the CATO JOURNAL

VOLUME 40 NUMBER 3 • PUBLISHED BY THE CATO INSTITUTE • FALL 2020

The Cato Journal (ISSN 0273-3072) is published in the winter, spring/summer, and fall by the Cato Institute, 1000 Massachusetts Ave., N.W., Washington, D.C. 20001-5403. Annual subscriptions are $22 for individuals and $50 for institutions. Single copies are $8. Two-year and three-year subscriptions are $38 and $55, respectively, for individuals, and $85 and $125, respectively, for institutions. Foreign subscribers should add $5 per year for regular delivery and $10 per year for airmail delivery.

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Printed in the United States of America.

CATO JOURNAL • VOLUME 40 NUMBER 3 • FALL 2020

ARTICLES

BOOK REVIEWS

Perspectives on Balance Sheet and Credit Policies: A Tribute to Marvin Goodfriend

Esther L. George

I appreciate this opportunity to pay tribute to Marvin Goodfriend and his many contributions to the theory and practice of monetary policy. At the Kansas City Fed, we knew Marvin as a scholar and a good Federal Reserve colleague. Marvin also was a participant in a number of our Jackson Hole Economic Symposiums. As a Research Officer at the Richmond Fed, he attended the first symposium that we held in Jackson Hole, Wyoming, in 1982, where his work on "Discount Window Borrowing, Monetary Control, and the Post-October 6, 1979 Federal Reserve Operating Procedure" was widely cited.[1] Thirty-four years later in 2016, as a professor at Carnegie Mellon, he presented a paper making the case for deeply negative interest rates as a policy tool that could breach the zero lower bound on nominal rates. He argued that "the zero interest bound encumbrance on monetary policy should be removed so that movements in

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Cato Journal, Vol. 40, No. 3 (Fall 2020). DOI:10.36009/CJ.40.3.1.

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[1]Later published in the *Journal of Monetary Economics* (Goodfriend 1983).

the intertemporal terms of trade can be reflected fully in interest rate policy to sustain price stability and full employment *with a minimum of inefficient and costly alternative policies*" (Goodfriend 2016; 128; emphasis added).

Balance Sheet Policy, Credit Allocation, and Negative Interest Rates

Willing to challenge conventional views, Marvin expressed concern that "central banks [would] be tempted to rely even more heavily on balance sheet policy in lieu of interest rate policy, in effect exerting stimulus by fiscal policy means via distortionary credit allocation, the assumption of credit risk and maturity transformation, all taking risks on behalf of taxpayers and all moving central banks ever closer to destructive inflationary finance." He understood the associated heartburn of this view, acknowledging that negative interest rates was an idea that would likely require "some getting used to." He noted, however, that the public also was initially resistant to leaving the gold standard, and later to floating the exchange rate, but gradually accepted these changes.

While the use of negative interest rates gives me pause as a way to address a future encounter with the effective lower bound, I share Marvin's concerns about the potential side effects of balance sheet policies that pose risks to financial stability and threaten the central bank's policy independence.

As a voting member of the Federal Open Market Committee (FOMC) in 2013, I expressed my concerns about the continuation of the asset purchase program known popularly as QE3. By then, financial markets were stable and the economy was growing. These concerns about the expansion of the Fed's balance sheet under those conditions echoed many of Marvin's concerns. In my view, the possible unintended side effects of the ongoing asset purchases posed risks to economic and financial stability and served to unnecessarily further complicate future monetary policy (George 2017). Today, however, it is conventional wisdom that the benefits of asset purchases have been clearly established and that their potential costs have proven negligible. History and further research may ultimately affirm that wisdom, but it remains less than clear to me that the longer-run costs of balance sheet policies have been fully taken into account.

As a consequence of large-scale asset purchases, for example, the Federal Open Market Committee (FOMC) had to evaluate and reconsider its longstanding operating framework. Given the abundant reserves associated with its balance sheet policies, the FOMC had to consider whether the federal funds rate target could be achieved administratively by setting the interest rate on excess reserves. Indeed, to ensure effective interest rate control and establish a firm floor on overnight rates, an overnight reverse repo facility was created. In addition, as the Fed began to shrink its balance sheet, it proved challenging to gauge the minimum reserve balances needed for achieving the federal funds rate target without intervention by the open market desk at the New York Fed. As a result, the desk resumed regularly conducting repo operations and outright purchases of Treasuries to build a bigger buffer and ensure an ample supply of reserves. These operations have caused some confusion in markets as some participants have seen them—incorrectly, in my view—as a type of quantitative easing.

More generally, to the extent that large-scale asset purchases succeeded in their aim of creating a wealth effect, they also played some role in contributing to elevated asset valuations. These effects, together with the perception that interest rates will remain at historically low levels for a prolonged period, can lead to a buildup of financial imbalances that ultimately pose risks to the real economy. Experience has shown that these imbalances can develop in sectors outside the lens of regulators and, as we witnessed a decade ago, can unwind with little warning.

Another concern I share with Marvin is the risk that income from the Fed's large balance sheet combined with our capital surplus could tempt fiscal authorities to view the Fed as a source of funding for government programs. I would argue that we have seen a degree of this risk unfold. The funding of the Consumer Financial Protection Bureau (CFPB), as required under the Dodd-Frank Act, is a case in point. Each quarter the Reserve Banks transfer to the CFPB, without congressional appropriations, the amount of funds requested by the director of the CFPB to carry out its operations. To date, the Federal Reserve has transferred almost $4.4 billion to the CFPB. In addition, the Dodd-Frank Act required the Fed to fund the first two years of the Office of Financial Research in support of the Financial Stability Oversight Council (FSOC).

