MILTON FRIEDMAN ON THE IMF—P. 2

POLICY REPORT

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Is Protectionism Back in Style?

Television cameras record Deputy U.S. Trade Representative Geza Feketekuty's remarks as Sen. William Proxmire looks on.

The current conditions of unemployment and stronger competition from foreign producers for U.S. consumers have led many prominent Americans to call for new protectionist measures. Among the general public, protectionism seems even more popular. Is the case for free trade outdated? Have the changes in international relations made protectionism an appropriate policy at last? This past September, the Cato Institute held a conference to deal with these questions. The theme was "International Trade: Free Markets or Protectionism?" Distinguished scholars and policy makers examined timely component issues: the history of U.S. trade policy, trade deficits, national security, the Third World, Japanese trade policies, and other questions related to the political economy of international trade. This issue of Policy Report *contains excerpts from several presentations given at that conference. The complete, final papers will appear in the Winter 1983/84 issue of the* Cato Journal, *which is available for $5.00 from the Cato Institute.*

U.S. Barriers to Imports and Exports

by Murray L. Weidenbaum

It would help to clear the air in discussions of international trade if the United States were to acknowledge that not all of its actions are on the side of the angels. We have created many obstacles that inhibit imports into the United States as well as exports.

"Buy American" statutes give domestic producers preference in government procurement. A premium as high as 50 percent is paid when military goods are produced domestically. Under the program of aid to mass transit systems, the Surface Transportation Assistance Act of 1978 requires that American materials and products be used for most purchases costing more than $500,000. At least 50 percent of the gross tonnage of all commodities financed with U.S. foreign-aid funds must be shipped on vessels that hoist the American flag.

Many states also have "Buy American" laws. New York requires state agencies to buy American steel. New Jersey requires that all cars used by the state be domestically produced. Various states and municipal authorities require utilities, whether they are investor-owned or government-owned, to use American materials.

Overregulation impinges on maritime commerce as well. In this case, what hurts foreigners hurts us too. The Jones Act prohibits foreign ships from engaging in commerce between American ports. This law, then, effectively bars competition in domestic marine transport.

Many of our statutes limit imports of such agricultural products as sugar, beef, dairy produce, and mandarin oranges. Under the Meat Import Act, the president has authority to impose import quotas for beef if imports reach a certain trigger level. The United States has generally encouraged foreign exporters to restrain their sales voluntarily so as avoid the imposition of formal quotas, but now we are eliminating the pretense of voluntarism.

Although our average tariff rates are low—about as low as Japan's—we do levy high tariffs on some items. Tariffs on textiles are on average 20 percent. Duties on fruit juices are over 27 percent, and the rate on ceramic products is 14 percent. Besides tariffs, many

(Cont. on p. 3)

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No Quota Increase for the IMF

by Milton Friedman

The International Monetary Fund was founded to preside over the system of fixed exchange rates established by Bretton Woods. Its power to make loans was created to facilitate that function, not to enable it to become a central bank, or a lender of last resort, or a savior for banks that have made bad loans.

The IMF's initial function disappeared with the breakdown of the Bretton Woods system and the emergence of a system of floating exchange rates. In all logic, its life should have been terminated simultaneously with the end of the Bretton Woods system. However, international bureaucratic organizations neither die nor fade away. And ever since, the International Monetary Fund has been in search of a new function, in the process encroaching on the territory of the World Bank, and apparently envisaging its future as a central bank for the world.

National central banks that have sought to stave off financial collapse by shoring up borrowers who face default in order to help lenders have not succeeded. Instead, the result has often been the postponement of relatively minor adjustments until a major collapse cannot be avoided. That was certainly true in the United States in the 1930s.

Commercial banks that have made loans should be held responsible for them, making what adjustments are necessary, organizing whatever refinancing is appropriate, and bearing whatever losses occur. The Federal Reserve System has ample power to prevent any losses that do occur from endangering our domestic monetary structure. The central banks of other countries have similar powers. We do not need an international central bank on top of the national ones.

The borrowing countries that are in the greatest difficulty are mostly countries that have used loans to finance current account deficits rather than to finance productive capital investment. They have been able to do so largely because the loans were to governments, not to individuals. The availability of such loans has strengthened the ability of governments to control economic activity. In doing so, they have distorted and suppressed market forces. Additional loans to governments, this time by an international governmental agency, will simply add to the problem. However serious the difficulties of the borrowing countries, their people will not benefit by encouraging their governments to continue the very policy of excessive centralized control of economic activity that has been the major obstacle to development.

The International Monetary Fund may be able to play a constructive role by providing information about the economic conditions of various countries and by serving a role in fostering cooperation among the banks and the countries. It does not need any increase in its funds for this purpose, and certainly from the long-run point of view, our objective should be to reduce the size and scale of the IMF, not to expand it. ■

This is the text of a letter sent by Milton Friedman to Rep. Clarence Long, chairman of the House Foreign Operations Subcommittee, on September 23, 1983.

Abolish the Marketing Orders

Once again the Reagan administration is faced with a test of its commitment to the free market. The Office of Management and Budget urges that the administration begin to dismantle the system of agricultural marketing orders overseen by the U.S. Department of Agriculture. As Michael McMenamin points out in a recent study for the Cato Institute, the legacy of the New Deal includes "tons of oranges rotting in the sun under a mandate from the USDA."

