is the *market process*. It is a hugely efficient process, despite the fact that it comes about quite naturally. It does not need to be thought out and consciously designed. It grows up spontaneously – like language or social conventions – and survives because it happens to be useful to us.

This *spontaneous social order* is not perfect, of course: nothing human is perfect. The structure of production does not instantly snap into some new balance just because the demand for tin changes. Things take time to adjust, and people make mistakes along the way. They may know what is going on close to them, but they cannot know exactly what is happening everywhere else. They cannot know how everyone else is responding to the changes, or exactly how they in turn can best adapt to those changing responses.

Information, then, is imperfect – dispersed, fragmentary, and fleeting. A taxi company, for example, needs to know what cars are available, how many customers are looking for transport, and where they want to go. It needs to anticipate surges in supply or demand – such as when the local cinemas close. It needs to know all this not just from month to month, but from moment to moment.

There is no way that a central planner in a large country could collect all the local information needed to make sure that a taxi is waiting for everyone who needs one. By the time the information had been transmitted up to the planning board, it would already be out of date, even before it was acted on. And much of the information required is just the gut feeling of the local people, which cannot be summed up in words and passed on to planners anyway – such as whether an important football game on television is likely to reduce the number of people wanting to go out to the cinema that evening.

The market is able to respond to such dispersed, local, incomplete, personal information far better than any central planning system. Indeed, given the number of different ways of allocating our resources, no central planner could possibly cope anyway.

Should we produce oil or wine? A planner would have to find out what people want, and how much they want it, then decide how many trees or vines to plant, organise pickers, make barrels or bottles which in turn need metal or glass, arrange the appropriate transportation… and this with only two products. When there are millions, the task is millions of times harder. Yet the market process co-ordinates all these production decisions quickly and easily.

Imperfections drive markets

What motivates the market process is not some central plan, but the alertness of individuals who spot that supply or demand has changed, or that consumers have wants that are going unfulfilled, or that products can be made better or cheaper. Their incentive is the profit that can be made by filling these gaps that other people have not spotted. You may call these people *entrepreneurs*. But we are all entrepreneurs, trying to establish where our abilities will be best rewarded – whether we should learn new skills or change jobs, for example.

Profit, though, is earned only by providing what other people want. When it comes to deciding what we should do and what we should make, consumers are in control. It is their votes that count. Not their votes in an election – where a whole package of political policies is decided once every few years. The votes that count in the market are consumers' money votes, which work like a daily referendum on each of millions of different products and services, revealing which ones consumers value most, and deciding which will be produced.

Entrepreneurs do not want to produce things that are identical to others – they want to distinguish their products by making enhancements that will attract customers. That is because they face competitors, and want to give themselves an edge. Competition is not some dead fact of economic life: it is a dynamic *process*, a *discovery procedure* in which entrepreneurs – any of us – try to find out what it is that consumers really want, and how much of their cash they are prepared to vote for it.

Getting the most out of markets

Many of our politicians have been brought up on textbook economics that has an idea of 'perfect' markets in which all producers are identical, prices remain fixed, and supply and demand always balances. No such world could ever exist. It is the very *imperfections* of the market that drive economic life towards constant improvement, progress and efficiency.

Markets need rules, just as a fire basket is needed to contain a fire. But politicians should not try to impose their own rules, or to 'perfect' markets by intervening with taxes, subsidies and regulations. Markets are powerful, and messing with them can produce powerfully counterproductive results. Politicians should therefore simply enforce the rules that make them work – the rules of property, contract and honesty – and enjoy the warm glow of increasing prosperity.

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3 Free trade by Daniel Griswold

Free trade can be defined as the freedom of individuals and companies to exchange goods and services across international borders unrestricted by government. In our daily lives, it means the freedom to buy a shirt stitched in Bangladesh, a banana grown in Ecuador, a car made in Germany, an iPod assembled in China, or a DVD produced in Hollywood.

The argument for free trade begins with the rights of the individual. We should be as free to trade for mutual benefit with somebody across a border or an ocean as we can trade with somebody across the street or in the next town, county, or state. Restrictions on trade violate our freedom to exchange our own property voluntarily with other people who happen to live in a different country.

The division of labour

Free trade allows nations to specialise in what their citizens can do best with the resources and productive advantages they possess. Because of differing climates, resources, histories, and levels of education, some nations will be better than others at growing wheat, building computers, making cloth, or offering holidays at the beach. Workers and companies within nations are better off specialising in what they can do best, and trading their surplus production for goods and services that other nations are better at producing.

Individuals engage in this sort of trade everyday. Think how poor your family would be if your parents insisted on building your own house, making all your clothes and furniture, and growing all your food without buying anything from others. The result would be self-sufficient poverty. Instead, through trade, people specialise in a line of work where they can be most productive, and then trade the product of their work with others in what economists call a 'division of labour'.

As Adam Smith, the father of modern economics, argued, free trade allows the creation of more wealth by expanding the size of the market, thus allowing a finer division of labour among and within nations.

In his famous 1776 book, *The Wealth of Nations*, Smith observed:

> *'It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. ...What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.'*

Comparative advantage

In 1817 a British stockbroker named David Ricardo expanded on the work of Smith with his own theory of 'comparative advantage'. According to Ricardo, even if a nation's workers can produce everything more efficiently than workers in other nations, they can still trade profitably. What matters is what those workers produce most efficiently compared to whatever else they could produce.

So if workers in a rich country are twice as efficient at producing shoes as workers in a poor country but five times more efficient at producing computer chips, it will still be to the advantage of both nations for the rich country to specialise in computer chips and import shoes from the poor country. By specialising in their comparative advantages, workers in both nations can increase their consumption of both goods.

Competition and economies of scale

Free trade allows people to benefit in other important ways as well. By producing for a global market, companies can enjoy greater 'economies of scale'. Once a company has invested heavily in research, development, and machinery to produce, say, automobiles, jetliners, or software, it can produce at a lower cost per item if it produces 100,000 for sale worldwide than if it produces only 1,000 for sale locally. Competition from trade also spurs companies to innovate in creating new and better products and to reduce costs and eliminate waste.

For consumers, free trade means lower prices, more variety, and better quality. We are better off as consumers when many producers are competing for our business rather than just a few or a monopoly. Competition from imports means that we pay lower prices and enjoy wider choices for such items as clothing, food, and consumer electronics than if we were limited to local producers only.

Protectionism

The opposite of free trade is often called protectionism, the practice of governments 'protecting' certain domestic producers from global competition through tariffs, quotas or other regulations. A tariff is a direct tax imposed on imports, either a percentage of the value or a certain amount per item. A quota is a numerical restriction on the amount of an item that can be imported. Other trade restrictions take the form of regulations designed to inhibit imports indirectly through what are called non-tariff barriers.

Almost every government engages in protectionism of one kind or another. It is not uncommon for politicians to ignore the larger benefits from free trade for the nation as a whole in order to benefit a specific producer or industry that wants protection from its foreign competition. Industries seeking protection are typically well-organised and highly motivated and thus better able to influence the political system.

The result of protection is that consumers pay higher prices, the country's resources are employed in ways that are less productive, and the overall standard of living is lower than it would be if trade were free.

Western nations learned a hard lesson in the 1930s about the dangers of protectionism. An economic downturn in 1929 prompted the United States, Great Britain and other governments to raise tariffs supposedly to protect jobs. But rising trade barriers prompted other countries to retaliate, trade levels plunged, and the Great Depression was deepened and prolonged.

Historians believe the international tensions caused by economic warfare contributed to the outbreak of World War II. The events of that time gave support to the saying attributed to the 19th-century French political economist Frederic Bastiat: 'When goods cannot cross borders, armies will.'

The movement towards free trade

After the devastation of depression and World War II, the United States, Britain and about 20 other nations signed the General Agreement on Tariffs and Trade. The agreement committed members to lower trade barriers and to keep them down, and to apply tariff rates equally to other countries.

At the urging of the United States, the nations of Western Europe agreed to eliminate most barriers to trade among themselves. The Common Market not only helped Europe rebuild itself after the war but also helped keep the peace by encouraging economic cooperation. The GATT became the WTO in 1995 and now has more than 150 members.

In the past 50 years, the movement towards free trade has gone beyond the developed countries of Western Europe, North America and Japan. Through engagement in the global economy, the 'Tigers' of East Asia – South Korea, Taiwan, Singapore and Hong Kong – transformed themselves from poor to rich countries.

Beginning in the 1970s, Mainland China, Chile, and a few other less developed nations began to lower their previously high trade barriers, welcomed foreign investment, and dramatically increased their trade with the rest of the world.

The collapse of global communism along with the Berlin Wall in 1989 caused disillusionment with protectionism as a tool of development. Since then, more and more countries have sought to lower their own barriers to trade and participate in the global economy.

Rising living standards

Today the evidence in support of free trade is growing. Those nations that have opened themselves to trade and investment typically grow faster and achieve higher incomes per head than countries that remain closed.