Yet another example of congressional funding of programs outside the regular appropriations process is the "Fixing America's Surface Transportation (FAST) Act." In the FAST Act, Congress funded highway construction by reducing the Federal Reserve Bank stock dividend rate for member banks with assets of more than $10 billion. The Act also placed a cap of $10 billion on the aggregate surplus funds of the Federal Reserve and directed that any excess be transferred to the Treasury general fund. The potential policy implications of modifying dividends to member banks, or more generally, the requirement for member banks to purchase stock in a regional Federal Reserve Bank, is a concerning development that risks undermining the Federal Reserve's long-standing institutional design of public and private interests serving the American public (George 2016).

Central Bank Independence: A Bright Line Needed Between Monetary and Fiscal Policy

To ensure the central bank maintains surplus capital against prospective exposures on a balance sheet inflated by large-scale asset purchases, Marvin argued that the central bank must have independent authority to retain its net interest earnings to build surplus capital. Without such capital, the "carry trade" exposure from the balance sheet would "[jeopardize] the operational credibility of monetary policy for price stability" (Goodfriend 2014b).

Marvin was adamant that central bank independence was essential for the credibility and effectiveness of monetary policy. In testimony before Congress, he said:

> Flexibility and decisiveness are essential for effective central banking. Independence enables a central bank to react promptly to macroeconomic or financial shocks without the approval of the Treasury or legislature. Central bank initiatives must be regarded as legitimate by the legislature and the public, otherwise such initiatives will lack credibility essential for their effectiveness [Goodfriend 2014a].

Furthermore, to maintain independence, policymakers must draw a bright line between monetary and fiscal policy actions. He said: "The problem is to identify the limits of independence on monetary policy and credit policy to preserve a workable, sustainable division of responsibilities between the central bank and the fiscal authorities—the legislature and Treasury" (ibid.)

Arguably, this bright line faded in November 2008 when the Federal Reserve announced its first round of large-scale asset purchases consisting of $100 billion of agency debt securities and $500 billion of agency mortgage-backed securities (MBS). This program was expanded in March 2009 with the planned purchase of a total of $1.25 trillion in MBS, $200 billion in agency debt, along with $300 billion in longer-term Treasury securities. Additional "open-ended" purchases of MBS were announced under the third round of LSAPs in September 2012. Today the Federal Reserve holds almost $1.4 billion in MBS on its balance sheet, and the FOMC has indicated that it currently does not anticipate selling agency mortgage-backed securities as part of its policy normalization process. These holdings arguably blur the line between monetary policy and credit allocation.

Treasury-Fed Accord on Credit Policy

To address this important distinction, Marvin proposed that the 1951 Treasury-Federal Reserve Accord on monetary policy be supplemented with a Treasury-Fed Accord on credit policy. He identified three key principles: First, as a long-run matter, a significant, sustained departure from a "Treasuries only" asset acquisition policy is incompatible with Fed independence. Second, the Fed should adhere to "Treasuries only" except for occasional, temporary, well-collateralized ordinary last-resort lending to solvent, supervised depository institutions. And third, Fed credit initiatives beyond ordinary last-resort lending should be undertaken only with prior agreement of the fiscal authorities, and only as bridge loans accompanied by take-outs arranged and guaranteed in advance by the fiscal authorities.

These principles are worth considering as the Federal Reserve contemplates its next encounter with the zero lower bound. The Federal Reserve's ongoing review of its monetary policy strategy, tools, and communications necessarily has surfaced a number of possible approaches to address such a future encounter. Among the possibilities are things we have tried in the past, such as asset purchases and forward guidance. Other ideas have been more novel, such as average inflation targeting, yield curve control and, yes, even negative interest rates.

Conclusion

Marvin may be right that these things, particularly when they are controversial, take some getting used to. But as importantly, he was keenly focused on preserving the central bank's integrity and independence at the same time. That perspective undoubtedly would serve us well today.

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Lessons from the Swedish Experience with Negative Central Bank Rates

Fredrik N. G. Andersson and Lars Jonung

Interest rates declined in the wake of the 2007–2009 global financial crisis. They remained low for most of the 2010s, only rising modestly toward the end of the decade. In some European countries, interest rates even became negative. While limited to a few countries initially, the likelihood of more central banks following suit is growing in the wake of the COVID-19 pandemic. Not least, the Federal Reserve System is under pressure to adopt a negative federal funds rate (Bernanke 2020; Lilley and Rogoff 2020).

The push for negative rates invites the question: What are their consequences? We examine this question empirically by analyzing the case of Sweden, one of the first countries to experiment with a negative policy rate, and the first country to complete the experiment.[1] We then discuss the implications of our results for larger economies.

The Swedish central bank, the Riksbank, first entered negative rate territory when its deposit rate for commercial banks became

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Cato Journal, Vol. 40, No. 3 (Fall 2020). DOI:10.36009/CJ.40.3.2.

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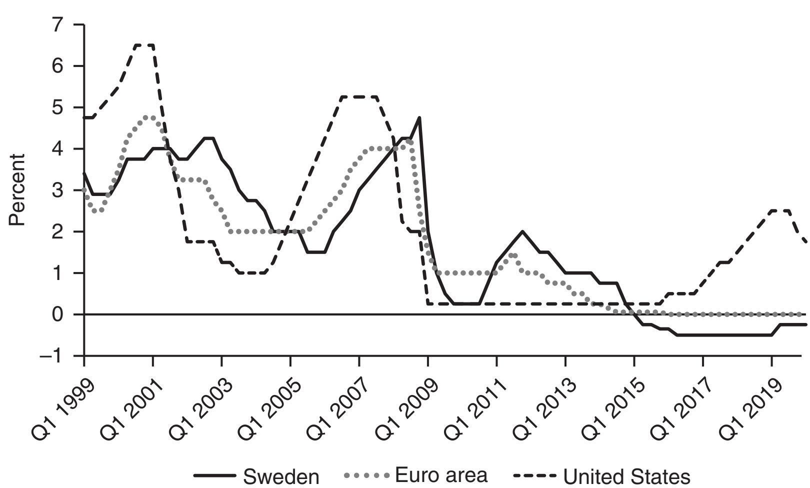
[1]To the best of our knowledge, this study is the first trying to assess, in a broad manner, the effects of the negative rates in Sweden from 2015 to year-end 2019. Eggertsson et al. (2019) provide a partial analysis of the impact on the bank-lending channel. Their conclusion was that negative rates reduced output. However, they do not examine the effects of negative rates on any other variables.

