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Economic Troubles and the Growth of Government

by Robert Higgs*



The current recession and, especially, the related financial panic in the fall of 2008 have given rise to an extraordinary surge in the U.S. government's size, scope, and power. As I write,

the financial panic has subsided, but the recession, already the longest since the 1930s, seems likely to continue for a long time. Even when it has passed, however, the government will certainly retain much of the augmentation it has gained recently. Hence, this crisis will prove to be the occasion for another episode of the ratchet effect in the growth of government.

According to the National Bureau of Economic Research, the recession began early in 2008, but the decline became severe only in the latter part of the year. The financial panic that came

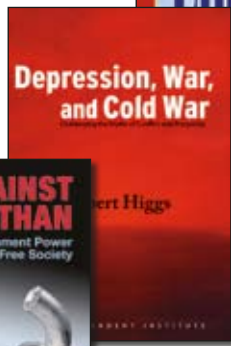
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to a head in late September 2008 proved to be the catalyst for an accelerated decline in real GDP and rise in the rate of unemployment. The so-called

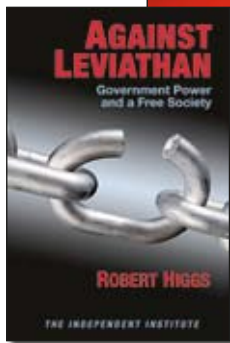


credit crunch in the fall of 2008 prompted the Fed, the Treasury, and the Congress to take a series of extraordinary actions in quick succession.

In September 2008, the Federal Reserve System ("the Fed") took control of the insurance



giant American International Group (AIG), and the Federal Housing Finance Authority took over the huge government-sponsored enterprises



Fannie Mae and Freddie Mac, secondary lending institutions that held or insured more than half of the total value of U.S. residential mortgages. On October 3, the president signed the Emergency Economic Stabilization Act, which, among other things, created the Troubled Assets Relief Program (TARP), authorizing as much as \$700 billion for the purchase of so-called troubled assets, primarily mortgage-related securities, held by banks and other financial institutions. Instead of making the authorized purchases, however, the Treasury used the TARP to inject funds into the banks by purchasing their preferred shares. In this way, the government acquired an ownership interest in nearly 600 commercial banks.

Meanwhile, the Fed made a series of unprecedented types of asset purchases and loans, loan guarantees, and asset swaps, and provided other forms of assistance to securities dealers, money-market mutual funds, Fannie Mae, Freddie Mac, the Federal Home Loan Banks, Citigroup, four-

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President's Letter

Culture and Liberty

"If we present man with a concept of man which is not true, we may well corrupt him. . . . The gas chambers of Auschwitz were the ultimate consequence of the theory that man is nothing but the product of heredity and environment—or, as the Nazis liked to say, of 'Blood and Soil.' I am absolutely convinced that the gas chambers . . . were ultimately prepared not in some Ministry or other in Berlin, but rather at the desks and in the lecture halls of nihilistic scientists and philosophers."



—Viktor E. Frankl, Holocaust survivor; Professor of Neurology, University of Vienna

A grassroots movement is sweeping the U.S., involving millions of people rediscovering the principles of liberty. This cultural awakening is challenging the bailouts, debt, wars, violations of the Bill of Rights, economic decline, and socialization of economic and social life.

Yet Washington power grabs are in a frenzy, pushing to control the well-being of every American. Based on a moral relativism that views individuals as mere raw material to be manipulated, most intellectual "elites" have long derided the cultural traditions of individual liberty and responsibility, private property, and free markets. Such "elites" believe that people should be controlled and socialized to solve every problem. And with a true-believing Barack Obama as President, the rush is on to impose every type of long-sought collectivism.

Although the folly of statism is becoming more and more apparent to many Americans, few understand the nature of and solution to this cultural malaise and the threat it poses. As a result, we have launched the **Center on Culture and Civil Society** (p. 7) to produce a new integrated understanding of the foundations of free societies. Senior Fellow **Robert Nelson's** new book, *The New Holy Wars*, builds on the work of **Jonathan Bean's** *Race and Liberty in America*, **Robert Higgs's** *Depression, War, and Cold War* (p. 1), and other Institute publications.

Because we cannot let a new Dark Age of collectivism take hold, we invite you to join as an **Independent Associate Member**. With your tax-deductible membership, you can receive a **FREE** copy of *Race and Liberty in America*, along with other publications, including our journal edited by Dr. Higgs, *The Independent Review* (p. 3), plus other benefits (see attached envelope).

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The Independent Review

Carbon Taxes • Nationalizing Private Life • Food Safety

Here we feature highlights of the Fall 2009 issue of *The Independent Review*, the Independent Institute's quarterly journal.