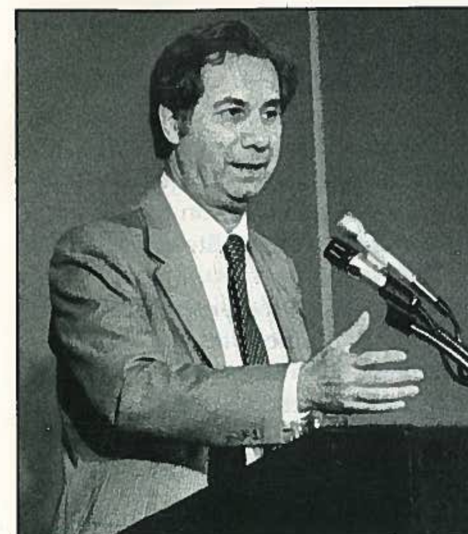
In order to keep prices high, the USDA enforces marketing orders that limit the number of oranges each grower can sell. Any oranges he produces over his "prorate" limit must be left to rot. Similar marketing orders apply to such crops as walnuts, raisins, hops, spearmint oil, lemons, and cherries.

What effect have these regulations had? David Stockman described the situation in a memorandum for the Cabinet Council on Food and Agriculture:

> The empirical evidence is precisely what economic theory predicts: the production restraints artificially but temporarily increase growers' average returns, which attracts excessive new investment in the production for future years, which in turn leads to higher production in later years and demands for even tighter production controls, and so on.

Early in the Reagan administration, the Task Force on Regulatory Relief identified marketing orders as having contributed to misallocation of resources in seven crops. In short, the administration is aware of the economic distortions caused by marketing orders. But will political considerations once again outweigh its economic understanding? ■

U.S. Barriers (Cont. from p. 1)



Murray L. Weidenbaum

other barriers, often in the form of regulations, are imposed by federal, state, county, and municipal governments.

Despite the overall free-trade posture of the United States, "protection" against imports now covers even such basic industries as automobiles, steel, and textiles. Domestic pleas for further restrictions on trade extend to such esoteric items as mushrooms, ceramic tableware, and even mechanics' shop towels. It is not a question of merely accepting the existing array of protection. The challenge is to deal with the rising internal pressures for further restrictions of world trade.

We must also acknowledge the great extent to which our government has erected obstacles to our own exports. These wounds are self-inflicted. It makes us a laughingstock overseas when we urge other countries to lower their barriers to our exports while we make trading more difficult for our own exporters.

The sad fact is that in the United States many laws and regulations limit our exports. In many ways—and often without considering the effects—we have enacted statutes and promulgated rules that prohibit U.S. exports or make it more difficult for American companies to compete in foreign markets. For example, the Trans-Alaskan Pipeline Authorization Act prohibits exporting oil from North Slope fields. A provision that was added to an appropriations act for the Interior Department bans exports of timber from federal lands west of the 100th meridian. When the injunctions become that specific, one can detect that pressures from special interests are at work.

The Export Administration Act provides for controls on exports of goods and technology to protect national security. That sounds unobjectionable enough. But in practice, the law mandates controls over many products, including domestically produced crude oil, refined petroleum products, unprocessed red cedar, and even (my favorite) horses exported by sea.

Controls on exports do more than limit the international trade of the United States. These restrictions also call into question the reliability of the United States as a supplier of products to other countries. Then those countries are likely to develop alternative sources.

Can Protectionism Work?

by Victor A. Canto

In the name of free trade, the Reagan administration is considering a new trade policy based on "reciprocity." The goal is to force other nations into reducing both trade barriers to American-made goods and subsidies to their own export industries. If a nation fails to meet this condition, the administration's response may be to impose restrictions, tariffs, or both on its exports to the United States.

This approach represents a radical change in U.S. policy. In essence, it is a bilateral framework that requires negotiations with each country before the United States will extend most-favored-nation (minimum) tariff structure. This policy abandons the unconditional most-favored-nation principle that has been the foundation of trade policy among the industrial nations since 1923. The reciprocity approach, by putting trade negotiations

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Protectionism (Cont. from p. 3)

Victor A. Canto

back into a bilateral framework, invites increased protectionism among the industrial countries and forebodes a return to the beggar-thy-neighbor policies of the early 1930s. Reciprocity is just the latest movement in the steady trend of U.S. policy away from free trade.

A review of major U.S. trade actions indicates a steady reduction in tariffs from 1934 to 1981. The Smoot-Hawley Tariff Act of 1930 raised tariff rates when duties on imports were raised to a maximum of 53 percent of their value. Two years later, in 1932, tariffs had risen to an all-time high of 59.1 percent. By the time World War II began, though, tariffs had decreased to 37 percent; when it was over, tariffs had dropped to 29 percent. In 1947 began the first of seven rounds of trade negotiations under the auspices of the General Agreement on Tariffs and Trade. By the end of the Kennedy Round of trade negotiations in 1968, the average tariff was only about 10 percent in the United States, the European Community, and Japan. The Tokyo Round of trade negotiations, completed in 1978, yielded another 30-percent reduction in tariff rates, with special attention paid to reducing the highest tariff rates the most.

A clear example is the case of soybeans—hardly a product that could be considered a strategic item. Although the U.S. embargo on exports of soybeans in 1974 was intended to contain a short-term increase in domestic prices, the main effect was to induce Japan to turn to other producing countries, particularly Brazil. Japan proceeded to invest huge amounts in Brazil to develop soybeans, thus effectively and permanently reducing the U.S. share of the world soybean market.

But not only embargoes on exports hurt domestic producers. There are a host of regulations that impose costly burdens on American manufacturers. Foreign producers, despite restrictions on the goods they can send to the United States, are not subject to the same regulatory burdens.

Companies involved in foreign trade suffer special attention from the federal government. The Foreign Corrupt Practices Act requires strict standards of recordkeeping to monitor the antibribery sections of the statute. Although it is difficult to discuss that law without being criticized for callousness on ethical matters, this trade statute has established another burdensome regulatory regime.

In international trade, policy will not remain static. The choice is between a further drift to protectionism or a joint U.S.-foreign effort to remove trade barriers. The credibility of our commitment to open and freer trade is not improved when companies send their lawyers to Washington on Monday to get overseas import barriers removed, and then on Wednesday send the same attorneys back to Washington to advocate import restrictions on the products of their foreign competitors. Free trade is a two-way street.