negative in 2009. The Riksbank became a pioneer with this one small step. However, its main policy rate, the repurchase (repo) rate, remained positive. This situation lasted for only a brief period. In 2010, the Riksbank moved away from the negative deposit rate due to a rapidly recovering economy.

The second move came in February 2015, when the Riksbank announced a repo rate of −0.10 percent. This rate was further reduced to −0.50 percent in 2016, a level maintained until January 2019, when the rate was raised to −0.25 percent. A further increase of 25 basis points followed in December that year, terminating the subzero regime after five years.

The move to a negative interest rate was an unusual step not only because the Riksbank became the first inflation-targeting central bank to break the zero lower bound, but also because the Riksbank broke its previous behavior of shadowing the European Central Bank (ECB). Figure 1 illustrates the policy rates in Sweden, the euro area, and the United States in the period between the introduction of the euro in 1999 to 2019. The Riksbank normally shadows the ECB's policy rate. Here the 2015–2019 period stands out with

FIGURE 1
Central Bank Policy Rate in Sweden, Euro Area, and United States, 1999–2019



Source: Thompson Reuters Datastream.

the Riksbank being more expansionary compared to the two major central banks judging from the main policy rates.[2]

It is too early to make a full assessment of the long-run effects of the negative rates. However, we can already observe some of the short-run consequences. Thus, we focus on how negative rates affected the Swedish economy from 2015 to 2019. We discuss why the Riksbank took the drastic step of adopting negative rates, consider the short-run effects of this policy shift, and the lessons this episode offers for other countries.

Background of the Riksbank's Negative Policy Rate

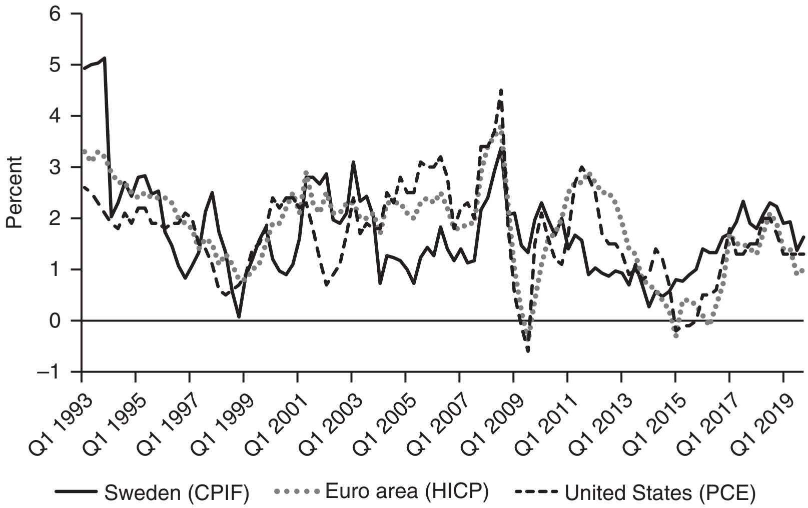
It is important to understand the background of the Riksbank's experiment with negative policy rates. They were introduced not during a time of crisis, as in many other countries, but during a time of relative prosperity with high growth and record employment levels. They were the outcome of a long drift in the Riksbank's approach to monetary policy. Over time, the Riksbank became increasingly dependent on a New Keynesian dynamic stochastic general equilibrium (DSGE) model, called Ramses. This model came to dominate the Riksbank's thinking about the Swedish economy. As inflation fell below the official inflation target of 2 percent, despite a relatively strong economy, the model's diagnosis was simple: high policy rates caused low inflation. Alternative explanations were discussed but largely disregarded in practice. The use of this specific model was a key driver behind the move toward negative rates. A broader analysis that emphasized, for example, financial stability would likely have resulted in a different policy.

Evolution of the Swedish Monetary Framework, 1993–2019

The Riksbank announced that it was adopting an inflation target in January 1993 following the collapse of the pegged exchange rate for the krona against the ECU during the European exchange rate crisis in the fall of 1992. The target was set at 2 percent within a tolerance band of plus or minus 1 percentage point. The Riksbank copied these numbers from the Bank of Canada's framework.

[2]Other central banks such as the Danish National Bank, the Swiss National Bank, and the Bank of Japan have also adopted negative interest rates.

FIGURE 2
Inflation in Sweden, Euro Area, and United States, 1993–2019



Note: Inflation is measured by the respective central bank's preferred price indices: the consumer price index with a fixed mortgage rate (CPIF) for Sweden; the harmonized index of consumer prices (HICP) for the euro area; and the personal consumption expenditure (PCE) chain-price index for the United States. Each index is constructed differently and some differences in the measurement of inflation are likely caused by methodological differences.
Source: Thompson Reuters Datastream.

