Introduction to the Hoover Classics Edition *by Richard A. Epstein*

MY SHORT ESSAY, *Free Markets under Siege: Cartels, Politics, and Social Welfare*, had its origin in the Thirty-third Wincott Lecture that I delivered in London on October 13, 2003. The original English version was published by the Institute of Economic Affairs in early 2004. The volume was republished jointly later that year under the same title for Australia and New Zealand by the New Zealand Business Roundtable and Institute for Public Affairs. The first Hoover edition of the volume appeared in 2005, with an introduction for American readers. I am happy to report that a Spanish translation of the volume has been completed and will be shortly published by the Peruvian University of Applied Sciences.

The importance of this topic, I think, deserves all the attention that I and anyone else can lavish on it. The book is divided into two parts. The first half argues that the central distinction for the organization of government and political life is that between competition and protectionism. Competition produces systematic gains unrivaled by any other system of production and distribution. Protectionism relies on the use of state coercion to introduce measures that lead not only to a loss of political liberty but also to state monopolies, high

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tariffs, and economic stagnation. Building on these insights, the second half looks at agricultural and labor markets to show the baleful results that ensue when political forces displace economic competition with an unwholesome mixture of subsidies and barriers to entry. In this introduction, I shall not review anew the arguments that lead inexorably to this conclusion. Rather my purpose in the summer of 2007 is to comment on the state of the long-standing struggle between competition and protectionism in the nearly four years since the London lecture.

The scorecard on that contest is at best mixed. I have little doubt that in those areas where the competitive, or free market, program, has been put into play its benefits are immediate. One component of the overall system is low and flat taxes, and without question the Bush tax reforms have been a great success in the United States. Furthermore, the stunning Estonian reforms of the past decade offer an even more powerful confirmation of the wisdom of the system. Lower taxes increase the returns of both capital and labor, allowing government revenues to expand with the increased size of the pie. The net effect is that government revenues increase when it takes a smaller share of the larger social pie. More important, that program leaves greater amounts of wealth in private hands, where it can be more efficiently directed toward investment or consumption as people see fit.

I would like to think that the congruence between the basic principle and the observed outcome would lead people on all sides of the political spectrum to

spurn the repeated calls for higher taxation. Nonetheless these calls continue unabated. The case rests on the quaint assumption that the rich don't really "need" their money so that the one-two punch of progressive taxation and a stiff increase in capital gains rates offer painless ways to fund domestic programs. It is discouraging to hear prominent politicians speak as if redistribution were a costless goal best achieved through increased state coercion, which in practice will only bring in its wake some unhappy combination of renewed efforts at tax evasion and reduced levels of output. The only assumption in this debate that is sure to be wrong is that changes in the structure of taxation defended on distributional grounds will otherwise exert no influence on output, prices, or production. The truth is, if anything, close to the opposite: changes in the tax structure will influence, for better or worse, the conduct of virtually all individuals in a thousand ways, none of which corresponds to the naïve view that a massive change in wealth distribution offers low-hanging fruit for any government with the courage to pick it.

The stark conflict between economic theory and political rhetoric has troubling implications. To my mind, the key challenge of public affairs is not to develop economic models that offer evermore sophisticated analyses of complex forms of individual behavior under conditions of uncertainty. Rather, it is to make it clear to the public at large that its deep bias in favor of high taxes and, for that matter, increased regulation rests on fundamental misconceptions. This is no small order. Professor Bryan Caplan has published a sobering vol-

ume, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton University Press 2007), which advances the thesis that democratic institutions have a strong bias to move in the wrong direction on economic matters because of the *systematic* ignorance of the public at large. That view comes into sharp conflict with the usual conclusions of public choice theory insofar as it discredits the assumption that all individuals act in a rational, relentless, and self-interested fashion in the political arena just as they do in their private contexts.

It turns out that any theory of public choice is incomplete and inaccurate insofar as it assumes that all the people fully understand the implications of their positions on matters of great political concern. This makes the problem of government still more difficult because we must add the problem of ignorance to the problem of faction, without knowing how these two pervasive forces interact in a wide range of political settings. Neither should we be surprised about the difficulties of public deliberation on these critical matters of economic organization. First, there is a perfectly rational explanation for people handling their private affairs better than they do voting or deliberating on the large issues of the day. The learning mechanism for understanding the often adverse consequences of personal decisions does not rest on the cognitive ability to understand the interrelationship between supply and demand or the economic proposition that all decisions are made at the margin. Rather, the feedback mechanisms that lead people to make corrections, however haltingly, in their daily

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lives are that they *personally* suffer the consequences of spending too much or buying the wrong goods and services.

