

# Reaganomics Goes Global

## What Can the EU, Russia and Other Transition Countries Learn from the USA?

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palgrave  
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# 1 Lessons from America's Founding Fathers and US Experience

*Steve H. Hanke*

In the aftermath of World War I, President Woodrow Wilson set out to make the world safe for democracy. Since then, US Presidents have marched to the drumbeat of Wilsonian idealism. Indeed, most US foreign policy is carried out under the pretext – and in some cases perhaps the genuine belief – that America is delivering democracy to the rest of the world. President George W. Bush's rationale for foreign engagements is, therefore, not new or unusual.

Most people, including most Americans, would be surprised to learn that the word 'democracy' does not appear in the Declaration of Independence (1776) or the Constitution of the United States of America (1789). They would also be shocked to learn the reason for the absence of the word democracy in the founding documents of the USA. Contrary to what propaganda has led the public to believe, America's Founding Fathers were skeptical and anxious about democracy. They were aware of the evils that accompany a tyranny of the majority. Not surprisingly, the Framers of the Constitution went to great lengths to insure that the federal government was not based on the will of the majority and was not, therefore, democratic.

The Constitution divided the federal government into legislative, executive and judicial branches. Each branch was designed to check the power of the others because the Founders did not want to rely only on the voters to check government power. As a result, citizens were given very little power to select federal officials. Neither the President, members of the judiciary nor the Senate were elected by direct popular vote. Only members of the House of Representatives were directly elected by popular vote. But even in this case, the franchise was restricted to white males who owned property. Moreover, state governments had the right to place further restrictions on the citizens' franchise.

If the Framers of the Constitution did not embrace democracy, what did they adhere to? To a man, the Framers agreed that the purpose of government was to secure citizens in John Locke's trilogy of the rights to life, liberty and

property. The Framers wrote extensively and eloquently on liberty. John Adams, for example, wrote that 'the moment the idea is admitted into society, that property is not as sacred as the laws of God, and that there is not a force of law and public justice to protect it, anarchy and tyranny commence' (Adams, 1851, p. 9).

The Founders' actions often spoke even louder than their words. Alexander Hamilton, a distinguished lawyer, took on many famous cases out of principle. After the Revolutionary War, the state of New York enacted harsh measures against Loyalists and British subjects. These included the Confiscation Act (1779), the Citation Act (1782) and the Trespass Act (1783). All involved the taking of property. In Hamilton's view, these Acts illustrated the inherent difference between democracy and the law. Even though the Acts were widely popular, they flouted fundamental principles of property law. Hamilton carried his views into action and successfully defended – in the face of enormous public hostility – those who had property taken under the three New York state statutes.

The Constitution was designed to further the cause of liberty, not democracy. To do that, the Constitution protected individuals' rights from the government, as well as from their fellow citizens. To that end, the Constitution laid down clear, unequivocal and enforceable rules to protect individuals' rights. In consequence, the government's scope and scale were strictly limited. Economic liberty, which is a precondition for growth and prosperity, was enshrined in the Constitution.

After European settlement, America consisted of thirteen English colonies. They benefited from a rather light administration from London and salutary neglect. This contrasted with the French colonies, which were controlled from Paris, and the Spanish colonies, which had entire institutional superstructures imposed from Spain.

Everything did not go well in the American colonies, however. One major colonial problem centered on money. Officially British silver coins were the coin of the realm in America. But there were problems. The Navigation Acts prohibited the export of silver coins from England. There was also a prohibition against any of the colonies establishing mints. As a result, there was an endemic shortage of silver coins in the colonies. To fill this large gap, bills of credit were issued and circulated freely during the first half of the eighteenth century.

This resulted in high inflation, which forced most of the colonies to abandon fixed exchange rates and a specie standard. Things finally deteriorated to such an extent that the British Board of Trade imposed the Currency Acts of 1751 and 1764. These prohibited the issuance and use of bills of credit not fully backed by specie. The prohibitions against paper money created an enormous source of resentment in the colonies. Coupled with the better-known Stamp Act of 1765, the prohibitions on bills of credit set the stage for the Declaration of Independence and the ensuing Revolutionary War.

The Revolutionary War added to America's money problems. The best estimates place the cost of the Revolutionary War at about 15 to 20 percent of the colonies' GNP. Roughly 85 percent of it was financed with fiat money. During the 1775–80 period, annual inflation was about 65 percent. Subsequently – and prior to the Constitutional Convention (1787) – the economic situation was one in which individual states increased taxes and regulations dramatically and money remained unstable. In addition, there was a great deal of political corruption and scandal. And to top it off, the economy was in a general slump which was punctuated by the crisis of 1787.