The initial reaction to the target was skeptical due to Sweden's history of high inflation in the 1970s and 1980s. However, inflation fell and held steady at around 2 percent from the late 1990s until the early 2010s (Figure 2). From 1993 until 2019, inflation averaged 1.7 percent, which was well within the Riksbank's original tolerance band of 1 to 3 percent[3] (Andersson and Jonung 2017). As a comparison, the average inflation rate in the euro area was 1.8 percent during the same period, and average inflation in the United States was 1.7 percent. Not only are the averages similar, but as is evident from Figure 2, the comovements among the inflation series are high,

[3]The Riksbank abolished the tolerance band in 2010. In 2017 it reinstated a variance band of the same size as the old tolerance band.

suggesting that a large share of the variation in inflation was caused by global rather than national factors.[4]

The early years of the inflation target was a period of experiment for the Riksbank, as it had no recent experience of implementing inflation targeting. It had to develop its operational and communication strategies from scratch (Andersson and Jonung 2018). The framework that emerged toward the end of the 1990s was quite simple: the goal was to keep inflation close to 2 percent, within the band of +/−1 percentage point. The monetary policy strategy was forward-looking and described by the Riksbank as follows: "The basic rule for monetary policy is simple: if forecast inflation one to two years ahead is above/below 2 percent, the repo rate shall normally be raised/lowered in order to fulfil the inflation target. However, the rule is not applied mechanically and minor deviations from the target may be weighed against other factors" (Riksbank 2000:63).

In the early 2000s, the Riksbank became more reliant on formal economic modelling. Eventually in 2007, the Riksbank adopted a new operational strategy and a new communication strategy. A central component of the new strategy was forward guidance, in which the Riksbank began to publish forecasts of its own policy rate two to three years into the future (Andersson and Jonung 2019). The forecasts were produced using a combination of quantitative methods and qualitative discussions, with the DSGE model taking a major role in generating the quantitative forecasts and framing the qualitative discussion (Goodfriend and King 2015).[5]

The old simple rule-of-thumb approach that, if the inflation forecast was above the target, the Riksbank would increase interest rates, and vice versa, was abandoned. The new assumption imposed on the models was that "that the repo rate will develop in such a way that monetary policy can be regarded as well-balanced. In the normal case, a well-balanced monetary policy means that inflation is close to the inflation target two years ahead without there being excessive fluctuations in inflation and the real economy" (Riksbank 2007: 3).

[4]For a discussion of the effect of globalization on inflation, see e.g. Ciccarelli and Mojon (2010) and Auer et al. (2017).

[5]The model is partially based on a Phillips curve linking the real economy to inflation and a Taylor rule to describe the behavior of the central bank (Adolfson et al. 2007).

In other words, the Riksbank moved away from a more flexible approach where the forecast influenced the interest rate decision to one where the forecast itself played an important role as a policy instrument and in influencing the policy rate decision.[6]

Forward guidance and the forecasts of the Riksbank model soon dominated the discussion within the Board of Directors. The use of traditional economic indicators and qualitative judgements about the economy lost out. As Goodfriend and King (2015: 89) put it: "There is something surreal about the precision of the guidance provided by individual board members as to the future path of the repo rate when contrasted with the sheer uncertainty about the future and the fact that markets took rather little notice of the published path in determining their own expectations."

Members of the Board spent much time arguing over whether the interest rate forecast several years into the future should be a few tenths of a percentage point higher or lower (Goodfriend and King 2015). The discussions rarely acknowledged that the forecasts were uncertain. Instead, several members apparently believed in monetary policy fine-tuning, where the smallest change in a forecast would have measurable effects on the macroeconomic outcome. In other words, the Riksbank became a hostage to its own model.

The shift toward the new strategy continued with the Riksbank abolishing the tolerance band in 2010. The new inflation target became "close to 2 percent" without further specification. The combined effect of forward guidance and of abolishing the tolerance band gave rise to a debate whether the Riksbank had fulfilled its target or not. Because average inflation was below 2 percent, but well within the original tolerance interval, critics argued that the Riksbank had voluntarily chosen to set aside the inflation target for some unexplained reason.

The Riksbank struggled to respond to these criticisms, because it had contributed to the view that it could fine-tune the economy by monetary policy and keep inflation exactly on the target. The new

[6]The new approach drew criticism from Goodfriend and King (2015: 7) in their review of the Riksbank: "there was heavy reliance, among both the majority of the Board and the dissenters alike, on forecasts produced by models developed by Riksbank staff. Although such models are useful in putting together consistent quantitative forecasts, inevitably they are based on strong assumptions and can act as no more than a starting point for a discussion of the challenges facing monetary policy at any particular juncture. They cannot be used mechanically."

reliance on specific numerical forecasts, setting out a path into the future where the Riksbank always ended up meeting the target of 2 percent, helped to give the illusion of a high degree of control over future events by its policy.

The growing reliance on the Ramses model and on interest rate forecasts are key components in understanding the introduction of negative interest rates in Sweden. The DSGE model perspective dominated policy discussions within the Riksbank and shaped the decisions made by the Board of Directors. Alternative views were discussed but downplayed.

Introduction of Negative Interest Rates

The 2007–2009 global financial crisis had only a temporary effect on the Swedish economy. The financial system survived the crisis intact with the help of early emergency measures by the Riksbank. Nominal property prices continued to grow throughout the crisis while household debt levels stabilized at record levels. The real economy was hit by the Great Recession and the Swedish economy declined by roughly 5 percent in 2008 and 2009. The output loss was temporary and the economic recovery began in the second half of 2009. Real GDP had already surpassed its precrisis level by 2010. Inflation rose above the Riksbank's official inflation target (Figure 2). Strong growth and higher inflation caused the Riksbank to begin to normalize its policy by gradually raising its policy rate to 2 percent in 2011. However, inflation began to decline following the euro crisis and the weakening of the euro area economy. By 2014, inflation was at only 0.5 percent.