The territory of Hong Kong, for example, has practised free trade since the 1960s. Once a poor outpost of the British Empire, today it is one of the richest cities on earth, in large measure because its people can buy, sell, and invest freely in global markets. In contrast, many of the world's poorest countries, such as North

Korea, Burma, and many countries in Africa, are the most closed to trade.

The spread of trade and globalisation in the past three decades has been one of the main reasons for a reduction in global poverty. Since the early 1980s, the share of the world's population living on less than the equivalent of $1.50 (US) per day dropped by more than half, from 52% to 25%, according to the World Bank. Progress against poverty has been the most dramatic in those countries that have most aggressively opened their economies to the rest of the world, such as China, Vietnam and Chile.

Better conditions and more cooperation

Critics of trade will sometimes point to the poor working conditions in less developed countries as a reason why we should not buy their products. But their criticism overlooks the important point that trade is one of the main engines for improving conditions in those same countries.

Our more open world is not engaged in a 'race to the bottom', but one of rising incomes and standards. During the recent era of expanding trade, the world has also witnessed rising life expectancy and literacy rates in developing countries along with declining rates of infant mortality, malnutrition and child labour.

New technologies have changed the nature of trade even though the economic theories in support of it remain unshaken. Almost half of the goods traded between nations are now transported by air rather than by ship, road, or rail. Many of the goods traded by sea are shipped in standard containers, which can be more easily loaded and unloaded at ocean harbours and transferred to trucks or trains. The spread of the Internet and satellite communications has spurred the growth of multinational companies, which coordinate the activities of affiliates located in multiple countries.

As a result, many products are now made through the cooperation of workers in lots of different countries. A jet airliner or an automobile may be designed in one country, assembled in another, and contain parts made by workers in dozens of other countries. An iPod bought by a teenager in the United States or Europe will be stamped 'Assembled in China', but it was designed and engineered in California. An American company supplied the processing chips, a Korean company the memory chip, and Japanese companies the hard drive and display screen.

Tolerance and understanding

Along with the economic benefits, trade also encourages tolerance and understanding among individuals. Trade and globalisation are teaching us to see people in other countries not as mysterious and threatening, but as customers, suppliers, and potential collaborators. Trade facilitates communication. Not only goods and services cross borders but also ideas and people, who then build relationships that tend to break down traditional prejudices.

Historically, cities and countries at the forefront of international trade were also among the most open and tolerant societies of their day. Venice in the 1400s and the Dutch Republic in the 1600s were the leading commercial centres of their time.

They each provided freedom and legal protection to Jews and religious dissenters. Their citizens learned to welcome people of differing religions and races because intolerance was, among its other shortcomings, bad for business. Today, societies open to trade are more likely to be open to freedom of religion and speech.

Trade and liberty

In the end, the argument in favour of free trade comes down to one of basic justice. If an individual wants to trade what he or she has produced for something a person or group of people in another country has produced, the government should not interfere. To use the power of government to forbid a transaction that is beneficial to the two parties involved is to violate the sovereignty of free individuals.

Trade barriers rob people of the rightful fruits of their own labour, distributing the spoils to other people with no moral claim to the confiscated wealth other than political power.

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4 Taxation and government spending

by Daniel J. Mitchell

When nations such as the United Kingdom became prosperous, government was very small. Throughout the 1800s, public sector spending accounted for only about 10 per cent of economic output, not only in Britain, but also in other rapidly-growing Western nations. This meant low taxes. Indeed, most nations in Europe and North America did not have income taxes until about 100 years ago.

Today, by contrast, governments are much larger. In the United Kingdom, public sector spending now consumes about 50 per cent of economic output. Taxes have also climbed dramatically, though not as fast as spending. This is why Britain – like most other nations – has enormous debts.

Is bigger government good for the economy? Every bit of government spending winds up in somebody's pocket, so it sometimes seems as if government is a big Santa Claus that provides things like roads and health care. Others just look at the taxes (and borrowing) that pay for government spending and conclude that government takes money from people and is a barrier to growth.

But it is a mistake to look at only one side of the equation. It is important to look at the costs and benefits of both taxes and spending. This makes the analysis a bit complicated. Government spending can be good or bad for economic performance, depending on both how the money is being spent and how it is being collected.

Economic research suggests, however, that government is far too big in all industrialised nations. When the public sector is too large, economists say that labour and capital are being misallocated, which is a more complicated way of saying that money is being diverted from more productive uses.

A large government also means that the tax burden is more likely to be excessive, meaning high tax rates that discourage work, saving, investment, and entrepreneurship. Big public sectors are also financed by borrowing, which diverts money from the private sector. All of these things – spending, taxes, and borrowing – are a burden on the economy. This means lower growth, higher unemployment, and less competitiveness.

Less government but also smarter government

This does not mean all government spending is bad for the economy, or that there should be no taxes. Public sector spending, for instance, can be either beneficial or harmful. Spending on 'public goods' such as police protection can help an economy prosper by creating the conditions for markets to function. 'Capital spending' on roads and schools can also generate benefits if done properly. That's the good news.

The bad news is that economic performance is undermined by 'transfer spending' on things like welfare benefits, and 'consumption spending' on things such as health care. Unfortunately, most government spending today is devoted to transfers and consumption.

Good tax policy

The same analysis applies to taxation. Taxes presumably are never good for growth, for instance, but some taxes do more damage than others. The simple rule for economists is that the government should raise revenue in a way that minimises the negative impact on the economy. These three simple principles are a good guide:

- **High tax rates are more damaging than low tax rates** – Politicians often say they want higher taxes on things such as tobacco because they want to discourage smoking. Setting aside whether government should be trying to control people's lives, the politicians are correct about the economic impact. Taxation is an effective way of discouraging behaviour, and high tax rates obviously hurt more than low tax rates. The same analysis applies to taxes on work, entrepreneurship, and other forms of productive behaviour. But since economic growth only occurs when more people earn more income, this means it is very important to keep tax rates low, particularly for personal income tax and corporate income tax.

- **Extra taxes on saving and investment are very costly** – Every economic theory agrees that saving and investment today is necessary to have more prosperity in the future. Yet many governments impose extra layers of tax on income that is saved and invested, which is sometimes referred to as 'double taxation'. Taxes on dividends, interest, and capital gains, as well as wealth taxes and inheritance taxes, make it much less attractive for people to save and invest. This means the tax rate on income that is saved and invested is much higher than the tax rate on income that is consumed. Not surprisingly, people respond with more consumption and less saving and investment. This hurts long-run economic performance.

- **Special tax loopholes reward economic inefficiency** – Many tax systems are riddled with credits, deductions, shelters, exclusions, loopholes, and other special arrangements. These create complexity and enable corruption, but they also have bad economic consequences. In a normal market, people are rewarded for making investments that generate the most wealth (better to get a 10 per cent 'rate of return' instead of a 5 per cent 'rate of return'). But if the tax system discriminates in favour of certain activities, that lures entrepreneurs and investors to put money in projects that produce tax benefits rather than to invest money in projects that produce growth.

To boost prosperity, politicians should design tax systems that recognise these three principles. The flat tax would be a good approach, and this simple and fair tax system has improved growth in Eastern Europe. But the flat tax is good because it generally means a low tax rate, not because there is a 'flat' tax rate. Until recently, Iceland had a flat tax, but the rate was nearly 37 per cent. Nations such as Singapore, which has a 'progressive' tax system with a top rate of 20 per cent, had much better tax regimes.

Analysing the costs and benefits

Determining whether various types of government spending are good or bad for the economy requires an analysis of the costs and benefits. The following set of questions can be thought of as an economic test for government programmes. If all the answers are positive, then that particular programme or activity has a positive impact on economic performance.

1. Does the programme or activity produce any benefits?
All government spending winds up in somebody's pocket, so there is a benefit in a narrow sense. But the relevant issue is whether a programme or activity generates any benefits to broader society. In some cases, such as a new road in a congested area, there can be significant benefits. In other cases, such as a welfare benefit that subsidises joblessness, there is a negative impact on society.

2. If a programme or activity generates benefits, are those benefits larger than the benefits that would result if the money was left in the private sector?

At any point in time, there is a limit to the amount of labour and capital that is available in an economy. If government spending causes those resources to be used for something with relatively little economic value, such as building a wind farm, then those same resources will not be available to the productive sector of the economy. And if the benefits of the wind farm are less than the additional output that the private sector would have produced, then the *net* effect of the government spending would be negative.

3. If a programme or activity generates benefits that are larger than those generated by the private sector, are they large enough to offset the damaging impact of taxation or borrowing?

Last but not least, it is important to measure how government spending is financed. The public sector spending is only pro-growth if the *net* benefit is large enough to compensate for the economic damage caused by taxation (or borrowing). The answer, of course, depends on the tax and how it is collected. Even very important and effective forms of government spending, for instance, might be net negatives if they are financed by higher tax rates on personal income. But those same types of public sector spending might be economically justifiable if financed by a low-rate tax on consumption.

The three-part test obviously is simplified. In many cases, the economic damage of government activity extends beyond the impact of diverting resources away from the private sector and the cost of raising revenue.