As a reaction to the overall political-economic situation, the Constitutional Convention convened in 1787 in Philadelphia. In due course, the Constitution was crafted and ratified in 1789. It is a short, clear, intelligible document. The Constitution's preamble contains only 52 words which are followed by seven short articles and ten amendments known as the Bill of Rights (1791). The original Constitution established the rule of law and limited government. About 20 percent of the Constitution itemizes things that the federal and state governments may not do. Another 10 percent of the Constitution is concerned with positive grants of power. However, most of these were simply a reaffirmation of powers that had been previously exercised under the Articles of Confederation or by the states. In total, the legitimate powers granted by the Constitution were less than those that had existed. The bulk of the Constitution – about 70 percent – addresses the Framers' conception of their main task: to bring the United States and its government under the rule of law.

The Constitution is primarily a structural and procedural document that itemizes who is to exercise power and how they are to exercise it. A great deal of stress is placed on the separation of powers and the checks and balances in the system. It was not a Cartesian construct or formula aimed at social engineering, but something to protect the people from the government. In short, the Constitution was designed to govern the government, not the people.

The Bill of Rights establishes the rights of the people against infringements by the State. The only claim citizens have on the State, under the Bill of Rights, is for a trial by a jury. The rest of the citizen's rights are protections from the State. For roughly a century after the Constitution was ratified, private property, contracts and free internal trade within the United States were kings. The scope and scale of the government remained very constrained. All this was very consistent with what was understood to be liberty.

A remark about the Framers and the public is in order. There were 55 Framers and 35 had attended college. The college entry standards in those days were very high and strict. At the age of 14 or 15, the normal college entry age, students were required to be fluent in both Latin and Greek and proficient in classics. They were skilled at the art of rhetoric and were

keenly aware of the necessity of garnering public support for their constitutional project. The Framers knew that policies needed to be developed from the bottom up.

At the time, Americans were literate and well informed, via pamphlets and manuscripts, about the political debates of the day. There were four times as many newspapers in the United States as there were in France, which was the center of continental thinking and debate on many constitutional and philosophic matters. The Federalist Papers were actually published in 1787 and 1788 in New York City's *Independent Journal*, an ordinary newspaper. These important essays, written under pseudonyms by Alexander Hamilton, James Madison and John Jay, were of very high quality and set the stage for the Constitutional Convention and the resulting product. In passing, it is worth mentioning that Hamilton organized this project, wrote most of the essays, and of all the Founding Fathers, performed the most intellectual work for the least historical credit. That said, two notable economists have given Hamilton his due. Milton Friedman wrote in 1972 that Federalist Paper 15, written by Hamilton, 'contains a more cogent analysis of the European Common Market than any I have seen from the pen of a modern writer' (Friedman, 1972, p. 92). And if that were not enough, Lionel Robbins (1998, p. 240) thought the Federalist Papers were 'the best book on political science and its broad practical aspects written in the last thousand years.'

After the Constitution was ratified and George Washington was elected President, the new federal government lacked credibility. Public finances hung like a threatening cloud over the government. Recall that paper money and debt were innovations of the colonial era, and that once the Revolutionary War began, Americans used these innovations to the maximum. As a result, the United States was born in a sea of debt. A majority of the public favored a debt default. Alexander Hamilton, acting as Washington's Secretary of the Treasury, was firmly against default. As a matter of principle, he argued that the sanctity of contracts was the foundation of all morality. And as a practical matter, Hamilton argued that good government depended on its ability to fulfill its promises.

Hamilton won the argument and set about digging the country out of its financial debacle. Among other things, Hamilton was what would today be called a first-class financial engineer. He established a federal sinking fund to finance the Revolutionary War debt. He also engineered a large debt swap in which the debts of individual states were assumed by the newly created federal government. By August 1791, federal bonds sold above par in Europe, and by 1795, all foreign debts had been paid off. Hamilton's solution for America's debt problem provided the country with a credibility and confidence shock.