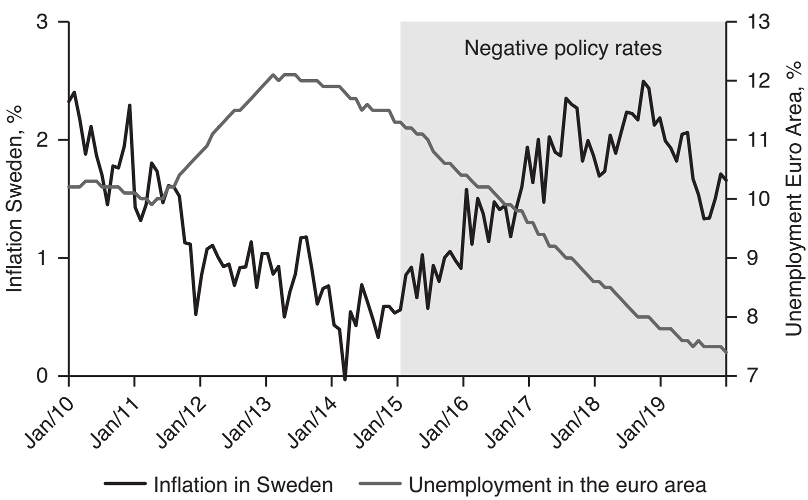
As inflation fell, the Riksbank reduced its policy rate first to 0.75 percent in December 2013, and then to zero in 2014. Despite a falling policy rate, inflation did not pick up. The Riksbank faced growing blame from some economists and the media. Critics focused on the inflation number and ignored the relatively high growth rate of almost 3 percent and the high employment in 2014.

In response to these objections, the Riksbank announced the introduction of a negative policy rate and a program of quantitative easing in February 2015. The Riksbank claimed that a negative rate was needed to defend the credibility of the inflation target, thereby assuming responsibility for inflation falling short of the target and presuming that a negative rate would soon return inflation to the target. It expected its interest rate to be positive again before the end of 2016 (Riksbank 2015). These predictions proved wrong, and the Riksbank maintained its negative interest rate policy throughout the boom until December 2019, when it raised the interest rate to zero percent. However, the Riksbank chose to continue with its quantitative easing, totalling about 300 billion Swedish kronor by 2019, a sum close to 6 percent of GDP.

Effects of Negative Policy Rates

The aim of the negative policy rate was to raise domestic inflation. Inflation did indeed increase slightly after the introduction of negative rates, reaching the inflation target of 2 percent by 2018 before falling back to 1.5 percent in the second half of 2019. Based on this outcome, it is tempting to conclude that the policy of negative rates was at least partly successful in raising inflation. However, Swedish inflation is highly dependent on the state of the euro area economy. Swedish inflation falls when euro area unemployment increases, and vice versa (Figure 3). The correlation between the Swedish inflation rate and the euro area unemployment rate was

FIGURE 3
Inflation in Sweden and Unemployment in the Euro Area, 2010–2020



Source: Thompson Reuters Datastream.

−0.8 for the period 2009–2018. In contrast, the correlation between the Swedish inflation rate and the Swedish unemployment rate was lower, only −0.3 during the same period.

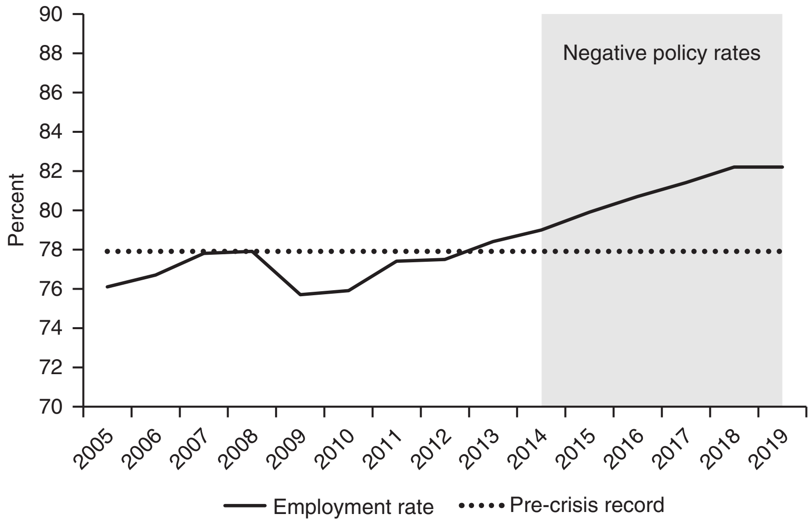
The Swedish economy is highly integrated with the European economy. Swedish exports as share of GDP increased from 30 percent during the 1980s (before Sweden's membership of the European Union in 1995) to between 45 and 50 percent in the 2010s. About half of Swedish exports go to the euro area. Sectors that do not directly export to the euro area are still highly integrated with the euro area economy through their supply chains. Developments in the euro area thus directly affect the Swedish economy. As a result, improved economic conditions in the euro area are a more important factor behind the rise in inflation than the Riksbank's policy based on negative rates.

The rise in inflation in Sweden was matched by a similar increase in inflation in the euro area, where inflation rose from −0.3 percent in February 2015 to 2 percent in the middle of 2018, and then fell to 1.4 percent in January 2020 (Figure 2). This is almost the same pattern as in Sweden, where inflation rose from 0.9 percent in February 2015 to 2 percent in the middle of 2018, and then fell to 1.2 percent in January 2020. That most of the movement in Swedish inflation correlates with changes in the euro area economy clearly indicates that the Riksbank's influence over the Swedish inflation rate is modest due to the forces of a high level of economic integration. The Riksbank's declining influence over the domestic inflation rate forced it to become increasingly extreme in its policy.

The situation was different when the inflation target was introduced in 1993. The Swedish economy was less integrated in the European economy and the Riksbank's influence over the domestic inflation rate was much higher. In fact, Sweden had just experienced a 20 year period of relatively high and volatile inflation compared to its main trading partners. However, the influence has since gradually declined. Thus, the historically high correlation between the inflation rate and the state of the domestic economy has also declined.