Certain government regulations, for instance, impose heavy costs on the private sector. Likewise, programmes to subsidise education, health care, housing, and retirement generally reduce incentives to save. That has a negative impact on economic performance above and beyond the effects discussed above.

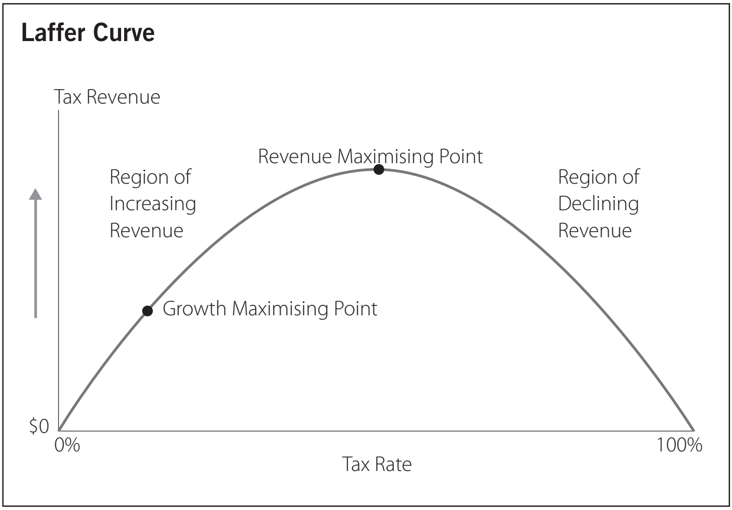
Another issue is the extent to which government activity encourages the misallocation of private resources. Many industries now assign some of their most capable people to tasks such as complying with government rules and lobbying for government favours (or, more honourably, lobbying against government intervention). The nation's economy surely would be more prosperous if these people could use their skills in productive ways.

The Laffer Curve

The short analysis above provides a useful framework for understanding the role of taxation and government spending. However, there are a three further policy issues that deserve a brief mention, starting with the Laffer Curve.

Most politicians naively assume that there is an automatic and fixed relationship between tax rates and tax revenue, so they think they can double tax revenue if they double tax rates. This is a flawed approach, since it overlooks the fact that taxpayers can change their behaviour in response to new incentives.

The Laffer Curve shows that government will collect zero revenue at a zero tax rate, but that it also will collect zero (or very little) revenue when the tax rate is 100 per cent. After all, few people



will produce if government seizes all their earnings. The revenue-maximising tax rate obviously is somewhere between 0 per cent and 100 per cent.

A key point is that the growth-maximising tax rate is lower than the revenue-maximising tax rate. Economic research shows that the long-run revenue-maximising tax rate is probably around 30 per cent. The growth-maximising tax rate, by contrast, will be much lower. (Any tax will be bad for growth, but as noted in the discussion above, some taxes are needed to finance public goods and other pro-growth forms of spending).

Keynesian stimulus

During the 1930s, economist John Maynard Keynes argued that a weak economy could be boosted if the government borrowed money and spent it. According to the theory, this new spending would put money in people's pockets and the recipients of the funds would then spend the money and boost the economy as cash began circulating.

The Keynesians also said that some tax cuts could have the same impact since the purpose is to have the government borrow and somehow put the money in the hands of people who will spend it.

Keynesian ideas have a rather glaring logical fallacy. They overlook the fact that, in the real world, government can't inject money into the economy without first taking money out of the economy. Any money that the government puts in the economy's right pocket is money that is first removed from the economy's left pocket.

There is no economic boost since every dollar that is spent on a stimulus package is a dollar that the government first must borrow from private credit markets. Keynesianism doesn't boost national income, it merely redistributes it.

Real-world evidence also indicates Keynesian stimulus does not work. Presidents Hoover and Roosevelt tried the policy in the 1930s and it did not work. Japan tried the policy in the 1990s and it did not work. And it has not worked this decade for politicians in many nations, including the United Kingdom and United States.

The Rahn Curve

Just as there is a Laffer Curve showing the tax rate that maximises revenues, there is also a Rahn Curve that seeks to identify the level of government spending that maximises growth.

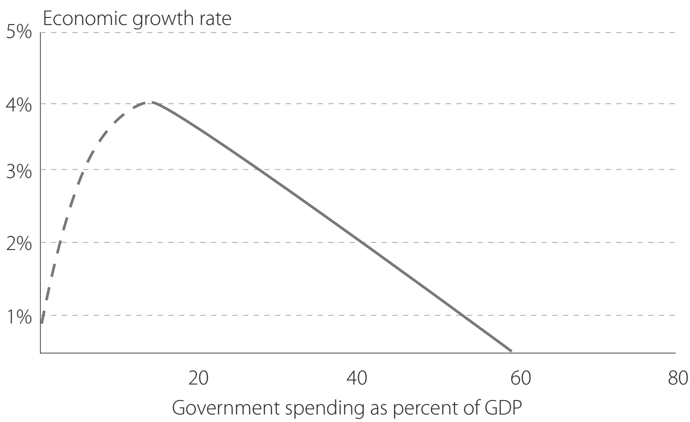
The Rahn Curve is based on the notion that there is very little economic growth or activity when there is no government. But as government begins to spend money and provide sound institutions and public goods, this enables a market economy to grow and prosper.

At a certain point, however, governments begin to spend money on transfer programmes and consumption programmes. These types of spending tend to undermine economic performance. It may also be true that spending of all kinds becomes less efficient as government becomes larger.

Research suggests that the growth-maximising level of government may be about 20 per cent of economic output, or perhaps even less based on long-run historical data. This is very far below the level of spending in North American and European nations.

Rahn Curve

Economy shrinks when government grows too large



Conclusion: high tax economies will lose out

Government spending is a major part of almost all advanced economies. There are a few small-government economies, such as Hong Kong. But many nations – especially in Europe – now have very large governments. Even the United States has become more like Europe under Bush and Obama.

The evidence indicates that this shift to bigger government has serious economic consequences. A larger burden of government diverts resources from the productive sector of the economy and results in a more costly tax regime. In a competitive global economy, nations with excessive spending and high taxes will lose jobs and investment to countries with more responsible levels of spending and low taxes.

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5 Property rights

by Karol Boudreaux

Secure rights to property play a vital role in promoting growth, alleviating poverty and conserving scarce resources. Property rights provide people with incentives to create, innovate and trade voluntarily with others. They give us a reason to conserve and maintain things and they also help protect us from others.

Because they play these roles, property rights are a part of the foundation that supports a free and prosperous society. Another way to think of property rights is that they are part of the glue that holds societies together.

What are property rights?

Property rights are rules that have developed to help solve problems. Just as people make rules to help traffic flow more smoothly and to avoid collisions, people have, over time, created rules about who can use different kinds of property, how they can use property, and how they can, or cannot, transfer that property.

Property rights encourage people to behave in particular ways (for example, 'better replace that leaking roof, otherwise the house will be ruined.') And they let people know what will happen to them if they break the rules (for example, 'if you cut down your neighbour's apple orchard without her permission you'll have to pay her.')

These rules can be formal and expressed in law and regulations, or they can be informal, unwritten, and a part of the social norms a society follows.

Both kinds of property rights exist simultaneously – formal rights that are supposed to be enforced fairly by the government, and informal rights that are supposed to be enforced by social pressure. So long as people respect the rules, both formal and informal property rights can work effectively to promote growth, conservation and individual freedom.

More specifically, if you own something you normally have a number of rights associated with the thing. Typically, you may:

- Use, or not use your property
- Profit from the use of the property (sell the apples that grow in your orchard)
- Allow others to use your property (for example, by renting it out)
- Sell your property or give it away (via inheritance or gift)
- Keep unwanted people off your property

We can have these rights in a variety of things:

- Real property – this means land and things, like houses and factories, that are attached to the land.
- Personal property – this means the stuff we own that is moveable, such as your mobile phone, your clothing, your jewellery.
- Intellectual property – this kind of property is often the result of creative or artistic efforts, such as a new invention or a piece of music. Patents and copyrights are types of intellectual property.

And finally, these rights can be 'held' by different people or groups:

- By individuals, organisations (partnerships or corporations) or by groups of individuals (this is communal property)
- By the government (an example is national parkland or, in many cases, the land upon which government schools are built)
- Sometimes no one holds property rights to a thing or an area. In these cases the area or thing is known as an open-access resource (the clearest example is the high seas, which are not owned by anyone or by any group or government).

Why do property rights work?

Property rights work because they provide people with incentives to behave in particular ways. When people hold secure rights to property they are more likely to invest in and improve, protect and conserve, and maintain their property than they are if they hold limited or no rights to the property.

Improving, protecting and conserving property is costly. People go to the time and effort to do these things when their property rights are secure. If these rights are not upheld by some authority, people will spend much less time and effort protecting their property.

Why protect and conserve property? The answer is because you expect to benefit from these actions at some point in the future. You fix the leaking roof of the house because if you don't the house will be ruined. If the house is ruined you won't be able to make as much of a profit on it when you sell it *or* you'll find it less pleasant to live in – either way, you'll suffer some cost from inaction. Property creates incentives to maintain and conserve because your efforts are tied directly to a benefit you reap.