The Case Against a Carbon Tax

Climate change proposals debated in Washington, D.C., have centered around so-called cap-and-trade legislation, but many economists and scientists favor a carbon tax to curb the carbon dioxide emissions believed to cause global warming. The case for a carbon tax, however, is weaker than they assume, according to **Robert P. Murphy**, an economist for the Institute for Energy Research ("Rolling the DICE: William Nordhaus's Dubious Case for a Carbon Tax").

The most influential economic model used to calculate an "optimal" carbon tax—developed by William Nordhaus of Yale University—is deeply flawed, Murphy argues. Among other problems, it employs questionable estimates of (1) future concentrations of carbon dioxide, (2) temperature increases associated with those concentrations, and (3) economic costs associated with those estimated temperature increases.

Why is this a problem? A change in any one of those inputs would yield a vastly different "optimal" carbon tax—and the model employs scores of dubious inputs. Recall the old computer-programming adage: Garbage in, garbage out.

But even if the models were perfected, political pressures would likely prevent a carbon tax from working as advertised, according to Murphy.

How then should we manage risks that might arise from climate change? Murphy recommends the removal of legal and regulatory obstacles that keep people from effectively adjusting to change.

"Rather than depending on conjectural models and the good faith of politicians," writes Murphy, "economists should instead consider the ability of markets to generate wealth to ease the adaptation process."

See www.independent.org/publications/tir/article.asp?a=751.

World War I and the Nationalization of Private Life

More than 10 million soldiers are believed to have been killed in World War I. Civilian deaths are harder to determine, but many millions died of mass murder, forced migration, execution

in reprisal or for spying, accidental killing, and starvation.

The war also took a heavy toll on its survivors and on European civilization itself, explains Austin College historian **T. Hunt Tooley** ("Some Costs of the Great War: Nationalizing Private Life").

For three centuries, individualism and constitutionalism had spread across Europe, but in the years just prior to the war, Europeans increasingly defined themselves by national and class membership. The war accelerated this collectivist backlash.



The Independent Review, Fall 2009

Governments of the belligerent nations led the way. They heavily intervened in civilians' economic activities and curtailed civil liberties.

To carry out their illiberal policies, governments fostered new attitudes about private property and private life itself. Statist propaganda flourished. By weakening property rights, governments downgraded the autonomy of individuals and families. Private life was in effect nationalized.

"The upshot of the Great War was a sea change in all relations of the individual to the state and therefore a sea change in all relations between and among individuals, families, churches, and nonstate groups," writes Tooley.

The nationalization of private life, Tooley contends, did not end with the signing of the Treaty of Versailles but continues to the present day.

(continued on page 6)

The Independent Institute in the News

• **Center on Entrepreneurial Innovation:** Senior Fellow **William F. Shughart II** discussed the Pittsburgh meeting of the G-20 on Radio Free Europe and wrote on the U.S. Postal Service for *Sacramento Bee*, *Denver Post*, and *Minneapolis Star Tribune*. His op-ed on taxing soda appeared in *Washington Examiner*, *News & Observer*, and *Providence Journal*. He also provided an article on California's budget crisis for *San Francisco Examiner*. Research Director **Alexander Tabar-**



Independent Institute Senior Fellow Alvaro Vargas Llosa on CNN en Español.

rok was interviewed on "Health Law & Politics" regarding organ donation shortages. His blog was recommended by *Wall Street Journal*. Research Fellow **Dominick T. Armentano** shared his opinion on health insurance in *Naples Daily News* and *Austin Business Journal*. *Economic History Review*, *Business History*, and *Books & Culture* reviewed *Good Money* by Research Fellow **George Selgin**. Research Fellow **Stan J. Liebowitz** covered the mortgage crisis for *Wall Street Journal*. Research Fellow **Gabriel Roth** discussed private road financing in a letter to *Washington Times*. He was quoted by *Washington Examiner* and his article on transportation funding appeared in *Wall Street Journal*. Research Fellow **Benjamin Powell** wrote for *NationalReview.com* on Deutsche Bank and the mortgage crisis. The Institute's participation in the **Out of the Storm '09** conference was mentioned in New Orleans's *Times-Picayune*.

• **Center on Global Prosperity:** Senior Fellow **Alvaro Vargas Llosa** continued to write his internationally syndicated weekly column for the Washington Post Writers Group. He was interviewed by CNN en Español on the Honduras military coup and was quoted by *Orange County Register*, *Americas Quarterly*, and *Washington Times*. Research Fellow **William Ratliff** supplied op-eds on the Honduras coup to *Miami Herald*, *Los Angeles Times*, and *Forbes.com*.