As in so many other aspects of economic policy, time is an important but often neglected factor. The longer we wait to move decisively to freer world trade, the more obstacles will be in place and the more difficult it will be to remove them. The best time to work for free trade is now.

Recently, as the free-trade policies began to conflict with a growing protectionist sentiment in the United States, advances toward free trade have been at least partially offset by increases in nontariff barriers. Before, a U.S. industry had only to furnish evidence of foreign subsidies for tariffs to be imposed. But according to the Smoot-Hawley Act, this protection of trade granted under the Tokyo Round applied only if the president could determine that the foreign country had become a signatory of the Tokyo Round agreements and accepted a similar obligation to the United States. An example of the dichotomy between restricting trade and freeing it is the novel requirement that domestic industries show material injury to have been done by subsidized imports before countervailing duties will be imposed.

Rep. Phil Gramm (R-Tex.) listens as Sen. William Proxmire (D-Wis.) addresses Cato conference on international trade.

The grim experience of the early 1930s amply demonstrates that this movement toward protectionism has critical implications for the U.S. economy. Virtually all economists and policy makers agree that trade restrictions are self-defeating, that they impoverish foreign countries and the United States alike.

The policy issue thus centers on whether protectionist measures, judiciously applied, can contribute at all to domestic economic stability and growth. In particular, can instruments of trade policy be used to improve a country's balance of trade and thus its overall economic performance? Furthermore, can specific industries that are suffering from competition by imports be assisted through protectionist measures so as to reduce unemployment and increase total output and income? The data reported in this study show that protectionist measures fail to achieve their goal of improving the overall economic environment: In some cases, protective restrictions may even be counterproductive.

Do Trade Deficits Matter?

by Paul Heyne

Some things matter whether or not they exist. The Loch Ness monster is one. National trade deficits are another. Trade deficits obviously matter to many people, because (whatever they are) they seem to have significant consequences. They cause problems, or create undesirable constraints, or compel governments to change policies.

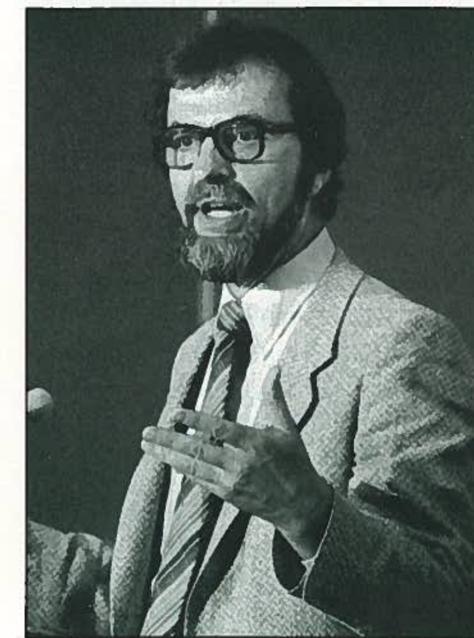
I do not deny that U.S. firms have often performed poorly in recent years, or that sizable sectors of the economy are going to diminish dramatically or disappear unless we respond to foreign competition with major adjustments. What I do deny is that comparing aggregate merchandise exports with imports is helpful in describing, diagnosing, or prescribing for this situation.

Such comparisons, however, do furnish political ammunition that can be used by people who want protection from foreign competitors or subsidies for their own efforts to sell abroad. An actual deficit cannot exist in an accounting system that defines credits and debits as being equal. Therefore, trade deficits must be conceptual phenomena only. A trade deficit must be a disequilibrium, not an actual inequality between purchases and sales. And a disequilibrium, we have argued, entails isolating and excluding some factors for purposes of analysis.

The claim that there is a trade deficit amounts to a vague complaint that international exchange transactions are somehow out of order and need to be set right. The fundamental issues of exactly what is out of order and how it got that way need not be addressed. With the problem undefined, the solution must remain undefined. A wide range of actions might be appropriate. Since even experts disagree extensively on just how any particular change in policy may affect the long list of variables in domestic finance and international exchange, declaring a trade deficit is in practice equivalent to declaring martial law. What is most dangerous about such a declaration is that it gives government officials a license to subordinate the rule of law and respect for rights to considerations of political advantage.

I do not want to be misunderstood. Whatever I might believe, I am not now claiming that we would be better off if central banks stayed out of the foreign exchange markets. Nor am I here trying to construct an argument for unrestricted international trade. My claim is much more limited. It is that whatever the proper role of government might be in affecting the course of international trade, the concept of trade deficits and surpluses or disequilibrium in the balance of payments darkens counsel. It has no agreed-upon meaning. It ought to be abandoned, so that the way can be cleared for more responsible and effective discussion of the issues that concern us.

In my experience, every case in which an economic problem was interpreted with the concept of a balance-of-payments disequilibrium could have been more clearly explicated by abandoning the concept. We would substitute for it whatever assertion the balance-of-payments concept is concealing in each particular case. Every claim of a balance-of-payments disequilibrium can be more accurately and adequately expressed as a prediction, such as "The dollar will depreciate in relation to certain other currencies," or "Certain desired imports will not be available unless foreign lenders can be persuaded to extend credit," or "It is going to be increasingly difficult for producer A to sell in market Y," or "Imposing quotas on the importation of goods M and N will secure crucial political support."



Paul Heyne

I am uncomfortably aware of the violence that this recommendation does to long-established tradition. Economists far more reputable than I have called the concept of a balance of international payments a significant analytical

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Trade Deficits (Cont. from p. 5)

achievement. I am claiming that it was from the beginning a conceptual device that concealed more than it revealed. And the trouble with such concepts in the social sciences is that they allow political arguments to be presented under the guise of empirical assertions.