In making their public choices, however, these same people, now voters, have no such direct feedback mechanism. Worse still, our dizzying world offers few natural experiments whose outcomes are easy to observe. On the contrary, the constant barrage of stimuli means that the *indirect* consequences of various government programs are ignored and that the direct consequences of those programs are given far too much weight. In the area of taxation, for example, the direct consequence of higher taxes is that richer people pay a larger fraction of their income and poorer people pay fewer taxes or none at all. Thus, measured by its intended consequences, a program of higher taxes looks as though it will have its desired effects. Only by studying the theory can people learn that those changes will usher in a myriad of private decisions dealing with investment, hiring, consumption, and the like. One great advantage of the flat tax, for instance, is that it minimizes the incentives for strategic behavior and the chances of error in calculation: no one need create cumbersome devices for income splitting when marginal tax rates equal average rates. But those benefits of simplicity in taxes, or regulation, can be gotten across only through education, which is hard to transmit over the political din.

The situation is still more complex because the distribution of ignorance is not random. Those interest groups at the heart of the fray—no matter what their

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stripe or cause—are often well aware of the long-term consequences of their initiatives. Yet once such groups gain influence, their agenda—whether in the form of punitive taxes on rivals or special tax breaks for themselves—is to steer wealth, opportunity, and power in their direction and away from competitors. If those groups can form alliances with independent, civic-minded groups and thus hide their self-interest, these potent coalitions of strange bedfellows can easily carry the day in democratic politics.

In this regard, because of the total lack of any clear message on these critical economic issues by any political leader of national stature, today's domestic outlook is somewhat pessimistic. Now, close to twenty years from the time Ronald Reagan left office, in January 1989, we can clearly identify, as Martin and Annelise Anderson have documented in *Reagan in His Own Hand*, the great, if sometimes unsung, edge that defined the Reagan presidency: he learned and internalized the important lessons of classical liberalism, with its emphasis on limited government, low taxes, strong markets, and self-reliance. Reagan was a great communicator because he had something to say. Neither of his two (Bush) successors have been able to articulate, or indeed accept, his program with sufficient clarity and conviction to offset the big-government rhetoric that dominates and corrodes public deliberation and debate.

The consequences of this breakdown in public discourse are not confined to matters of taxation. They seep into just about every domestic and foreign policy issue. In July 2007, the federal minimum wage rose from

$5.15. to $5.85 (with additional $0.70 increases in July 2008 and July 2009), an initiative that met with intellectual resistance from economically minded individuals but faced no true political opposition in Congress on either side of the aisle. The usual platitudes carried the day: the minimum wage would raise the wages of those at the bottom, without creating dislocations elsewhere. The second part of that statement would be true if the statutory minimum were set below the market wage. But the two parts of the sentence cannot be true together because employers will take steps to minimize their costs, thereby creating some short-time dislocations and hurting the long-term prospects of the poorest and least-educated individuals, those with, at best, a toehold in the market.

The same sort of political rhetoric has, fortunately, taken less of a toll in the recent debates over the rise in gasoline prices. Even though too many people still think that some hidden form of greed or monopolization is at work, many realize that what is actually happening are sensible and continuous adjustments in prices to reflect shifts in supply and demand, in both directions. Thus the populists condemn the rise (but never the fall) in the price of standard commodities and often seek to punish the very actions that help ration goods with increased scarcity value. I suspect that the demands for maximum price controls on gasoline, although commonly voiced, have not been as successful as the calls to hike the minimum wage because enough people remember the long queues that formed when Richard Nixon imposed price controls on gasoline in the early

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1970s. It turned out that we were not immune to government-induced shortages that replicated the endless lines characteristic of the Soviet system.