Of course, not every property owner can fix or conserve her property at all times. At any given moment an individual may lack funds to make needed repairs. However, the general tendency will be to take care of what you own because, from your perspective, it's a smart thing to do. By taking care of your property today you stand to gain in the future.

Promoting trade and economic growth

When people have secure rights to property they trade with other people. Without property rights trade is difficult, if not impossible, and so opportunities to benefit from trading are limited.

Another way to think of this is that property rights allow people to allocate scarce resources: for example, their scarce working time and other valuable resources. If societies have generally accepted rules about how to allocate scarce resources they have less conflict related to resource use. In this way, clear property rules promote peace.

But also, when people control their labour and other resources *they* decide how to use these valuable things: some authority does not command them to do one thing or another. This empowers individuals and allows them to pursue opportunities they find appealing. It also provides them with incentives to do things that other people will value.

For example, imagine that you love baking. If you own (control) your labour and are able to save money to lease space, you can open a bakery. You use your labour and your capital in pursuit of a passion, and in the process you trade what you do and what you produce for what other people have (money to buy your cakes and pastries, space to lease etc.).

As a result of the various trades people are better off: you build your business, the landlord uses her property in a profitable way; the consumer has a cake she wants. The billions upon billions of trades that take place world wide each day are based on people having things to trade.

Strong evidence exists to support the claim that people who trade more are more prosperous. In countries where people are free to trade their talents, goods and services with other people, standards of living rise and people, on average, live longer and healthier lives. More trade is the key to economic growth and reducing poverty. Trade depends upon property rights.

Protecting the environment

Because property rights give people incentives to conserve and maintain things, property rights play a vital role in protecting the environment. An example from Africa can shed light on this connection.

Before 1990 the apartheid government of South Africa, which treated black and white people differently, ruled the neighbouring country of Namibia. The government controlled not only the people of Namibia but also the wildlife in the country – except, that is, for wildlife found on land owned by white farmers.

On all other land the government 'owned' wild animals. It made it extremely difficult for black Namibians to hunt legally. Local people had few opportunities to benefit legally from wildlife, but they did suffer costs (elephants trample and eat crops, antelope graze in areas where goats and cattle could graze, and predators attack livestock). This created strong incentives to poach elephants, kudu, oryx, rhino, and to kill predators, such as lions and leopards.

Did the white farmers have the same incentives and behave the same way? They did not; instead, they fenced their lands, voluntarily enclosing wildlife. Many stopped raising cattle and opened private game parks. They had a way to benefit legally from wildlife.

In 1990 a new independent government took control in Namibia. This government eventually changed the property rules in the country and gave rights to manage and benefit from the use of wildlife to local communities. Since the policy began, in 1997, over 50 communities have formed to manage wildlife and benefit from the use of these resources.

Poaching on these community lands has essentially disappeared because now local people benefit directly from the wildlife. They build tourist lodges that create jobs for locals and that generate income; they hunt some animals for their own use; they sell some live animals to other game parks in other countries and, in some cases, they allow trophy hunting.

All of these activities create benefits for local people and all the benefits are tied to the animals. Local people now protect and conserve animals rather than poaching them.

One powerful way to protect the environment is to provide property rights to environmental resources to people who will benefit from protecting the resources.

Empowering individuals

Perhaps the most important role that secure property rights can play is, however, to promote human flourishing. When individuals or groups of individuals are able to decide how to use their resources, people are empowered to pursue their unique talents and to flourish in ways that they find worthwhile.

On the other hand, when authorities (public or traditional) control property they often limit the ability of some groups within society to use resources or to pursue certain careers or opportunities. In other words, property rights are often restricted to limit economic and other opportunities for minority groups, for political opponents, for any disfavoured group. This is a special problem and concern for women in many societies. They face significant discrimination in terms of owning, inheriting, or keeping control of land and other resources.

The key to freedom and prosperity

For all these reasons, secure rights to property are a key institution in terms of unlocking prosperity and human flourishing. They promote trade and the peaceful allocation of scarce resources. They help to alleviate poverty. They provide people with incentives to care for and maintain natural resources, and empower people by giving them opportunities to pursue their unique talents and abilities.

Without these rights, societies are poorer, more conflict-prone, and less able to provide outlets for the unique creative abilities of citizens. Property rights truly are the building blocks of a free and prosperous society.

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6 Why government fails

by Peter J. Boettke and Douglas B. Rogers

There is an old tale that many economists use to set up the discussion of how well the market works in comparison to government policy. A Roman Emperor is asked to judge a contest between two singers. After hearing the first contestant sing, the Emperor awards the prize to the second singer under the assumption that surely the second cannot be worse than the first.

What is wrong with this? Clearly, for the contest to be an accurate measure of talent, the Emperor must let the second contestant sing before passing judgment.

It is similar when we are asked to compare the market economy with government action. We should carefully examine not only how the market economy works but also how government decisions will be made.

The theory of government failure

Markets are not 'perfect' – we discuss possible examples of 'market failure' below - but that should not lead to the automatic conclusion that government policy can improve upon the market outcome. Instead, it may make matters worse. This basic point is often overlooked in efforts to justify government interventions into the market economy.

The theory of 'government failure' was developed to explain why government policy often fails to achieve its aims. The political decision-making process has to cope with several problems. These include the difficulties of calculating costs and benefits, a lack of detailed knowledge of time and place, and attempted manipulations of policy by special interest groups.

In order to compare market outcomes with government interventions, we must take the costs of government decision making into account (letting that second singer sing). Indeed, when we do this, the standard argument, 'markets fail, use government', breaks down.

Why governments can't solve 'market failure'

A brief look at three standard types of 'market failure' – monopoly, externalities and public goods – will help us demonstrate some of the problems that arise when governments intervene.

Monopoly

It is argued that with a monopoly, the single supplier of a good or service has control over the final price of their product. It will use that power to restrict output and raise the price of the good or service being offered. Since there are no substitutes, consumers have little choice but to buy from the monopoly. They have to pay higher prices than they would if there were competition.

The main problem with seeing monopolies as a 'market failure' is that they are usually created by the power of government. Monopoly rights are given to a certain party by government, preventing others from competing. In other words, monopoly is not usually a product of the market economy. In most cases it results from government giving privileges to a special interest group.

Externalities

An externality is a cost or benefit imposed by one party on another party who has no say in the matter. Economists distinguish between negative and positive externalities.

The classic example of a negative externality is pollution. The production process in my factory may spoil the river where I dump my waste. The waste is carried downstream, ruining my neighbour's crops. Because I do not have to pay the full cost of my decision to pollute, I will *overproduce* the negative externality of pollution.

Positive externalities reflect the opposite effect; others will benefit from the effects of my decision, even though they do not have to pay any of the costs of my decision.

Take education, for example. The more educated I am, the more I will be able to contribute to community life. However, since the community will benefit more than me, I will *underproduce* education if I have to pay for it myself.

In theory governments can correct this problem by taxing activities that produce negative externalities and subsidising activities that produce positive externalities. They can set the levels of taxes and subsidies so that the benefits of the activity are maximised for society as a whole.

This solution assumes, however, that government can measure the costs and benefits involved. There are major problems with this.

First, only those directly affected really know the costs and benefits of an activity. This means any government solution is likely to fail because there is no way to access the required information (for example, to set an appropriate rate of tax or subsidy).

Second, the people involved may agree a contract to solve a dispute over an externality. For example, if I value a clean river more than a factory values polluting it, I can pay the factory not to pollute. In such cases there is no need for the government to get involved.

Public goods

Public goods are our final example of 'market failure'. There is little incentive for profit-seeking businesses to provide some goods in the market. This may be because it is impossible to exclude those who do not pay, and because the consumption of the good does not prevent others from consuming the good.

Typical examples might include law enforcement, national defence and environmental goods such as clean air. The lack of a profit incentive means such public goods may be underprovided unless government acts by providing them itself.

Yet most of what government provides as ‘public goods’ could be supplied at least partly by the market. For example, law enforcement by private security and defence by hired fighters (mercenaries). Even environmental goods can be supplied by profit-seeking businesses when suitable property rights allow the exclusion of those who do not pay. And let’s not forget that attempts by governments to supply ‘public goods’ will still face the problems identified by the theory of government failure.

Markets as problem solvers

Our brief look at monopoly, externalities and public goods has shown that government attempts to correct apparent ‘market failures’ may often be misguided. Indeed, economists have given reasons why the market might not be as bad as policy-makers are inclined to believe.

So far, we have neglected the true potential for the market to self-correct. Today’s inefficiencies are tomorrow’s profit opportunities. To ignore this basic insight is to be biased in favour of government intervention.

The policy-maker looks at the economy as a snap-shot in time and determines whether the market meets his or her ideal criteria. Instead, the economy should be seen as an unfolding moving picture through time. In other words, it is the less than ideal conditions that set in motion the entrepreneurial actions that solve problems and improve the situation.