I think Adam Smith was right. "Nothing . . . can be more absurd than this whole doctrine of the balance of trade." It is a concept originally devised and promulgated by merchants to promote their special interests under the pretense of protecting the national interest. And a government that tries to watch over the balance of trade has embarked upon a task that is intricate, embarrassing, and fruitless.

Trade, Change, and Industrial Policy

by Leland B. Yeager and David Tuerck

The case for free trade is a particular application of the general case for the unfettered market economy, or price system. That case does not rest on any contention that free trade at home and among countries results in Pareto optimality (to use a favorite concept of the technical literature). Instead the case is based on comparison with any other way of organizing economic activity. The market system leaves people free and motivated to seek and reap gains from production, innovation, and exchange. It puts knowledge that is inevitably dispersed to use in decentralized decision making, while prices convey signals about circumstances beyond the decision makers' immediate ken. Market prices, while not exactly "right" in the sense of the abstract theory of general equilibrium, do come under competitive pressures that tend to adjust them as necessary. The price system also has the great merit of tending to keep down the power of man over man by separating political power from economic power.

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The protectionist assertion that the free-trade case rests on unreal theories and unreal assumptions must boomerang, especially when it is decorated with remarks about a dynamic world. The concept of an ideal pattern of corrective interventions, always kept ideally adjusted to changing conditions, is much more unreal. Any moderately competent theorist can dredge up arguments that are intellectually respectable in the abstract for almost any intervention plausible enough to enjoy political support. The fact that one can concoct superficially plausible cases for all sorts of specific interventions is a warning against overenthusiasm for them. Each situation has repercussions that redetermine which other interventions would be ideal. Adapting each case not only to the "imperfections" of a free economy but also to the distortions caused by all the other interventions is hardly practical.

Leland B. Yeager

Sophisticated protectionists occasionally try to score points by contrasting free markets in the real world with the conditions required for Pareto optimality. Yet the charge that the case for free trade rests on hopelessly unrealistic theories and assumptions is more consistent with a sweeping contempt for economic theory. Certainly, if one cannot answer an unwelcome argument, one can disparage it in a broad, vague way. In rejecting economic theory, protectionists are rejecting attention to the possibly far-reaching and unwanted repercussions of the particular government interventions that they call for; they are rejecting attention to general economic interdependence. They are refusing to see an economic system as just that—a system of intertwining and mutually conditioning activities operating in conformity with economic laws. Instead, they tend to view an economic system as a collection of separate activities amenable to improvement by whatever separate government interventions their untutored pragmatism recommends.

No one, not even self-styled pragmatists, can operate without theory. Theory—at least some notion of how things hang together—is essential both to organizing one's perceptions of reality and to forming expectations of (for example) the results of a recommended intervention. Anyone who presents a fact or a figure in a policy argument has some notion, presumably, of how it fits in, of what difference it makes; and that is his theory. The true contrast is not between academics who theorize and practical men who stick to the facts but between people who theorize with the advantage of knowing what they are doing and people who theorize without realizing it. Unarticulated, unexamined theory is the worst kind.

How does it matter to us why foreigners offer us their goods as cheaply as they do? How does it matter why Ruritanian widgets delivered in the United States are as cheap as they are? Perhaps Ruritania's climate and resources are ideal for widget production. Perhaps the Ruritanian widget industry enjoys the special skills that its workers have developed over generations. Perhaps a mass market in Ruritania affords scope for economies of large-scale production. Perhaps Ruritanian manufacturers are selling below current cost in an effort to expand sales and production, take advantage of the learning curve, and get costs down. Perhaps widgets grow wild on bushes and can be harvested at little cost. Perhaps, on the other hand, Ruritanian employers scandalously underpay their workers; or perhaps the Ruritanian government subsidizes the dumping of widgets in the United States at a price below the home price or the cost of production. Perhaps the Ruritanian government, using all manner of policy instruments, has been deliberately fostering a large and efficient widget industry. How does the effect of widget imports on the American economy depend on the particular reason why they are cheap? If cheap foreign goods either benefit or harm us Americans, how could the nature and degree of that benefit or harm hinge on something more recondite than the prices of the goods themselves? If a detailed investigation of costs and prices abroad would be necessary to determine whether dumping is taking place (in either of the senses mentioned), does that not indicate that the reason why the imports are so cheap cannot be inferred from effects observable in the United States?

Nevertheless, recently the U.S. Department of Commerce has been snooping around the premises and records of a firm in France to determine whether that firm has been dumping industrial nitrocellulose in the United States. The investigators felt that they had to consider such questions as whether it is appropriate to use straight-line or accelerated depreciation, whether costs should include expenses of research and development incurred for other product lines also, and whether the seller really does offer discounts to French customers equivalent to those offered to American customers. The investigators concluded that dumping had indeed occurred: The French market value of the nitrocellulose exceeded the price in the United States by an estimated weighted-average margin of 1.38 percent. What a remarkably precise answer to so inherently vague a question! It is as if psychological researchers concluded that Icelanders are on average 5.16 percent happier than Patagonians.

An economy with rising standards of living, improving job opportunities, freedom for consumers and workers—and, yes, for entrepreneurs and investors—to explore and cultivate the opportunities open to them is bound to be an economy of constant change. Change always harms some people. In response to change, the choice lies between institutions and policies that attempt either to block change or to provide shelters against its impact on the one hand, and institutions and policies that encourage adjusting to change and taking advantage of it on the other hand. The protectionist road leads to stagnation. Furthermore, efforts to protect particular sources or types of income displace the burden of change even more onto the ones left unprotected—for not all can be protected, short of literal totalitarianism. The protectionist approach impairs the economy's coping mechanisms, including the signals and incentives conveyed by prices responsive to changing conditions. Protectionist policies also impair the growth that itself eases coping with change: The relative or absolute shrinkage of particular job opportunities will be more bearable in a growing economy.