The consequences of political mistakes are not confined to domestic issues but also exert a vast influence on foreign relations. Some sense of the depth of ignorance on this issue was captured by then presidential candidate John Kerry, who spoke of CEOs who sought to outsource work from the United States to foreign countries as Benedict Arnolds, a sentiment which was echoed by his Republican rival, George W. Bush. Such remarks are far off base: Benedict Arnold was a traitor who plotted to turn over West Point to the British during the Revolutionary War. Should we really equate CEOs who seek to lower costs and improve quality with people disloyal to the United States? That position garners public respectability for one familiar reason: it studiously avoids the indirect benefits of these sensible maneuvers in a world economy, both here and abroad.

Domestic American protectionist sentiments hurt our credibility overseas, which I hope to exemplify with a personal anecdote. I still remember my acute embarrassment when, in the spring of 2003, I was asked to defend open markets before an economic meeting in Brussels, the headquarters of the European Union, shortly after President Bush had announced that he was putting tariffs on imported steel to shore up his political position in Pennsylvania or West Virginia. Fortunately, the tariffs were eventually removed, but not without protest. It took some twenty months to contain but not eliminate the dangers. Lifting is better than keeping, but it

is far from ideal, especially when said removal is not accompanied by a candid recognition of the initial error and a solemn vow never to repeat it. Instead we declared victory, announcing that the tariffs had achieved their goal because the steel industry had "wisely" used the time for consolidation and restructuring, which could have been done more efficiently if the temporary protection had never been supplied.

Unfortunately, that episode has not proved to be an isolated incident, given the increased willingness on all sides to use transient expedients to justify other restraints on international trade. All too often tariff walls in the United States erect barriers to goods from countries whose political support we desperately need. The situation is no better on the question of subsidies, for lavish farm subsidies distort the domestic market and create (this time for real) unfair competition against the produce of poorer nations who cannot compete with subsidized American goods in world markets. The beat does not end there. As this introduction was being written, relationships between the United States and Peru were strained because of U.S. insistence that Peru enact certain domestic reforms in labor and environmental matters as a condition of a free trade agreement with the United States. The folly of this approach lies not in the particulars of the terms that are demanded but in linking free trade to domestic reform in other countries. Free trade is itself a great reformer: the input of cheap goods and services from foreign sources acts as a powerful and persistent spur to domestic reform that no local firm or union can evade as long as the tariff barriers remain low.

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The most notable illustration of this proposition is the enormous expansion in output and profitability of New Zealand agriculture after its inordinate subsidies were removed at one stroke in the mid 1980s. Make no mistake, the true purpose of such proposed U.S. restrictions is to make exports from those countries more expensive, meaning that protectionists at home get an imperfect substitute for the tariff barriers that are about to be lowered. How ironic it is that the price for free trade in foreign countries is the acceptance of external controls on labor and other markets that those countries do not seek to impose on themselves.

The same situation can be observed in the constant struggle over immigration into the United States. The first, and most tragic, point is that one consequence of our strong welfare state is that it makes more respectable demands for limiting immigration into the United States: How, such arguments go, do we know whether people from overseas are coming to this country to work or to receive a generous package of welfare benefits paid for by others? That problem would not arise were those benefits smaller. But now that they are fixed in the domestic political market, a heavy price is paid by foreigners who are shut out of this country in larger numbers than is appropriate.

Yet the protectionist elements have proved powerful in the recent immigration debate, especially with the shortage of coveted H-1B visas for highly skilled workers who are needed to power our high-tech efforts in biotechnology and computers, as once again a bipartisan coalition seeks to block or reduce entry. Those limited

visas are snapped up the day the government makes them available. Efforts are now under way to require such skilled workers to receive the prevailing American wage, as a clear barrier against entry. But any effort to expand the pool of eligible entrants is met with fierce protectionist resistance from people who see new immigrants only as competitors for American workers, not as current or future suppliers, colleagues, buyers, or prospective founders of businesses and employers of thousands. Once again that narrow perspective, which sees only harm from direct competition, has taken over the public debate.

To these intellectual follies, the only answer is education. As Caplan's research indicates, the public at large takes the wrong position on just about every issue relating to domestic issues of business and labor, international issues, and tariffs, trade, and immigration. The educated public, however, does far better on these issues than the public at large, to whom politicians of both parties pander. The most important economic and social issues of our time depend on lifting the siege that today surrounds the operation of free markets. I am proud and pleased that the Hoover Institution, true to its basic mission, has seen fit to reissue this volume under its Hoover Classics imprint, especially so soon after its original publication. I hope it will embolden the proponents of free trade, both at home and abroad.