Many economists and political scientists have also developed a set of practical criticisms of government solutions. This is where our tale of the Roman Emperor kicks in – we have to hear the second singer sing by examining the way that choices are actually made in politics. We do so using the same principles that we use to address decision making in the market economy. This area of research is called public choice.

Reasons for government failure

The economic analysis of political decision-making assumes that people behave in basically the same way whether they are inside or outside government. Individuals in the voting booth and in Congress or the Houses of Parliament are the same individuals as those at the grocery store or in company boardrooms.

These individuals are neither pure sinners nor pure saints; they are the same as you and me. They have purposes and plans and they use the resources at their disposal to achieve their purposes and plans as effectively as possible.

We have two sides to politics - demanders of government services (voters) and suppliers of those services (politicians). If politics worked perfectly, then the policies adopted would accurately reflect the wishes of the voters. In other words, voter's preferences would be fed into the workings of politics and policies would come out of the other end that reflected the popular preferences of the day. We would get the government we desired.

This simplistic view of the political process does not describe reality. Why does the government we have fail to live up to such an ideal?

We have already argued that government cannot calculate costs and benefits. Government also has to operate without the knowledge of time and place provided by market prices and the discipline of profits and losses. At a fundamental level, policy interventions into the marketplace are grasping in the dark. We also made passing reference to the role that special interest pressure groups play in political decision making. Let's explore that a bit more.

Voters and interest groups

Politicians can usefully be looked at as election seeking entrepreneurs. By definition a politician wants to get votes and money to pay for his campaign. If he is unable to obtain these votes and contributions, he will not get elected.

If an election is coming, politicians will try to gain voters' support. To do this, they will concentrate benefits in the short run and spread the costs over the long run. For example, they may increase government spending on popular projects before an election, even if it means raising taxes in the long term.

Politicians also know that many people don't bother voting and that a lot of voters do not think it is worth taking the time to learn much about political issues. In contrast to these unorganised groups, there are special interest voters who know and care a lot about a particular issue.

Politicians know they will gain little by focusing their efforts on the ill-informed mass of voters and those that don't vote at all. They will benefit most from concentrating benefits on well-organised and well-informed special interest groups, while spreading costs on everyone else.

We have thus identified two sources of political failure – the short-sighted bias of politicians and the concentration of benefits on special interest groups at the expense of the wider public. But it gets worse.

These special interest groups will often use substantial resources to try to get their favoured policies passed. They may spend large amounts of time and money trying to influence politicians. This is called 'rent seeking'. They will also try to make sure that they control any government regulation of their own behaviour. This is often referred to as the 'capture theory' of regulation.

Such interest group lobbying for special favours is what economists call a *deadweight* loss. Overall it produces no value; it expends resources simply to take resources away from others.

Politics vs. the market

Another reason why governments fail to correct economic problems is that the nature of political goods is different from market goods. In the market economy, we can purchase goods individually. We can buy a blue shirt, khaki pants, red Adam Smith tie and a blue blazer (the official uniform of the economist!).

In politics we are forced to 'buy' a bundle of goods. We may like the health policies of one politician, but prefer the foreign policy of another. We cannot choose these 'goods' separately. This creates still more differences between voter's preferences and government policies.

Finally, one of the strongest features of the market economy is that if a business is not satisfying consumer demand, it receives that feedback quickly. It will either have to change what it does or go bankrupt. The market disciplines its participants. The market economy is a profit and loss system, and the loss element is critical to its operation.

Instead of being disciplined by the profit and loss mechanism, politicians are disciplined at the voting booth. The voting booth, however, is slower and more ambiguous. One measure of this is the high proportion of politicians that are re-elected. Politicians turn over a lot less than businesses.

We could delve into many more examples of government failure that public choice analysis exposes. For our purposes, we have laid out the three main reasons for government failure:

- An inability to calculate alternative policies in terms of monetary costs and benefits.

- A lack of responsiveness to demand resulting from the absence of profit and loss.

- The influence of special interest pressure groups, who obtain benefits at the expense of the unorganised and ill-informed mass of voters.

Let markets work

Markets may fail to meet ideal conditions. But this does not mean we should automatically turn to government. Instead, when we follow the advice to ‘let the second singer sing’ we often find that the alternative of government regulation makes matters worse.

We live in a world where perfect outcomes are not an option. When choosing between social systems, we must recognise that we are always dealing with erring entrepreneurs (market) and bumbling bureaucrats (government). Markets fail, and governments fail. However, we have good reason to believe that government failure is more harmful than market failure.

Not only must we always allow the second singer to sing, we must also never judge any one singer based on a first impression. Instead, we have to look at the ability of markets to adjust to changing conditions. In contrast with politics, today’s problems represent tomorrow’s profit opportunities in the marketplace. In other words, markets fail; use the market to solve the failure.

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7 Sex, drugs and liberty: the case against government bans

by John Meadowcroft

Imagine you are sitting down to dinner one evening. You open a bottle of wine when there is a knock at the door. You open the door to find your neighbours standing outside. They tell you that they have decided that you must no longer drink alcohol. They confiscate your wine and tell you that if you drink again they will fine you and perhaps even imprison you.

Most people would consider such behaviour outrageous: what right do our neighbours have to tell us that we cannot drink alcohol? But this is exactly what happens when governments ban things, whether alcohol, tobacco or other drugs, or prostitution, gambling or boxing – things that are all banned in some countries.

Some people may say that bans by governments are reasonable if they result from a democratic vote, but such a vote is really nothing more than people's neighbours telling them what they can and cannot do – just like in the example above.

Laws banning things are widespread: all over the world governments try to stop people from doing things that they want to do, even when those things do not harm other people. This chapter asks whether it is right that governments ban things and looks at the consequences that follow when governments introduce bans.

'The harm principle'

It is usually claimed that things should be banned in order to prevent harm, either to other people or to the person undertaking the activity to be banned. So, for example, drugs like cannabis, ecstasy, and cocaine are banned in most countries to prevent harm to users and other people. Boxing is banned in some countries to prevent harm to fighters, and alcohol was banned in the United States from 1920 to 1933 to prevent drinkers and others being harmed by the perceived evil of alcohol (this particular ban is often referred to as 'Prohibition').

Banning to prevent self-harm breaks what is known as 'the harm principle'. The idea of 'the harm principle' comes from the liberal philosopher John Stuart Mill's essay *On Liberty*, written in 1859. Mill argued that in a free society, people should have the freedom to do whatever they want, as long as they do not harm other people, even if that means they sometimes harm themselves. This means that if someone wishes to take cannabis or alcohol, for example, we cannot physically stop them (although we may try to persuade them not to do so).

To physically stop someone from doing what they want to do implies that we know what is best for them better than they themselves do. The problem is that anything could be banned by following this line of argument. Smoking cigarettes, eating fatty food or spending large amounts of time playing video games could all be banned to prevent people from doing things that other people think are self-harming.

If we try to physically stop people from doing things that we think are self-harming, then very soon we will no longer live in a free society. Instead, we will live in a society where many things are banned or restricted by government. This would be a rigid and regimented society that would not be much fun to live in.

The consequences of banning

Not only does banning things lead to the creation of an unfree society where very few things are permitted, banning also produces lots of very negative consequences.

Banning places markets into the hands of criminals
Wherever things are banned criminal organisations will try to profit by providing them illegally. Banning drives a 'wedge' between the cost of production and the final selling price, ensuring that people prepared to take the risks involved in supplying illegal goods and services can make exceptional profits.

The US prohibition of alcohol, for example, enabled criminal gangs to make huge sums of money supplying alcohol and illegal drinking premises. As a result, many criminals, such as the gangster Al Capone, became very rich during this time.

After alcohol prohibition was repealed in 1933, organised criminals turned to the supply of the remaining illegal drugs, particularly cocaine, where once again huge fortunes were to be made. In 1989, *Forbes* magazine listed the Colombian drug baron Pablo Escobar as the seventh wealthiest man in the world. They estimated that his Medellin drug cartel had an annual income of $80 billion.

Banning increases the risks of already risky activities

By shifting the supply of banned goods and services to the black market, banning increases the risks of already risky activities. For example, the criminalisation of drug users contributed to the spread of HIV and AIDS. Users re-used dirty needles as clean needles were very difficult to obtain without drawing attention to oneself as an illegal drug user.

Moreover, banning drugs like cocaine and heroin increases the dangers of drug use because users must buy drugs without knowing their purity or precise contents, which can lead to overdoses and poisonings.

Banning criminalises people who would not otherwise be criminals

Banning involves the creation of what are called 'consensual crimes' – crimes where there are no real victims because everyone engaging in the 'criminal' activity wants to be involved. This criminalises people who would otherwise be law-abiding. For example, if alcohol was banned tomorrow, anyone who wanted to keep their wine cellar stocked or tried to hide a bottle of beer at the back of the fridge would automatically become a criminal.

The impact of the criminalisation of otherwise law-abiding people can be seen in the thousands of people currently in American prisons solely for non-violent drug-related crimes. Many of these convicts are young people whose prospects of a 'straight' career are badly damaged because they have been in prison.