David Tuerck

The other road is that of a free-market economy, with flexible prices both tending to adjust to keep markets cleared in the face of changed conditions and also conveying appropriate signals and incentives. Businesses and workers challenged by new domestic or foreign competition or by adverse changes in consumers' tastes then have the option of slowing the loss of customers and jobs by accepting reduced prices and wages while searching for more attractive opportunities to adjust. Ordinarily they need not suffer instant total displacement. In a free economy, workers, businessmen, and investors can sort themselves into more and less risky lines of endeavor, according to their diverse tastes, to balance chances of gain against risks of unemployment or loss. In a free economy, entrepreneurs will discover ways of making mutually advantageous offers to displaced workers and owners of displaced productive assets. Demands for economic security will be met by insurance schemes and in other ways.

We know that the United States does not now have a fully free economy of the kind we have mentioned. We have a market economy that is distorted and impaired by all sorts of protectionist interventions. We refer to protectionism in the broad sense, meaning measures intended to provide shelter against all sorts of competition and change and not merely against the competition of imported goods. Besides itself undertaking innumerable protectionist actions, the government also tolerates certain notorious private coercive interferences with voluntary transactions.

Yet today's new realists and new protectionists recommend, in effect, more of the same. In particular, they want more government interference with international transactions. The more sophisticated among them, to be sure, do recognize the sorry record of government intervention so far—it has been piecemeal, working at cross purposes, distorted by political considerations, and generally counterproductive. Ironically, this state of affairs provides an argument of sorts for an industrial policy (to use the phrase now in vogue). Interventions will be rationalized, systematized, and made to serve coherent goals. The record has been sorry so far, but we are going to change all that.

Protectionism, the Welfare State, and the Third World

by Melvyn B. Krauss

American liberals and European social democrats appear to suffer from split personalities. They believe government should intervene in all sectors of the economy except one. That exception is foreign trade. These days it is hard to meet a liberal-left economist who doesn't believe in both the welfare state and free trade at the same time.

Once one realizes that the welfare state is itself the basis of today's protectionism, however, the intellectual inconsistency of espousing free trade on the one hand and the welfare state on the other becomes obvious. To be in favor of the welfare state is ipso facto to be in favor of protectionism.

The subsidy has now replaced tariffs and quotas as the primary protectionist device in the industrial countries. Subsidies, because they do not explicitly discriminate between the foreign and domestic sectors of the economy, do not appear as beggar-thy-neighbor as tariffs. But the subsidy is just as deadly as conventional protective devices, or even more so.

Subsidies serve various purposes in the welfare state. One is to bring about the welfare-state goal of making labor immobile. In a competitive economy, of course, mobility of labor is essential to promote efficiency in the allocation of resources. But the welfare state today frowns upon labor mobility because of its supposed negative social impact. Those who hold that belief see a proper function of government as being to bring work to the workers by means of subsidies, as opposed to letting the workers go to the work according to the free market.

The result of such a paternalistic policy is not only a misallocation of resources in the domestic economy. This attitude leads on to international protectionism, because subsidization either blocks competitive goods from entering from abroad or else it encourages competitive goods to be exported from the welfare state.

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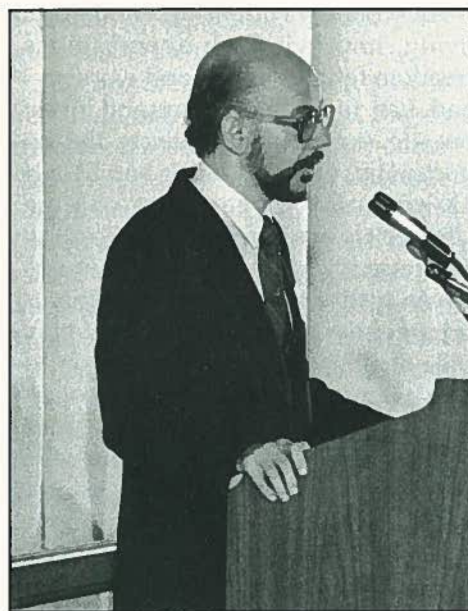
Melvyn B. Krauss

Those whom I refer to as favoring free trade only in the sense of being against tariffs and quotas, namely, Robert Reich and Lester Thurow, are also the ones who advocate a "new industrial policy" for the United States. The subsidy that they champion makes it easy and profitable for protectionists to forgo the tariff; the subsidy is all that protectionists need to reach their objectives. The subsidy, in other words, is our latter-day wolf in sheep's clothing. The neoliberals' version of free trade is free trade without a bite.

While it is generally recognized that subsidies to promote the immobility of labor harm the overall economy of the subsidizing country, it has not been recognized that those subsidies cripple the economies of the poorer nations as well. Consider, for example, a less-developed country that becomes an international competitor in standardized steel products. If the world economy operated on a free-market basis, the locus of production of standardized steel products would shift from its earlier place in a developed country to the less-developed country. For the LDC this would mean a reallocation of domestic resources from other industries to steel. The reverse obtains in the industrialized country. Both would be made better off by these reallocations, because they represent a shift of factor resources from low-productivity to high-productivity uses in each country.

But if the developed country is a welfare state, the reallocation of factor resources is likely to be resisted there. Because of "workers' rights" programs, steelworkers can be expected to insist that the welfare-state government "protect their rights" by subsidizing the domestic steel industry. The workers would make such demands although they could themselves protect their own rights by retrenching as needed, even taking a cut in pay, to keep the firms they work for in business. Subsidization, by artificially lowering the costs of the domestic steel industry, prevents the industry from contracting and thus reduces the need for steelworkers to find jobs in other areas. Unfortunately for the LDC, the subsidy also prevents its steel products from entering the market of the industrialized welfare state. Had government allowed the steel industry in the social democracy to shrink or go out of business, steelworkers would have had to either accept a cut in wages or lose their jobs to their counterparts in the Third World.