In the past, inflation increased during booms and declined during recessions. Today that correlation is much weaker. For example, in 2014 when inflation was low, pushing the Riksbank to introduce negative rates, the economy was booming. Growth was close to 3 percent and the employment rate for 16 to 64 year olds hit a record level, at close to 80 percent (Figure 4). The employment rate

FIGURE 4
Employment Rate for 16 to 64 Year Olds Born in Sweden, 2005–2019

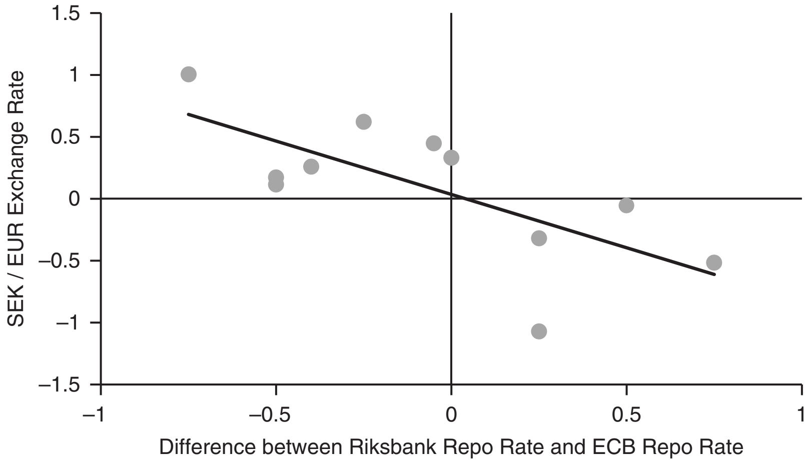


Note: The employment rate for the total population is lower due to substantial refugee migration during the last five years. The employment rate for the population born in Sweden is thus a more accurate measure of the state of the labor market.
Source: Statistics Sweden.

was even higher than during the precrisis boom of 2008. Instead of being countercyclical (tightening during booms), monetary policy became clearly procyclical. The Riksbank's raising of rates in 2019 actually coincided with the economy moving toward a slowdown. The booming economy, without increasing inflation, is visible in the current account balance, which declined from steady surpluses of between 5 to 6 percent during 2008–2014 to a surplus of 1.7 percent in 2018. Rather than causing inflation, the boom contributed to rapidly rising imports.

Reduced control over the domestic inflation rate does not imply that the Riksbank has no influence over the Swedish economy. There are still markets that are highly influenced by its policy. For example, Figure 5 illustrates the change in the krona-euro exchange rate in relation to the difference between the Riksbank's repo rate and the ECB repo rate. Between 2015 and 2019, when the

FIGURE 5
Change in the Krona-Euro Exchange Rate and Difference between the Riksbank and ECB Repo Rates, 2009–2019



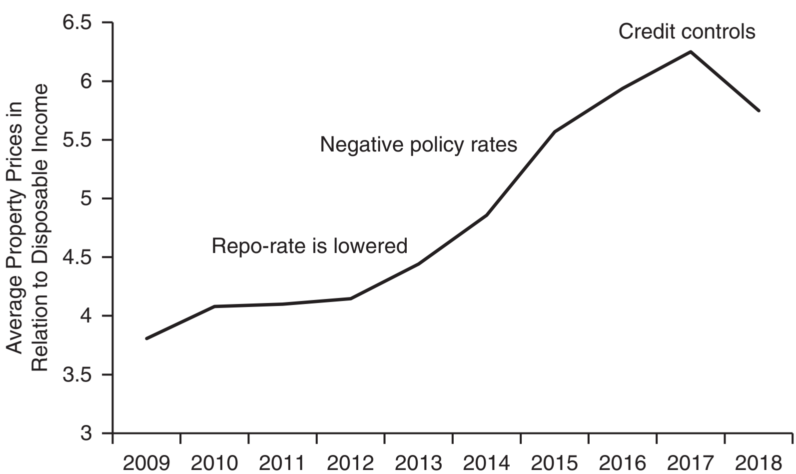
Source: Thompson Reuters Datastream.

Riksbank maintained a lower policy rate than the ECB, the value of the Swedish krona declined from an average exchange rate of approximately 9.25 per euro between 1999 and 2012, to roughly 10.50 per euro. This corresponds to a depreciation of 12 percent. This weakening of the Swedish currency is one of the largest in modern times. Only the "super devaluation" of 16 percent in 1982, and the depreciation following the collapse of the pegged exchange rate in 1992 of about 20 percent, match the present persistent decline of the currency.

A depreciating currency should contribute to higher inflation. However, since the pass-through rate is low, the rise in consumer price inflation due to the depreciation is small. The overall increase in inflation between 2015 and 2019 from all factors affecting inflation was 1 percentage point. The exact effect of the exchange rate depreciation is difficult to gauge; however, it is unlikely to account for the entire increase in inflation. The contribution by the weakened exchange rate was less than a percentage point. Although the inflationary effect of the depreciation is small, the persistent weakening of the exchange rate may affect economic growth negatively in the future. Empirical evidence suggests that the many devaluations of the fixed exchange rates of the krona from the 1970s to the early 1990s reduced growth over the long term by lowering investments in new innovations by Swedish firms when they shifted from competing through quality and innovation to gaining market share through a weak exchange rate (see, e.g., Jonung 1991).