Banning diverts law enforcement resources away from conduct that harms other people

The enforcement of any ban is costly: the detection, arrest, prosecution and punishment of people who engage in illegal activities costs money. In 2006, for example, the annual budget of the US Drug Enforcement Administration was $2.4 billion. Bans mean that government is bigger than it would otherwise be and taxes are higher than they would otherwise be.

Banning also imposes *opportunity costs* on society – the costs of the goods and services that could have been produced if the money used to enforce the bans had been spent on other things. As a result of the banning of many drugs, for example, a large proportion of the money that is currently spent on law enforcement goes to prevent and punish consensual crimes. This is an opportunity cost because the money could have been spent preventing crimes with real victims, such as murder or burglary.

Banning increases public ignorance

Some people say bans are needed because many people do not fully understand the likely consequences of their actions. But this argument is flawed because by their very nature bans increase public ignorance. Where boxing is illegal, for example, people who continue to fight outside the law will be even less likely to get reliable information about the risks of boxing.

Banning almost never works and is almost always counter-productive

The costs outlined above might be considered worthwhile if bans worked, but the evidence suggests that bans rarely work and are usually counter-productive.

The banning of recreational drugs is a good example. In the US, cannabis has been illegal since 1937; in Holland it has been tolerated since 1970 and today it may be freely bought from licensed 'coffee shops'. In 1997, 33% of the US population aged 12 years and over had used cannabis in their lifetime. In Holland, by contrast, only 16% of people aged 12 years and over had used cannabis in their lifetime. Although the difference is less marked when older age groups are analysed, the evidence shows that cannabis use is greater in the US than in Holland.

Banning handguns and other firearms has been similarly ineffective in combating violent crime. For example, the Republic of Ireland banned firearms in 1971, a year in which there were 10 murders in that country. Since 1995 there have never been less than 38 murders per year and in 2005 there were a total of 54 murders.

In Jamaica guns were banned in 1974 when the country's murder rate was 10 per 100,000 people every year. Since then the murder rate has continued to rise, not falling below 31 per 100,000 people per year since 1995. There is no evidence that 'gun control' reduces violent crime. Rather, it ensures that only criminals will possess guns.

There are a number of reasons why bans and controls almost always fail. One reason is that people will try to find a way around them. High taxes on tobacco lead to cigarette smuggling and counterfeiting; banning drugs leads to vast networks of illegal supply; the outlawing of prostitution leads to the provision of 'massage' and 'escort' services. Just because government passes legislation to ban something, it does not necessarily follow that it will cease.

Also, for a ban to be successfully enforced requires a level of government spending and interference in people's lives that is unacceptable in a free society. The 'War on Drugs' costs the US government billions of dollars every year and has seen thousands of US citizens imprisoned, yet drugs continue to be widely available. It is hard to imagine the price (in every sense of the term) that would have to be paid in order to make a significant impact on the supply of illegal drugs in America.

Bans may also fail because they address the *symptoms* rather than the *causes* of social problems. For example, gun control is not a solution to violent crime. Violent criminals are perfectly capable of illegally acquiring guns or finding other ways to maim and kill people, such as using knives. To reduce violent crime demands a much cleverer approach than just trying to stop criminals from using one type of weapon.

It is also the case that bans often seem to promote the very behaviour they are supposed to stop. For example, one American study found that measures to stop teenage smoking by restricting the sale of cigarettes to young people had exactly the opposite effect. In towns where more restrictions on the sale of cigarettes were introduced, teenage smoking rose compared to towns where no new measures were introduced. Similar results have been found for controls designed to reduce teenage drinking and to reduce car accidents by lowering speed limits.

Exactly why bans should have this opposite effect is not entirely clear. It is probably related to the 'forbidden fruit effect' – whereby activities that are forbidden become more attractive, especially to young people.

Liberty and personal responsibility

The evidence supports the view that all actions that do not harm other people should be legal. This does not necessarily mean that we approve of activities like drug use or prostitution. Rather, it means that we believe that what people do should be a matter of personal choice, as long as they do not harm other people.

It is possible to believe that people should not do something *and* to believe that that activity should be legal. It simply means that we believe that where people's actions do not harm other people they should make their own moral choices.

A free society based upon the principle of liberty is one in which other people cannot decide whether we drink alcohol, smoke tobacco or consume other drugs, or engage in prostitution, gambling or boxing. Equally, it means that we cannot decide for other people. It is a matter for each individual to make their own choices. We may find that when people are given responsibility, they act responsibly. That is the basis of a free society.

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8 Welfare without the state by Kristian Niemietz

Government welfare systems were created to help the poor, sick, elderly and unemployed. Politicians believed that transferring resources to these groups would end poverty and make society more equal.

But they were wrong. Government welfare has been disastrous, both for the economy and those it was designed to help. It is the main reason taxes are so high in Western countries, accounting for about half the money governments spend. It has also trapped vast numbers in poverty, while often providing very low-quality services in areas such as health.

The poverty trap

For many people, the welfare state's so-called 'social safety net' is more like a spider's web. In the UK, for example, around 5 million working-age people – most of them capable of working – receive out-of-work payments. More than half of them have done so for several years.

The problem of long-term dependence on welfare benefits is found in all Western countries. In the government housing blocks of London's Hackney, Berlin's Neukölln, or Paris's Clichy-sous-Bois, many residents inhabit a parallel universe. They share the laws of gravity with the rest of society, but not the social and economic laws.

Outside of the parallel universe, people usually improve their economic situation if they increase their work effort, improve their qualifications, put money aside for a rainy day, and maintain social networks. Inside of this universe, these activities are penalised.

Small sums earned or saved lead to a withdrawal of benefits. Even moving in with a partner can mean payments are stopped. Trapped in the web of the welfare spider, people do not just lose formal qualifications, but also the social habits associated with work.

While leaving employment has been made relatively painless, barriers have been erected against re-entry. Out-of-work benefits often pay as much as low-skilled jobs.

People who argue that welfare benefits are *too low* look at the sums paid out in cash, but that is only half the story. People on welfare usually get other valuable benefits, such as free or subsidised housing.

Those who want to work also face huge obstacles created by the government. Minimum wages and strict employment regulations increase the cost and risk of hiring workers. Government controls, as well as high taxes, make it much harder for people to start their own businesses.

There is therefore a strong case for ending the restrictions that stop people providing for themselves. This means introducing free-market alternatives to welfare payments, and removing the barriers to entry into the workforce.

Instead of relying on the government, people would insure themselves against the risk of unemployment, sickness or disability. Insurance companies, trade unions and voluntary associations would cover the risk of income loss. It would be in their financial interest to help jobless people to find work and, where necessary, provide them with training.

They would ensure that payments went to those genuinely looking for employment, rather than those wishing to depend on others for a work-free lifestyle. Private welfare provision would therefore be far more effective at helping the jobless find employment.

Private charities can provide an effective non-government alternative in cases not covered by insurance schemes. They tend to be better at tailoring help to reflect individual needs. Their more personal approach also makes it easier to weed out fraudulent claims – a major problem in state welfare systems. Unfortunately government controls and high taxes have made it far harder for charities to fulfil this valuable role.

Old-age provision

The problems of the poverty trap are mirrored in government old-age provision. State pensions and benefits have discouraged people from saving for themselves. Worse still, the rising cost of government schemes now threatens effectively to bankrupt many Western countries.

Governments have promised a pension to everyone but they have not put away money or bought assets to back their promises. In reality, state pensions are paid from current taxes, just like any other welfare benefit.

This creates enormous unfairness. The amount received bears little relation to the amount paid in taxes. Instead it is decided by politicians and therefore often follows political considerations. To buy votes, politicians grant special favours to influential groups.

In contrast, people in a free society would save and accumulate reserves while of working age, and use them up in old age. Since saving would take place over an extremely long time horizon, most people would probably choose to acquire assets in one form or another, to benefit from the returns they yield. People would invest in some combination of stocks, bonds, real estate, and perhaps a home of their own.

Since people's beliefs differ hugely, so would their savings and investment strategies. There could be funds adhering to the principles of Islamic finance; there could be 'green funds' investing in renewable energy companies and organic farms; and there could be ‘local community funds’, offering an investment portfolio with a home bias. In any case, people could make provisions in the way that best suits their individual conditions and preferences. A free-market approach would allow diverse institutions to develop to help people save for old age, each with different aims, strategies and principles. Profit-making pension funds, insurance companies and banks would be obvious candidates.

But in this area voluntary non-profit associations were once highly prominent before the welfare state pushed them out by making long-term provision unnecessary. Friendly societies, cooperative savings banks, and schemes run by trade unions could readily win a large market share. Even low-income earners could, over time, amass sizeable fortunes.

Private old-age provision would help take the politics out of welfare. The current systems encourage lobbying for political favours at a terrible economic and social cost. The free-market alternative would encourage saving, long-term thinking and work effort.

Healthcare

Reforms are also desperately needed in the health sector. Government-run healthcare systems are marked by long waiting lists and poor patient care. A typical example is Britain’s National Health Service.