The Northern European social democrats and American liberals see themselves as the champions of the Third World. But no amount of conscience money (i.e., foreign aid) is going to change the fact that what the social democrats give as foreign aid, they more than take away by restricting trade.

Subsidizing labor in the welfare state is not the only question, although it is a major part of the whole problem. Subsidization also offends by artificially keeping capital from seeking higher productive returns where they are to be found. In the welfare state, "capital rights" programs as well as "workers' rights" programs are coalescing. It is dangerous to forget or fail to see that the welfare state is just a variant of Mussolini's "corporate state." Its claim to intellectual respectability, its appeal for Franklin D. Roosevelt and Gunnar Myrdal, was that it purported to reconcile the Marxian conflict between labor and capital. The welfare state, however, lends itself more to being viewed in "corporativist" terms than in Marxian terms.

The industrialized welfare state damages the Third World further (besides promoting protectionism) by downplaying the importance of economic growth. Advocates of welfare states claim that economic growth ruins the environment. And in societies where leisure has become a way of life, the hard work that economic growth implies has become anathema. This development is tragic for the poorer nations of the world, whose very survival depends upon rapid growth in the industrialized countries. Only when the welfare state in the northern industrial powers is dismantled will their protectionism and slow growth cease to damage the Third World.

The Secret of Japan's Success

by Katsuro Sakoh

The Japanese government contributed to the enormous economic success of Japan after World War II, especially during the 1950s and 1960s. Ironically, however, the contribution is based not on how much it did for the economy, but on how much it restrained itself from doing. Its interference in the economy was only sporadic and slight, including efforts aimed at industrial development.

But the Japanese government helped provide an exceptionally favorable economic environment for private enterprise by maintaining a small and balanced budget, fairly low and stable interest rates, relatively low rates of taxation, stable prices, brief and mild recessions, minimal defense and social-welfare expenditures, and very few government-owned enterprises. Moreover, by maintaining the political stability necessary to promote private investment, the government contributed even further to a great increase in the growth of the economy.

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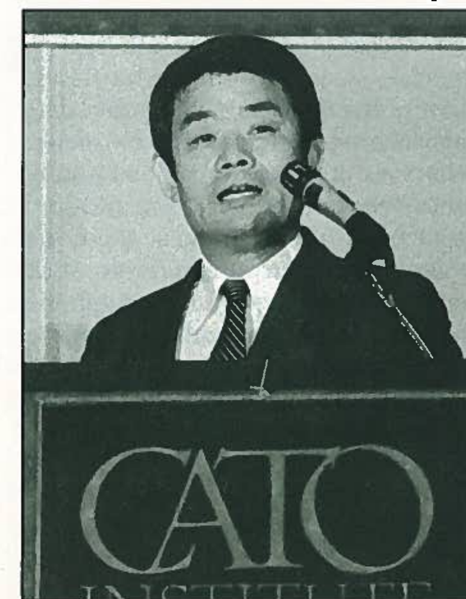
To be sure, factors outside Japan furthered Japan's economic success, but those who capitalized on this favorable environment must be credited with moving the country's economy into much higher economic growth than Japan ever experienced before the war. These people were the hardworking, educated, imaginative, private entrepreneurs, in cooperation with millions of workers. Together, they developed efficient, productive, and competitive manufacturing industries. G. C. Allen wrote, "The chief function of the bureaucrats and politicians (of Japan) was to provide a congenial environment for the enterprise of private firms. The state may have built the furnaces; private entrepreneurs (companies, groups, and individuals) supplied the fuel. It was mainly these entrepreneurs that determined Japan's economic future."

In the field of industrial development, the Japanese government, mainly the Ministry of International Trade and Industry (MITI), has extended special supports—mainly subsidies, low-interest loans, and import protection—to certain industries for balance-of-payments, political, and national-security reasons. Although some of these industries appeared to be successful under favorable international conditions, they are in fact not competitive in world markets. In recent years, they have shown themselves to be depressed industries in a competitive international environment. The government is now helping these depressed industries with low-interest loans, preferential tax policy, and other government aids. Fortunately, the government is not trying to keep them all alive with high government expenditures or stiff import protection.



Katsuro Sakoh

Because of the two oil shocks and a worldwide recession, many private businesses in Japan are facing the same difficulties as those government-assisted industries. However, these private businesses are confronting reality with the full cooperation of their workers. They have striven to economize energy consumption, to improve productivity, and to enhance the quality of their products without government assistance. It is these manufacturing industries that are maintaining Japan's competitive strength in international markets and (as in the past) providing a source of economic growth.

During the last 10 years, the Japanese economic growth rate fell drastically (2 to 3 percent). At least partial responsibility for this drop lies with the two oil shocks of 1973 and 1978. Perhaps the shortage of technology, the increased difficulties in recruiting a young labor force, and the transformation of daring and aggressive entrepreneurs of the 1960s into more staid and conservative business leaders of the 1980s could be other reasons for Japan's slower growth rate.

However, one of the most profoundly negative influences on Japanese economic vitality since 1970 has surely been the vast expansion of government expenditures, complete with huge budget deficits. Heavy borrowing by the Japanese government and the rise of oil prices together created the symptoms of stagflation and recession

(Cont. on p. 11)

Capitalism, Competition, and Money

Philosophical and Economic Foundations of Capitalism, *edited by Svetozar Pejovich (Lexington, Mass.: Lexington Books, 1983), 144 pp., $19.95.*

This book is the result of a conference that the Liberty Fund held in 1981 in Freiburg, Germany. Participants in the conference, called "The Philosophical and Economic Foundations of Capitalism," included Friedrich A. Hayek, James Buchanan, Ronald Max Hartwell, and Svetozar Pejovich, who are represented in this book. Although the essays are of uneven quality, there are enough interesting pieces to make the book worthwhile.