The state of economic affairs in the United States, roughly until World War I, was in the spirit of the Constitution. The economy flourished, with

large increases in labor and capital inputs as well as strong productivity growth. There was, of course, one near fatal interruption during this period: the Civil War. The war consumed 15 to 20 percent of GNP, about the same proportion as during the Revolutionary War. War finance was somewhat similar in the Confederacy (the South) as it was during the Revolutionary War. About 60 percent of the financing for the southern effort was paper money. The North also resorted to fiat money financing, but at only a 13 percent rate. Consequently, there was inflationary surge. In addition to the major disruption caused by the Civil War, it is worth mentioning one major anomaly in the US economy: lands were owned by the federal, as well as state and local, governments.

Alexander Hamilton, the first Secretary of the Treasury, wanted to sell the public lands as fast as possible. This did not happen. In consequence, the government still owns a lot of real estate. Its surface area is about ten times larger than the total area of Poland. This is a huge state-owned enterprise. As you might expect, it is also very unproductive. Detailed studies of SOE lands indicate that they are only about 25–30 percent as productive as comparable private ones.

America's SOE lands have been the center of repeated debates about the free market system in the United States. Indeed, even the American Economic Association put itself at the center of one of these debates. One of the major motivations for establishing the American Economic Association was as a protest against *laissez-faire* attitudes in the United States. Not surprisingly, therefore, the May 1885 *American Economic Review*, contains three papers justifying the retention of government-owned timberlands!

On the eve of World War I, government expenditures were less than 2 percent of GNP and 99 percent of the population paid no income tax. Income tax had just been introduced, but the top rate was only 7 percent and applied to incomes exceeding \$500,000. The federal government had around 400,000 employees, less than 1 percent of the labor force. About 165,000 troops were on active duty. No federal regulations of capital or labor markets existed. Agricultural production and distribution were also unregulated. There was no minimum wage rate and no social security. One area where there was a rather aggressive interference in the economy concerned the rates and tariffs the railroads charged. Antitrust was also strong.

World War I marks a violent break with the letter and spirit of the Constitution. Property rights were suspended on a large scale. There were wide-scale nationalizations of rail, telephone, telegraph and to a lesser degree ocean shipping. Over 100 manufacturing plants were nationalized. The government got involved in labor-management relations under the Adams Act in 1916. Conscription was instituted. The Espionage Act was passed in 1917. The Sedition Act of 1918 imposed penalties for anti-government expression, subverting the Bill of Rights. Upton Sinclair was actually arrested for reading

the Bill of Rights and Roger Baldwin was arrested for reading the Constitution. President Woodrow Wilson accomplished all this under emergency powers granted to him by Congress in 1916.

Much of this anti-Constitutional apparatus was scrapped after the war. However, residues remained and eventually resurfaced. All it took was another national emergency – the Great Depression, World War II, the Vietnam War, and so on. With each, laws were enacted, bureaus created and the budgets enlarged. In many cases, these changes turned out to be permanent. The result is that crises acted as a ratchet, shifting the trend line of government size and scope up to a higher level.

It comes as no surprise that governments spend more money and regulate more actively during crises – wars and economic bail-outs are expensive and complicated. But a more active government also attracts opportunists, who perceive that a national emergency can serve as a useful pretext for achieving their own objectives.

The US and other countries seem no more aware of this today than they were in the past. And yet history has provided many examples to illustrate how damaging it is. Take the Great Depression. At that time, the organized farm lobbies, having sought subsidies for decades, took advantage of the crisis to pass a sweeping rescue package, the Agricultural Adjustment Act, whose title declared it to be 'an act to relieve the existing national economic emergency.'

Almost 70 years later, the farmers are still sucking money from the rest of society and agricultural policy has been enlarged to satisfy a variety of other interest groups, including conservationists, nutritionists and friends of the Third World. Then, during World War II, when government accounted for nearly half the US GDP, virtually every interest group tried to tap into the vastly enlarged government budget. Even bureaus seemingly remote from the war effort, such as the Department of the Interior (which is in charge of government lands and natural resources), claimed to be performing 'essential war work' and to be entitled to bigger budgets and more personnel.

Within the US government, the latest emergency – the war on terrorism – has given cover to a multitude of parochial opportunists, whose proposals range from bailing out the airlines to nationalizing vaccine production. As a result, President George W. Bush – a so-called conservative – has blessed a record-setting expansion of government. That is where we are now.

What lessons can we learn? First, 'democracy' and 'freedom' are not interchangeable words. Second, only the first century of the American experience represents a standard for freedom. Expanding democracy is a slogan which requires great caution. It can easily result in elected tyranny. Freedom is the concept. Our challenge is to persuade every citizen that benefits flow from freedom's practical applications. Freedom might then flourish in very diverse and unexpected forms in different parts of the world.

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