While many countries, such as the USA, have some combination of private and public provision, the health sector remains tightly controlled. As a result, patients do not enjoy the full benefits of competition and free markets. Government controls tend to raise the cost of care and deny access to the latest treatments. Life-saving activities – such as trade in transplant organs or using new drugs – may even be banned completely, indirectly killing huge numbers every year.

In a free society, competition would take place on many different levels: between different medical philosophies, different codes of practice, and different ways of evaluating the safety of drugs and the qualifications of doctors. There would be competition between different healthcare providers and a wide variety of institutions could co-exist.

This would help to keep costs down and ensure speedy access to the latest treatments. Patients would be treated as customers and care would better reflect their needs rather than those of doctors and health officials.

Profit-making insurance companies, hospital chains etc would obviously be well-placed in a competitive marketplace. But it should not be forgotten that numerous non-profit, voluntary associations inhabited the healthcare sector before the welfare state cut the ground from under their feet.

Friendly or fraternal societies, cooperatives and trade unions ran insurance schemes. Hospitals were often set up as independent charitable or educational institutions. There is no reason why the healthcare sector of a free society should not be able once again to accommodate such variety.

Again, incentives would change profoundly. In a modern welfare state, the cost savings resulting from healthy lifestyle choices do not go to the individual concerned. Governments therefore try to fill the void by the use of advertising campaigns, 'sin taxes', and heavy-handed regulation.

Under the alternative arrangements described above, insurance schemes would put price tags on health-related habits. Nobody would be bullied to stop smoking or to start exercising. However, they might decide to do so to cut their health insurance payments.

Why have welfare systems?

The failures of government welfare call into question the existence of these vast tax-funded systems. Instead of any single 'system', why not have dozens, indeed hundreds of competing ways in which people protect themselves against the various risks in life, and provide for difficult times?

There is surely nothing special about welfare that means it should be subject to levels of state control which would generally be considered unacceptable anywhere else.

For example, there is no 'British leisure system'. There is no American, French or German one either. In each of these places, there are myriads of ways in which people can spend their spare time. Nobody 'created' what could loosely be called 'the leisure industry'. It just evolved.

People were looking for ways to entertain themselves or relax. Entrepreneurs had an inkling of what people in their area might find enjoyable, and set up cinemas, night clubs or travel agencies. Some failed. Some succeeded.

Instead of any singular 'system', we find a huge variety of different business models interacting and competing with one another. This complex fabric is constantly evolving and changing its shape. It is a testing ground for new business ideas.

Few people suggest that our free-time should be organised in a different way. Yet from a classical liberal or libertarian perspective, it is just as nonsensical that there should be such a thing as a 'British healthcare system' or a 'French pension system'.

Unleashing choice and competition

The free-market alternative to government welfare systems would consist of free choice and never-ending competition. There are several general reasons why this would be more effective than state welfare:

- Providers who constantly face the threat of losing customers to competitors face strong incentives to improve the quality of their products and/or lower their prices.

- Governments cannot really know people's needs and wishes. Private entrepreneurs do not possess this knowledge either, but markets put their ideas to the test, with the profit and loss account offering them continuous feedback.

- Even if governments knew people's wishes, they would still not know how best to fulfil them. This knowledge has to be discovered via the market. The market is a permanent trial-and-error process, which continually discovers the best way of serving individual needs. Successful ideas grow while less successful ones change or disappear.

These arguments help explain the failure of government welfare services. Imagine you ran a nationalised healthcare system and were given an extra £1m to invest. How would you know whether patients preferred more preventative treatment, newer drugs or better equipped surgeries? And should these be delivered in hospital clinics, or by self-employed doctors? In the absence of a testing ground with clear feedback mechanisms, you would either have to make an informed guess, or rely on the advice of professionals. In the latter case, the door would be open to 'producer capture' – when nationalised industries cater for the needs of their workers instead of their customers.

Unleashing the power of competition would therefore vastly increase the diversity, quality and affordability of welfare goods. It would also amount to a massive transfer of power from the government to the individual. It would enable individuals to take their lives into their own hands instead of relying on the promises of politicians. Individuals would also be free to form voluntary communities of solidarity and mutual support.

If the state must have a role in welfare, it should be limited to modest cash transfers, enabling poor people to purchase insurance services themselves. Governments should not use their powers to prevent private companies, voluntary associations and charities from playing a leading role.

Criticism of welfare states is often confused with a lack of sympathy for the poor. In fact the poor stand to gain the most from free-market reforms. When government welfare fails, rich people are least affected. They can always afford better alternatives. It is the disadvantaged who deserve the chance to experience the benefits of choice and competition.

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9 Banking, inflation and recessions by Anthony J. Evans

It is 7am when the alarm clock sounds and your head is whizzing. You'd only returned home a few hours earlier and regret getting so drunk on a week night. Into the bathroom for a quick shower, realising that you've still got that giddy buzz. You're almost dressed and you face a choice – right now you're headed for the mother of all hangovers and you can already feel the headache, the nausea, approaching. But on the side of the bed there's a half empty bottle of whisky and you just wonder… Maybe a few slugs will be enough to fend it off for a little while longer… You just need to get through the day. You slip the bottle into your pocket and head out of the door.

What do 1920s Germany, Robert Mugabe's Zimbabwe, America under Bush and Obama, and Britain under New Labour have in common? The answer is a catastrophic relationship between the banking system and the government, with economic policy conducted for political objectives.

Financial crises are common and there are three stages to this process of economic self-destruction: government debt, inflation, and recession. They are seen throughout history and across the world. You might even call them regularities. Let's look at each stage in turn.

Government debt

We all like to spend money, and we like to spend other people's money even more than our own. Whether on wars, health systems, or public works, there is an almost infinite appetite for government expenditure. It's the reality of politics that politicians want to spend (see chapter 6).

The traditional way of financing spending is through taxation. But this is unpopular. People can get pretty angry if taxes are too high, so it saves a lot of hassle (and makes you far more electable) to fund spending through debt. Leave the bill to future generations, and hope taxpayers are too short sighted to care.

Governments borrow money by selling *bonds* to investors. These work like loans, with the government promising to pay the investors' money back, plus interest, over a set period. This is a very powerful way to fund government activities.

It was Renaissance Italy where governments first unleashed the true power of debt. Unlike other institutions, governments have the power to tax. The prospects of them not paying back a loan are therefore relatively low.

But even bonds are subject to constraints. If too much money is borrowed, investors will become concerned that the government simply can't pay back the debt. This is where the third type of public finance comes in. And it is far less visible than taxation or borrowing.

If private investors won't buy government bonds, central banks – such as the US Federal Reserve and the Bank of England – can buy them instead. In this case one of arm of the state has effectively financed another.

Historically this process is the cause of all major *hyperinflations*, periods when prices rose very rapidly and economies collapsed, as in 1920s Germany, and modern-day Zimbabwe.

Most developed nations have made their central banks independent to try to stop this kind of nightmare occurring. It's important that politicians can't pay off government debts simply by ordering the central bank to create money out of thin air.

The supply of money is still nationalised, however, and it is still a political issue. While the money supply may not be under the day-to-day control of politicians, central banks must still follow government policies. And it is still in the interests of governments to reduce the value of their debts by inflating the economy. This is why we live in an age of inflation, an issue we now look at in more detail.

Inflation

How much would you be willing to pay to become a millionaire? For under £100 you could buy more than a million Indonesian Rupiah (at the time of writing), but that's probably not what you had in mind!

The key thing to understand about currencies is that we value money for one thing: purchasing power. Being a millionaire isn't all that significant until we know how much you can buy for it.

Inflation means a fall in the value of money, and, as with any good, a key driver of this is the supply. For example, if there is more money, but the same amount of other goods to spend it on, then the prices of those goods will tend to rise. When the economist Milton Friedman famously said, 'inflation is always and everywhere a monetary phenomenon', he meant that the root cause of rising prices is a rising supply of money.

In the UK the Bank of England controls the money supply. It determines how much money gets printed, and therefore how much is available for high street banks to lend out. This should strike you as highly socialist: *The Bank of England is a nationalised institution with a monopoly over the supply of currency.*

This hasn't always been the case. Up until 1946 it was a private organisation. Before 1694 it didn't even exist. But money did. Indeed there have been episodes of 'free banking' (where the state does not control the money supply) – most famously in Scotland in the first half of the 19th century. In these cases private banks have been able to print their own bank notes and consumers have been free to choose between them.

Of course a free market in banking no longer exists. Banks gave up their ability to print money to the central bank, which would in turn lend to them in a crisis. The modern system of banking was born: the state promises to bail out banks that fail to protect their customers' money. Unfortunately banks are encouraged to take risky decisions by this system. If they gamble and win, they get to keep the profits. However, if they lose they know the central bank and the government will rescue them.

The main way central banks control money is using interest rates, and there are three main rates they can influence. Imagine that you are in charge of the central bank. You can manipulate three things. Firstly, the 'deposit rate' is how much interest is given to commercial banks for the money they keep in reserve at the central bank. Secondly, the 'discount rate' is the rate that you as the central bank charge the commercial banks for money they wish to borrow from you. Finally, the 'interbank' rate is the rate that commercial banks charge each other to borrow money.