Perhaps the most rewarding piece is "The Origins of Capitalism: A Methodological Essay," by economic historian Hartwell. He provides an overview of the traditional literature on the historical origins of capitalism. While the mainstream theorists disagree on the specific causes of capitalism, they all have at least one point in common: They postulate an "age of capitalism," which at some point was preceded by an "age of feudalism." Hartwell shows that not one of these writers has a clear conception or definition of exactly what "capitalism" is. Hartwell suggests that the real problem is explaining the ebb and flow of the market economy and private enterprise through history, rather than explaining why one "age" succeeded another. As Hartwell concludes, "Capitalism has always been with us. . . . The history of capitalism is largely the history of how enterprise over time has coped with institutional ideological constraints."

Hayek's essay, "The Muddle of the Middle," is slanted toward public policy, as he makes some observations about his famous book, *The Road to Serfdom*, in light of today's political climate. Undiluted praise of Margaret Thatcher and unfair criticism of John Stuart Mill weaken Hayek's effort, but his observations on current problems of unemployment and inflation are on the mark. Perhaps the most interesting aspect of Hayek's essay is his critique of monetarist economic policy—a topic that he has never subjected to a lengthy formal examination. Hayek praises monetarism for pointing out the relationship between rising prices and increases in the quantity of money. Nonetheless, Hayek insists that monetarism is an unsatisfactory approach because it emphasizes aggregates and averages and consequently refuses to examine shifts in relative prices; instead, monetarism only looks at changes in the price level.

There are other interesting essays in this book. Two of them are Ingenar Stahl's "Sweden at the End of the Middle Way," a critique of Swedish economic policy, and James Buchanan's

Policy Report Reviews

"Constitutional Contract in Capitalism," which emphasizes the necessity for constitutional change to create a free society.

One of the strengths of this book—namely, awareness of the need to make a moral case for capitalism and free enterprise—leads to one of its flaws. Many of the thinkers in this book seem unsure how the case can be made. Others are trying to inhabit a halfway house between libertarianism and conservativism. Nonetheless, the book serves a useful purpose in raising such important questions concerning the philosophical and economic foundations of capitalism.

Economic, Legal, and Political Dimensions of Competition, *by Harold Demsetz (New York: North-Holland Publishing Co., 1982), 125 pp., $27.75.*

The perfect-competition model that has dominated economic thought for decades is being rapidly replaced by more realistic models that incorporate information and transaction costs, finite numbers of market participants, and other aspects of the real world. Competitive activity is totally absent from the model that purports to represent "perfect" competition. UCLA economist Harold Demsetz has long been in the forefront of the move toward greater respect for real-world conditions in economic analysis, and the four lectures contained in this volume present many of his valuable insights quite clearly.

Although Demsetz maintains that using the perfect-competition model (perfect information, zero transaction costs, infinite numbers of buyers and sellers, no changes in tastes or technology, all market participants as price-takers, etc.) has generated some valuable insights concerning mutual coordination through price, this model fails to account for many phenomena encountered in the real world. In response to such perceived deficiencies as well as to practical difficulties posed for economists by antitrust law and the growth of government, Demsetz argues that "a revolution in the focus of economic work has been taking place during the last three decades. The new interests of economists increasingly center on the very matters abstracted from by our professional predecessors. The focus is on the economics of information and transactions, and the context for the investigation of these has enlarged to include legal and political institutions." Demsetz applies the results of this new interest to institutions in the private and government sectors that had proven impossible to explain in terms of the perfect-competition model.

Besides having profound implications for antitrust law, the new approach helps to explain how the firm, fair-trade contracts, skewed industry structures, product differentiation, voluntary rate bureaus, and other institutions (all absent from the world of "perfect" competition) emerged from efficient competition.

In the realm of political competition, the introduction of information and transaction costs ("voting costs") helps to explain the emergence of political parties, political lethargy in responding to changes in voter sentiment, the organization of special-interest groups, upward wealth distribution, and intergenerational conflict.

The final chapter sets forth a theory of the growth of modern government in a world of positive transaction costs. This theory is based on the consequences of economic specialization that emerged from the Industrial Revolution. Demsetz argues that the governments of most western countries (and that of Japan as well) have probably reached the limit of their growth because of "political opposition at the polls and avoidance of taxes through underground transactions." Demsetz's analysis of the data "suggests that the tolerable range of contemporary real government sectors in democracies is contained between 30 and 45 percent of total real GNP."

This book offers an excellent and very readable guide to the new economics of transaction costs and a stimulating and insightful alternative to the obsolete model of perfect competition.

Money, Expectations, and Business Cycles: Essays in Macroeconomics, *by Robert J. Barro, New York, Academic Press, 1981), 375 pp., $25.00.*

This volume is a well-balanced sample of many of the most important articles by one of the most influential macroeconomic theorists of the 1970s and 1980s. Unlike many macroeconomists, Barro always relates his work to questions of economic policy. Among the topics examined in this book are the causes of business cycles, the effects of monetary policy, the effects of government debt, the Phillips Curve, and the gold standard. To introduce them all, the first essay in the book is a concise survey of other economists' views on macroeconomics.

While Barro's analysis covers many different topics, his contributions fit generally into the "rational expectations" school of thought. Rational-expectations theorists, tending to emphasize the impotence of governmental policies, claim that market participants will both foresee such policies and take steps to circumvent their effects. Market expectations concerning policy are considered "rational" because individuals are fully using all available information. The only sorts of policies that can have real effects are short-run, unpredictable shocks that cannot be foreseen. Rational-expectations theorists like Barro advise against such policies.