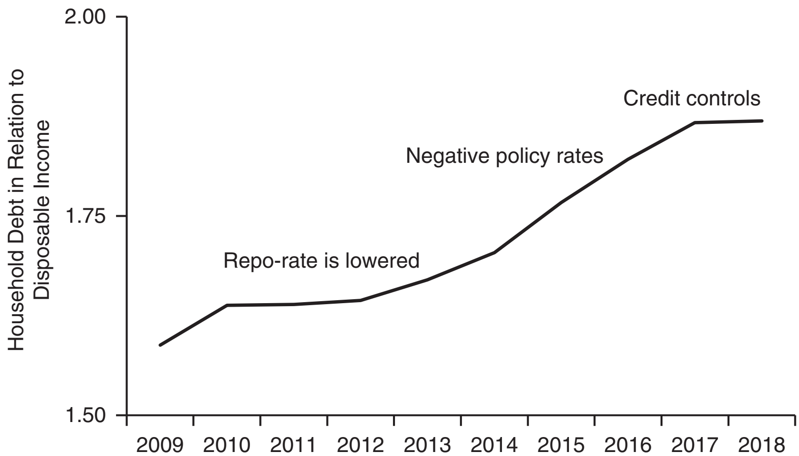
Another market that was highly affected by negative interest rates was real estate. Negative interest rates boosted property prices and household debt levels to new record levels relative to income. As in other countries, property prices increased rapidly prior to the global financial crisis of 2008, raising concerns of a future correction and possibly a financial crisis (Andersson and Jonung 2016). Nevertheless, Sweden suffered only briefly from the crisis of 2008 and avoided a full-scale banking crisis. House prices (Figure 6) and household debt levels (Figure 7) stabilized in 2010–2012 after the crisis. Temporarily higher interest rates during the economic recovery phase limited the rise in prices and debts. As the Riksbank softened its policy in 2012–2014 due to the euro area crisis, they slowly began to creep upward again.

FIGURE 6
Average Property Prices (for Flats) in Relation to Disposable Income, 2009–2018



Source: Statistics Sweden.

FIGURE 7
Household Debt in Relation to Disposable Income, 2009–2018



Source: The Riksbank.

Negative rates accelerated the speed of increase. Prices in relation to disposable income rose by 50 percent between 2012 and 2017, with most of the increase occurring after the introduction of negative rates in 2015. Rising prices and debt levels forced the financial supervisory authority (*Finansinspektionen*) to take action, imposing a string of credit controls on households, such as amortisation rules and debt ceilings, beginning in 2016. The controls dampened the rise in real estate prices and in debt, but also contributed to growing inequalities, because they mostly affected younger households and those without assets. Nonetheless, the credit controls did not arrest the upward trend in real estate prices. Prices increased from roughly four times disposable income in 2009 to six times in 2018. This compares to 1.5 times disposable income in the year 2000. In other words, property prices quadrupled in relation to disposable income between 2000 and 2018.

The average household debt ratio increased from 110 percent of disposable income to 187 percent during the same 20-year period. The Swedish pattern stands in contrast to the United States, where the household debt ratio was 105 percent of disposable income in 2018, having declined from a record 144 percent in 2007.

While the impact of negative rates on domestic inflation rate was small, probably negligible, the effects of negative rates on the housing market and on household debt levels were large. Imbalances that had already begun to emerge before the Great Recession worsened. Real estate prices rose rapidly, contributing to rising wealth inequality. Household debt reached record levels. The exchange rate of the Swedish krona depreciated by more than 10 percent, with no major impact on the domestic rate of inflation. In addition, monetary policy turned procyclical during the experiment with negative rates, contributing to record high employment. In short, the negative policy rates contributed to an economy suffering from "overheating".

Was there an alternative policy? The Riksbank law permits the Riksbank to revise the inflation target as economic conditions change. The Riksbank is not required by law to maintain 2 percent inflation at any cost. There is no evidence of the Swedish economy suffering from low inflation. In fact, the economy performed quite well when inflation was below the target, growing by 2 to 3 percent per year and registering high employment figures.[7]

A policy that avoided negative interest rates would have implied lower consumer price inflation and a less overheated labour market, but would also have dampened the depreciation of the exchange rate and the rise of property prices. The risks of a future financial correction with potentially severe economic consequences would have been lower. Despite having the legal right to alter the inflation target, the Riksbank chose to experiment with the Swedish economy. In our view, it did so partially because of the narrow perspective that dominated the monetary policy discussion within the Riksbank. The negative interest rate experiment was a choice, not a necessity forced upon the Riksbank.

Lessons from Sweden

The Swedish experiment with negative interest rates offers several lessons. Due to globalization, the relationship between the state of the domestic economy and the consumer price inflation rate has been weakened (see, e.g., Auer et al. 2017). This is demonstrated by a large number of studies on the "flattening of the Phillips curve,"

[7]Using international data, Borio et al. (2015) find little evidence of low inflation, or even deflation in consumer prices, having a negative effect on the real economy. However, they do find a negative relation between asset price deflations and economic growth.

a phenomenon observed in many countries including the United States. However, central banks maintain a strong influence on the housing market and financial markets directly affected by the domestic interest rate, such as the foreign exchange market.

Rather than acknowledging their reduced influence over consumer price inflation, central banks have turned to increasingly extreme measures in their effort to raise this inflation rate, such as negative policy rates and quantitative easing. While quantitative easing and low policy rates started out as elements of a crisis policy during the international financial crisis, they have become common tools also during normal times of economic prosperity.

In Sweden, the gravitation toward extreme measures was connected with a growing dependence on an approach to monetary policy heavily influenced by a DSGE model based on a Phillips curve relationship to link the real economy to inflation, and a Taylor rule to model central bank behavior. The low inflation rate was interpreted as a crisis in itself, warranting a crisis policy response.