Since the central bank controls the money supply, by altering the amount of money in circulation you can target a particular 'price'. This is called monetary policy – manipulating the money supply to influence interest rates. Although we commonly read that interest rates are 'set' by central banks, they're merely the cover. It's the money supply that is the smoking gun; and inflation that causes the damage.

Recession

Most economists agree that the main consequence of inflation is a rise in the overall price level. If you see how much a basket of goods cost last year, and compare it to this year, the difference is our typical measure of inflation (the 'consumer price index', or CPI).

One of the flaws of this method is that it's an incomplete sample – it doesn't fully capture the price level for all goods. It is possible that our data tells us there is low inflation (e.g. 2%), but it is merely missing the parts of the economy where the inflation is taking place (e.g. housing).

There are many reasons why a rising price level is a bad thing. As we have already seen, inflation is a good thing for heavy borrowers (such as government), because it erodes the value of their debt. But it's a bad thing for lenders, because it erodes the value of their savings.

So rising prices make some people better off and other people worse off. And this brings us to another consequence of inflation – one that few economists really understand. Whilst inflation leads to a rise in the overall price level, those prices don't all rise at the same time. Some prices rise more quickly than others.

The main harm caused by inflation is that it distorts the whole structure of the economy, and in doing so makes painful readjustment (i.e. unemployment) inevitable. Prices play a crucial role in providing signals to people who are buying and selling in the market. Inflation distorts these signals and creates chaos as a result.

For example, in the build up to the 2008 financial crisis amateur property developers would buy houses to do up and sell on. After several months of hard work and investment, they would often end up making a profit, but only because house prices had risen in the meantime. In actual fact, many of the scarce resources being spent on housing were being wasted. Whilst inflation created an illusion of success, as soon as house price inflation fell the mistakes became obvious: real wealth had been destroyed.

Interest rates are the ‘price’ that co-ordinate savings and investment. When market forces are allowed to work, they bring together lenders and borrowers and set a market rate. This reveals how patient consumers are – the extent to which they’re willing to wait for more goods in the future.

But when the central bank creates money this also reduces interest rates. Consumers are penalised for saving and businesses are encouraged to borrow. As a result, people save too little and consume too much. And since the real wealth of the economy, the pool of savings, has not changed, there isn’t enough to go around. At some point there’ll be a scramble, a credit crunch.

According to William McChesney Martin the role of the central bank was to ‘take away the punch bowl just when the party starts getting interesting’. But in the age of inflation they’re more likely to be handing out shots!

We can now return to the allegory that began this chapter. We all recognise that hair of the dog might work in the short term, but it merely delays the hangover. A hangover is an inevitable consequence of getting drunk.

It's not the recovery that is the real problem here; it's the artificial boom. Policy-makers are faced with this trade off all the time, but aren't able to plan successfully for the long term. Medicine sometimes tastes bad, but it's the only lasting cure.

What we see is a regular boom-bust cycle with high government borrowing leading to the creation of money to pay off the debt. In other words, government debt, financed through inflation, resulting in recession. For as long as politicians control the money supply, it will be ever thus.

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10 The role of government by Stephen Davies

Perhaps the biggest question in politics is that of what and how much governments should do. It is this that mostly provides the dividing line between left and right (although as we shall see things are more complicated than often supposed).

There are many answers given. At one extreme are those who argue that there is nothing that government need or should do, that in fact we would be better off without it, in a stateless society. This is the anarchist position, held by a small but determined group over the last two hundred years. However it is very much a minority one. Most people think that government is an inevitable and necessary institution for one reason or another.

Interestingly, while some people argue for no government, nobody has explicitly argued for government to be responsible for everything, for all aspects of life. The closest we have ever come to this were totalitarian states of the communist or fascist variety. North Korea is the closest still in existence; Cambodia under the Khmer Rouge is the place where it actually happened. Most people, however, accept that there should be limits on what government does, that it should not do everything. The argument then is over how widely and where the bounds of government action should be drawn.

Personal choice or political choice?

Another way of putting this makes it clearer what is at issue here. Broadly there are two ways of deciding what people can do and how they can dispose of resources. One is to leave it to the decisions made by individuals. This may be individual decisions by particular persons. Alternatively it may mean decisions arrived at collectively by groups that people belong to on a voluntary basis, such as clubs, trades unions, corporations, or even informal groups such as people deciding to go out for dinner together for example.

The other way is for rules to be made to bind individuals, and resources to be allocated by a collective process which does not come from immediate consent. This is the political process. You may say that surely there is consent, exercised through the vote. However a moment's thought will show this is not so. Laws made through the political process bind everyone including those who do not vote, and even those who cannot such as juveniles and residents from abroad.

A simple example will show the difference between political choice of this kind, and the personal choice described first. Suppose a group of people go out to dinner together. In the first case each person will choose their own meal from a menu, individually. Even if the meal is decided collectively, each person is free to not take part and go elsewhere. It is ultimately a personal, individual choice. Suppose though the content of the meal was decided collectively by a vote, with the minority bound by the decision and unable to opt out or go elsewhere, at least not without severe penalty. This would be like political collective choice, exercised through government.

The key debate

So the question is this: how many areas of life, and how much allocation of resources should be decided through the political process and how much by personal choice? In education, for example, most of the choices are made through the political process rather than by individual choice. In groceries, say, the opposite is true: most choices are ultimately made by individual consumers and firms like Tesco and Wal-Mart ultimately respond to them.

This is not the same thing as asking how *big* government should be, that is how much of the total output of society it should dispose of. A government may only concern itself with a limited range of activities and areas of life. However, if those areas involve employing lots of people or spending large sums of money then you will have a large government even though it only does a few things. Conversely, you might have a government that controls and decides many aspects of life but does not spend that much money. This is the case in contemporary Singapore for example. In Britain we now have a government that both spends a great deal (more than half of total output) and is concerned with many aspects of life.

Beyond left and right

This argument is also not always a simple one between people who want limited government and those who want large, extensive government. Much of the argument is between people who want government to be responsible for some things but cannot agree what they should be.

There are some who think that political decisions should rule much of economic life but think things such as sexual choice and lifestyle should be a matter for individuals. Others take the exact opposite view and would have economic life ruled by individual choice while government and laws should regulate much social and cultural activity. Some though are consistent 'collectivists' and believe in most of life being subject to collective, political control. Others are 'individualists' and would maximise personal, individual decision-making.

In the past government has been responsible for many things that are now a matter of personal choice. The most obvious area is that of religious belief and observance. This was once the central concern of government but is now entirely private and voluntary. Another is clothing and consumption. At one time government regulated this through laws. These laid down how much could be spent on things like weddings and stipulated details of the clothes people could wear, depending on their social status. They even went so far as to say what kinds of hats or shoes people could wear.

However, we should not laugh or feel self-satisfied. Government is now responsible for many things that were once a matter of private choice and voluntary collective action. Education is one, another is health care, yet another is provision for old age (see chapter 8). There are serious suggestions that government should have a view about the kind of food people eat, their lifestyle choices and even whether they should be allowed to become parents. During and just after World War II many argued that government should control restaurants and diet, through rationing.

Deciding the role of government

So is there a principle or set of rules by which we can decide what areas of life government should be concerned with? Or must we just rely upon fashion and the outcome of particular political struggles?

The consistent individualist position is that things should generally be decided by personal choice and voluntary cooperation. A case should be made for any departure from this. The burden of proof should be on those arguing for collective political decision making and a role for government in any area of life. Five main reasons are given for making individual choice the default position:

- Individuals are in general the best judges of their own interests. They know what it is that they value most, they know their own circumstances best. Most women agree that their husband knows them better than anyone else but would never dream of letting him buy their clothes. Why let a complete stranger or collection of strangers decide what kind of education your children should have?

- Personal development and flourishing can only happen if people are free to choose and to learn from the choices they make. To the extent that they are not they remain like children and do not develop.

- Social progress and development is best served by allowing individuals to choose as much as possible for themselves. It is the experiments that eccentric individuals make that are the source of innovation and discovery.

- Collective political decision making inevitably means giving particular people power to decide what others should do. This is both dangerous and morally corrupting for everyone, particularly the people with power. As Lord Acton said, ‘All power tends to corrupt’.

- Finally, all of the evidence is that collective decision making is simply less effective and efficient than relying on individual choice. Not only are personal desires less likely to be met but there is a huge waste of resources.

The counter argument essentially has two elements. The first is that we are in a real sense child like. We do not know what is best for us and left to ourselves will make the wrong decisions. Apparently, though, some people are not child like and know what is good for the rest of us. The second is that we are collective social beings and individual identity and personal choice are ultimately an illusion. Since we all really want the same things we should collectively decide what it is we want to have. Government is the instrument by which these collective choices are realised.

There are a very few cases where this kind of argument is true and where allowing personal choice is unrealistic. Collective national defence is probably one; another may be the provision of law; public sanitation perhaps another. These, however, should be seen as exceptional. Individual choice should guide most aspects of life and the sphere of politics and government should be strictly limited.

Further reading

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