• **Center on Law and Justice:** Research Fellow **Jonathan Bean** provided commentary on the 46th anniversary of Dr. King's "Dream" speech for *San Gabriel Valley Tribune*, *Fort Worth Star-Telegram*, *Times Union*, *Athens Banner-Herald*, and *Tallahassee.com*, and on the Supreme Court's *Ricci v. DeStefano* decision for the *Providence Journal*. Broadcast interviews included the "Mike Siegel Show," Voice of America's "Hip Hop Connection," and "Urban Journal." Reviews of his book *Race and Liberty in America* appeared in *Southern Illinoisan*, *Birmingham Times*, and on *Reason.com* and *NationalReview.com*. Research Fellow **Stephen P. Halbrook** was quoted by *Honolulu Star-Bulletin* on Justice Sotomayor's confirmation.

• **Center on Peace and Liberty:** Director **Ivan Eland** wrote commentary on U.S. oil policy for *Pittsburgh Tribune-Review* and *Manistee News Advocate*. Broadcast interviews included *Russia Today*, *Press TV*, and *Radio Free Europe*. *Baron's* and *Reference & Research Book News* reviewed his books *Recarving Rushmore* and *Partitioning for Peace*, respectively. Senior Fellow **Robert Higgs**



Independent Institute Senior Fellow Charles Peña on CTV.

opined on economic stimulus for *Investor's Business Daily* and on government expansion for *The Freeman*. His op-ed on the Federal Reserve was syndicated by *McClatchy-Tribune News Service*. He also discussed the economic recession on BBC World Service radio, and his book *Depression, War, and Cold War* was reviewed by *Reference & Research Book News*. Research Analyst **Anthony Gregory** provided commentary for *Christian Science Monitor* on the constitutionality of a nationalized health care system. Senior Fellow **Charles Peña** wrote on U.S. intervention in Pakistan for *FoxNews.com* and was quoted by *Palm Beach Post* on ignition interlocks. He also appeared on CTV and Al Jazeera to speak on U.S. foreign policy. •

Policy Reports Seek Insurance Deregulation

Hurricanes, severe storms, and devastating floods wreak havoc in the southeastern coastal United States and elsewhere. The total economic damage done by Hurricane Katrina in Louisiana and Mississippi, for example, may have exceeded \$150 billion, with insurers losing an estimated \$45 billion.

What changes in public policy would best mitigate the damage from natural disasters? How can states reform insurance regulation to enable devastated communities to recover more quickly?

From September 30 to October 2, a distinguished group of insurance experts convened in New Orleans to examine these questions at the second annual “Out of the Storm” conference, sponsored by the Independent Institute and the Competitive Enterprise Institute, in cooperation with the Louisiana and South Carolina Departments of Insurance and other organizations.

The Independent Institute was represented by three Research Fellows. **Patricia Born** (Florida State Univ.) and **Jeffrey Pompe** (Francis Marion Univ.) discussed lessons Florida can learn from the experiences of Louisiana and South Carolina, and **Lawrence Powell** (Univ. of Arkansas) discussed the future of reinsurance—i.e., insurance for insurance companies.

The conference enabled the Independent Institute to introduce policymakers and the public to its new series of policy reports about property and casualty insurance regulation. The first report, by Born and **Barbara Klimaszewski-Blettner** (Munich School of Management), examines the consequences of price regulations imposed after natural disasters.

Although caps on insurance premiums are intended to help customers, they can backfire badly, the authors argue. If, for example, an insurer cannot maintain solvency by adjusting premiums, it will exit the market, leaving property owners with fewer insurers to choose from. Policymakers may respond by making it hard for insurers to exit, but ultimately this type of a regulatory “chain reaction” exposes taxpayers and consumers to greater risks

when disaster strikes again.

Market-determined insurance premiums, Born and Klimaszewski-Blettner conclude, ultimately protect consumers against future losses. In contrast, restricting the flexibility of insurers to adjust premiums in light of changing conditions ultimately harms consumers.

Insurance is regulated at the state level, and because regulations differ by state, the growing complexity of regulation makes it costly for insurers to operate in multiple states. The second report



in the series, written by **Robert Klein** and **Martin Grace** (both of Georgia State University), examines regulatory alternatives to the state-based status quo.

An optional federal charter, first proposed in 2007 and favored by many

insurers, would allow insurers to choose federal regulation, thereby exempting them from state oversight. Klein and Grace note that federal regulation would not necessarily be less onerous than state regulation

nor immune to interest-group pressures.