It is true that rational-expectations theorists have often been sophisticated and much-needed critics of certain stabilization policies. On the other hand, the rational-expectations theory has weaknesses that Barro's book also reveals. In particular, that theory confuses the notion that individuals fully utilize all available information and the notion that the available information is accurate and complete. While the first assumption may be justified, the second is not—especially in regard to the future of governmental policy and its effects. By such a confusion, rational-expectations theorists may be seriously misrepresenting the results of certain policies. If the available information is not completely accurate, or if the government's information is different from the private sector's information, even "predictable" policies can have permanent long-run effects. Of course, these effects will be *bad*—but Barro misses this point, as he presumes that only random or haphazard policies can have bad effects.

Barro's approach to business cycles is plagued with problems also. The models that Barro uses tend either to be timeless or to deal in aggregates, in both cases obscuring important issues of capital theory. Instead of using those, it would be productive to examine the effects of monetary expansion upon the capital structure (as in works by Hayek). Instead, Barro focuses on imperfections in the labor market and the more obvious distortions caused by short bursts of inflation.

One of the most famous essays in this book is "Are Government Bonds Net Wealth?" There Barro argues (in a qualified way) that there is no difference between added taxes and expanded government borrowing. In the former case, individuals can simply borrow money if they wish to postpone their debts, as would be the case if the government accumulated taxpayer-supported long-term liabilities. This essay is a good example of Barro's work—it is original, albeit often incorrect; but it is always stimulating. ■

Japan's Success (Cont. from p. 9)

in Japan during the 1970s. Government involvement in the financial market today will probably produce a very unfavorable economic environment for the private sector in the future. This will be an environment in which economic growth will be slow, at best, especially when the government is forced to raise taxes or to inflate the currency to cover the nation's accumulated deficits.

In a market-oriented economy like Japan's, government support in the form of subsidies to targeted industries is rarely a vital ingredient in the nation's general economic growth, even though it may be temporarily beneficial to the favored industries. In such an economy, government policies in the macroeconomic area tend to influence economic growth far more than any selective industrial policy.

History reveals an unblemished record of failure by governments to improve on the market. While Japan's economic success during the past 30 years has indeed been accompanied by governmental activities aimed at promoting industry, it would be a very serious mistake to conclude that there must have been some critical cause-and-effect relationship. The facts show that Japan's success has been in spite of government tinkering rather than because of it. ■

"To be governed . . ."

This is illegal if you do it overseas

Executives from [Wall Street investment] firms . . . disclose that finance and politics have become increasingly entangled for state and local governments throughout the country. . . . Making political contributions is part of the process, officials say. . . .

"[California State Treasurer] Jesse [Unruh] is utterly direct about the importance of contributions—you come with one or you forget about the business," says a top executive with one major investment bank. . . . Mr. Unruh adds: "Probably, as long as all things are equal, and all firms are equally capable, we do tend to go with them if they are friends."

Since so many firms contribute, Mr. Unruh says, no single underwriter enjoys a special advantage. "What we try to do here is try to push everybody into the same corral—we try to get reasonably the same amount from everybody," Mr. Unruh says.

An executive with one securities firm recalls that a state official seeking a political contribution from his firm told the following parable during a visit: A judge, having tried a case, received a $5,000 gift from the defense attorney and a $10,000 gift from the prosecution. The judge went back to the defense attorney and asked for another $5,000; only then would he decide the case on its merits.

—*The Wall Street Journal*, Oct. 18, 1983

This little piggy went to Congress

The Republican floor leader carried a pink plastic piggy mask and complained about a "sickening pork-out," but undaunted House members yesterday passed a $440 million spending bill to supplement the budget for the fiscal year that began five days ago. . . .

Among these other things [in the bill] was money for highways to be built by the Appalachian Regional Commission. When Democrats Jamie L. Whitten (Miss.) and Tom Bevill (Ala.) brought this up, they did not say where the roads would be.

[Rep. Silvio O.] Conte demanded to know. Bevill stepped to the microphone and said that the roads were to built in Mississippi and Alabama.

"That's one for Jamie Whitten and one for Tom Bevill," Conte said after the debate.

—*The Washington Post*, Oct. 6, 1983

And they're doing just about as well

In recent years . . . presidents have tried almost as hard to control federal rule-making as to restrain federal spending. . . .

During 1981 and 1982, the [Office of Management and Budget] reviewed 5,436 regulations and sent 101 back to the agencies; 81 were withdrawn.

—*The Washington Post*, Oct. 9, 1983

A billion here, a billion there

The Energy Department sank nearly $45 million into a geothermal power plant in New Mexico before finding there was not enough underground steam to run it, the General Accounting Office said yesterday. . . .

[Sen. Sam] Nunn called the failure to determine in advance whether enough steam was available to run the plant a "rather serious oversight."

—*The Washington Times*, Oct. 14, 1983

When experts advise the government to wait and see [whether] multimillion-dollar weapons systems work before buying them, Congress seldom follows their advice. . . .

One example: the Army's Patriot missile, to be used by NATO. It may cost $11 billion.

The [General Accounting Office] had said no increases in production should be allowed for 1983 until tests showed that deficiencies had been corrected.

Yet, for the coming year, [Congress authorized] . . . $885 million for 440 missiles, 12 fire units and $100 million for spares.

—*USA Today*, Oct. 4, 1983

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Asked [whether] there were any group in New Mexico that hadn't benefited from [Senate Budget Committee Chairman Pete] Domenici's largess, [Domenici's legislative director George] Ramonas responded: "If there is, they haven't contacted us."

—*The Washington Post*, Oct. 9, 1983

One giant step for feminists?

Uganda has granted women a right formerly given only to men—the right to be scrutinized by the tax collector.

Starting next year, all women except those classified as "peasant cultivators" will be assessed on their own income for the East African country's graduated income tax. . . .

—*The Wall Street Journal*, Oct. 17, 1983

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