A second option, proposed in 2004, is to create federal standards for state regulation. Although this approach would avoid the potential pitfalls of full-blown federal regulation, monitoring and enforcing the standards could prove difficult, Klein and Grace argue. By retaining regulation by the states, gains in efficiency would be limited.

In the third report, **Lawrence Powell** examines insurance scoring—the use of credit information in insurance underwriting and pricing. Insurance scores are powerful and accurate predictors of losses for automobile insurers, according to Powell. Their low cost would reduce the overall cost of providing insurance.

“When insurers use insurance scores to improve the accuracy of predicted losses, it benefits individuals and society,” writes Powell. “It increases the equity or fairness in insurance pricing outcomes because, on average, premiums are more closely related to consumers’ risk of loss.”

A report by **Eli Lehrer** (Competitive Enterprise Institute) examines federal roadblocks to the

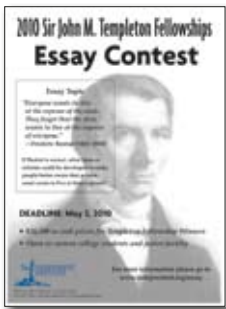
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Student Programs Spark the Spirit of Liberty

October 17, 2009 marked the 30th anniversary of the formal creation of the U.S. Department of Education (ED). Over the past 30 years, millions of dollars have been pumped through the system all in the name of our children's well-being and future success. Unfortunately, problems increasingly ravage the system and today's students hardly seem better off than they were all those years ago. While we can't dismantle the ED, the Independent Institute is committed to providing opportunities for students to achieve personal success, and just as importantly, to exposing them to the ethical and economic principles of liberty and free markets.

The student programs at the Institute consist of four parts: the prestigious **Sir John M. Temple-**



ton Fellowship Essay Contest for college students and young faculty; the Independent Institute's **Summer Seminars on Liberty, Economy, and Society** for high school and college students; our year-round **Student Internships** program; and our program of textbook course adoptions for high schools and colleges. Each component encourages educational excellence among up-and-coming generations by examining the nature and relevance of the entrepreneurial spirit and liberty.

Whether it's over the course of their internship, or through attending one of our Summer Seminars, each student is personally challenged to understand the dynamic process of markets and technological innovation, without regard to prevailing popular or political biases, trends or phobias. As a result, our students are able to explore important areas that might otherwise be ignored, including questions normally considered "out-of-the-box," but which might well be crucial to their understanding in order to get at real answers and lasting solutions. In the end, students walk away with an appreciation for individual responsibility and free-market processes, and in today's increasingly statist environment, this

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The Independent Review: Nationalizing Private Life • Food Safety Regulation

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See www.independent.org/publications/tir/article.asp?a=749.

Ideology and U.S. Food Safety Regulation

Although the budgets of federal food-safety regulators have increased in recent decades, you couldn't tell by looking at the number of food-borne illness outbreaks and cases reported in the United States.

Why, in the absence of success, have politicians and the public approved more resources for the regulators? The simple answer is: *ideological change*. But why did an ideology that values greater funding for ineffective programs gain traction?

The process of ideological change had long defied systematic analysis, but we can learn much about it by applying concepts borrowed from biological evolution, according to **Tomohide Yasuda**, from the University of Massachusetts, Boston ("The Application of Darwinism to Ideological Change, with a Case Study of Food-Safety Regulation").

Like living organisms, ideologies come in varieties, pass certain traits to their offshoots, and

are subject to a process of selection. Government agencies play a dominant role in the selection process, Yasuda contends.

His argument is as subtle as it is intriguing: Tax-funded information programs tend to outlast privately funded ones; ideologies that attach themselves to government agencies therefore have higher survival rates in the psychological and socioeconomic environments in which ideological selection takes place.

How well does Yasuda's theory conform to reality? Splendidly. As predicted, federal agencies (mainly the USDA and FDA) provide a larger and growing share of the public information about food safety. Also, the agencies increasingly work with academia, which provides theoretical justification for agencies that fund academic research.

Government bureaus are the major selective agent in the competitive environment for ideas about food-safety policy, and they favor a pro-regulatory ideology. Yasuda's theory of ideological change helps explain why.

See www.independent.org/publications/tir/article.asp?a=750.

Independent Institute Launches New Center

The Independent Institute is pleased to announce its new **Center on Culture and Civil Society**. The Center will work to advance new



Robert H. Nelson

research, bridge and cross-fertilize such work among disciplines, and help foster an integrated intellectual and cultural renaissance that will challenge the pervasive paradigms of reductionism and

determinism with a new understanding both of the timeless truths that connect liberty with the natural and social sciences.

As part of this new program, the Independent Institute has welcomed **Robert H. Nelson** to the Institute as a Senior Fellow. Nelson is also Professor of Public Policy at the University of Maryland, and the author of the Center's new book, *The New*

"It is in Man's power to treat himself as a mere 'natural object' and his judgments of value as raw material for scientific manipulation to alter at will. . . . The real objection is that if man chooses to treat himself as raw material, raw material he will be: not raw material to be manipulated, as he fondly imagined, by himself, but by mere appetite, that is, mere Nature, in the person of his de-humanized Conditioners. . . . A dogmatic belief in objective value is necessary to the very idea of a rule which is not tyranny or an obedience which is not slavery."

—C. S. Lewis, Author, *The Abolition of Man*

Holy Wars: Economic Religion Versus Environmental Religion in Contemporary America (Pennsylvania State University Press).•

Robert Higgs: Economic Troubles and the Growth of Government

(continued from page 1)

teen foreign central banks, and buyers of certain asset-backed securities based on consumer and small-business loans. As a result, the monetary base of the United States increased by more than 100 percent between August 2008 and January 2009.

After Barack Obama became president, Congress passed the American Recovery and Reinvestment Act, authorizing a variety of federal spending increases and some tax reductions over the period from 2009 to 2019. According to estimates by the Congressional Budget Office, the combined amount of these spending increases and tax cuts comes to \$787 billion over the ten-year period.

These actions, among others, caused federal outlays to jump by 24 percent in fiscal year 2009,

raising the U.S. government's spending from 21 percent of GDP to 26 percent. They also increased the budget deficit by 246 percent, to approximately \$1.6 trillion. Public debt held by the public rose from \$5.8 trillion to \$7.6 trillion during the course of fiscal year 2009, a 31 percent increase. These spending and borrowing surges will certainly have very long-lasting consequences.

Although these consequences are now in large part unavoidable, amelioration of their harm, as well as the prevention of similar government actions in a later crisis, requires a renewed commitment to liberty and a heightened understanding of its attainment and preservation. Toward these ends, the Independent Institute continues to work relentlessly. •

Policy Reports Seek Insurance Deregulation

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velopment of private flood insurance. Legislation passed in the 1930s and '40s, he explains, set the stage for periodic interventions that have made private flood insurance more difficult to provide.

"America ended up with a system of political insurance that has placed an enormous burden on the Treasury and created a moral hazard," Lehrer writes.

Other authors in the series include **Martin Eling** (U. of St. Gallen), **Joan Schmit** (U. of Wisconsin), **Jeffrey Pompe** and **James Rinehart** (both of Francis Marion Univ.), **Tyler Leverty** (U. of Iowa), **David Eckles** (U. of Georgia), **Stephen Pociask** (TeleNomic Research), and **Andrew Morriss** (U. of Illinois).

See www.independent.org/publications/policy_reports/insurance_reports.asp. •

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Help Us Advance the Future of Liberty

It's that time of year again; can you believe it? Holidays are nearly in full swing and 2009 is coming to a close, and what a year it's been! While liberty is undoubtedly under siege, 2009 has also seen a tremendous growth in outreach for our ideals of freedom, as more people grow tired of the rhetoric and partisan plays for increased government power.

Looking to the future we can be sure of one thing: ideas matter. They shape and form the principles on which all policy is written. Who better to supply such a foundation than the Independent Institute? As Senior Fellow **Robert Higgs** shares on page 1, every day the Independent Institute continues its relentless push on the issues that matter most—the economy, healthcare, foreign policy, civil and economic rights. We look forward to continuing this important work.

But we can only continue to do so with your help! Despite the serious effects the economic downturn has had on some of our members, we continue to expand and do more with less. We are truly entrepreneurial in all we do! But we know that our ability to grow in the coming year will rely heavily on our nearest and most committed friends—friends like you.

Before the year comes to a close, we ask you to join with us and offer your support by making a donation today. With your help, we have the daily opportunity to reach many millions of people with the message and principles of liberty, never more needed than now.

For further information on giving to the Independent Institute, please contact **JuliAnna Jelinek**, Development Director (510-632-1366) or visit www.independent.org/membership.



The Challenge of Liberty Summer Seminars provide students with the opportunity to learn the economic and ethical principles of free societies.

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Student Programs Spark Spirit

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couldn't be more necessary to our country and our children's future success.

If you, or a student you know, would like to learn more about the Independent Institute's student programs, please contact **Carl Close**, Academic Affairs Director, at cclose@independent.org or visit <http://www.independent.org/students>.

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