While the effect of an expansionary monetary policy on consumer price inflation is modest, imbalances tend to grow elsewhere in the economy. To address those imbalances, policymakers tend to rely on various forms of controls, including credit controls. These, in turn, distort the workings of markets. For example, they limit the effectiveness of monetary policy by restricting some of the channels through which monetary policy operates. The central bank ends up in a vicious cycle of overstimulating the economy while trying to control the negative side effects of the expansionary policy through various credit controls. The lessons from the past that credit controls distort markets and are commonly inefficient in achieving their aims are forgotten.

Are these lessons from the Swedish monetary experiment unique or are they valid also for a larger economy? The flattening of the Phillips curve and thus a reduction of central banks' influence over the consumer inflation rate is a global phenomenon that has been observed for quite some time (see, e.g., Atkeson and Ohanian 2001; Blanchard 2016; Smets and Wouters 2007). Why the Phillips curve has flattened remains uncertain. A wide range of explanations have been suggested: digitalization, expectations, improved policy, wage stickiness, demographical change, structural change, and globalization, among others (see, e.g., Conti et al. 2017; Hooper et al. 2020; Kiley 2015). The specific reasons for the flattening are of less importance here; the fact that it is flatter is the key.

A negative interest rate in a large economy such as the United States would likely have a larger impact on consumer price inflation than a similar policy in Sweden. Still, the effect is likely to be relatively small. The effect on the U.S. housing market and financial markets are likely to be as large, if not larger, than in Sweden. The tradeoff between a small increase in consumer inflation versus larger financial imbalances is the same in the United States as in Sweden. A narrow focus on consumer inflation runs the risk of destabilizing asset markets when the central bank's influence over the consumer inflation rate is waning. There is little international evidence for low inflation, or even moderate deflation, having a severe negative effect on the real economy. There is on the other hand ample evidence of financial imbalances causing severe economic damage not just in the short run but also in the long run. The negative effects of financial crises are often reenforced by growing political populism in the wake of the crisis (Eichengreen 2018).

Conclusion

Stefan Ingves, the governor of the Swedish Riksbank, described the use of negative interest rates as an "experiment" never tried before (Dagens Industri 2017). The experiment ended in 2019. We conclude at this early stage that the costs to Swedish society of negative interest rates most likely exceeded the benefits. Negative rates were the outcome of a narrow focus on consumer inflation and the flattening of the Phillips curve. To *increase* consumer inflation, the Riksbank felt forced to take extreme measures. Housing markets and financial markets responded quickly while consumer inflation remained largely unaffected.

There are clear lessons from the Swedish experience for the United States—despite differences in country size and the international role of the dollar and the Fed. Evidence from Sweden suggests that negative policy rates in the United States would lead to a rapid increase in housing prices, greater demand pressure, and a depreciating dollar, with only minor effects on consumer inflation rates. International evidence suggests that *low* inflation has no measurable negative effects on the economy. However, history shows that inflated asset prices carry the risk of a financial correction with potentially large negative economic and political consequences.

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Financial Transactions Taxes: Inaccessible and Expensive

Diego Zuluaga

Financial transactions taxes (FTTs) have become increasingly popular since the 2008 financial crisis. During the 2020 Democratic presidential primary race, FTTs featured prominently on the platforms of both moderate Michael Bloomberg and socialist Bernie Sanders. The likely nominee, Joe Biden, has also expressed support for an FTT, albeit without offering any details in his election platform (CNBC 2019).

FTTs are taxes on the purchase or sale of financial instruments. Some countries, such as Britain and Hong Kong, have long had a form of FTT they call "stamp duty" on shares. Yet, while still by no means exceptional, FTTs had declined in popularity during the 1990s and 2000s, as countries abolished them in a bid to make their capital markets more competitive. But the 2008 crisis prompted a revival, as some regulators called for curbing "socially useless" financial market activity and politicians looked for retribution against the financial services industry. The need to balance government budgets after the Covid-19 pandemic may give these efforts new vigor in many countries.

Some politicians advocate FTTs as a progressive revenue-raising measure to help taxpayers "get even" with financial institutions that benefited from their support in the past. But although some economists argue that well-designed FTTs can serve to deter socially

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Cato Journal, Vol. 40, No. 3 (Fall 2020). DOI:10.36009/CJ.40.3.3.

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harmful financial activity, even they tend to regard FTTs as a relatively inefficient way to raise revenue because of the large behavioral changes they cause. And despite their theoretical usefulness as a behavioral tax, actual instances in which FTTs might be desirable have been fewer than proponents claimed.

Theoretical Case for FTTs

In his *General Theory of Employment, Interest, and Money*, John Maynard Keynes advocated for "a substantial Government transfer tax on all [investment market] transactions . . ., with a view to mitigating the predominance of speculation over enterprise in the United States" (Keynes [1936] 1965: 160). He worried that wider access to stock and bond markets thanks to innovation and affluence, and the growing liquidity of financial instruments, would make short-term speculation—"the activity of forecasting the psychology of the market"—predominant over long-term investment, or enterprise—"the activity of forecasting the prospective yield of assets over their whole life" (ibid.: 158). In proposing such a tax for the United States, Keynes had the British model in mind, noting approvingly that it made the London stock market "inaccessible and very expensive" to the ordinary investor (ibid.: 159).

Keynes's proposal, on which he didn't elaborate further, and the U.S. experience notwithstanding, the academic case for FTTs was first made in earnest by James Tobin in a 1972 lecture and a subsequent article, "A Proposal for International Monetary Reform" (Tobin 1978). What motivated Tobin was the breakdown of the Bretton Woods regime, with a consequent dramatic increase in cross-border capital movements as investors responded to (and helped amplify) fluctuations in exchange and interest rates. That breakdown "severely restrict[ed] the ability of central banks and governments to pursue monetary and fiscal policies appropriate to their internal economies" (ibid.: 154).

To preserve domestic policy autonomy, Tobin called for "an internationally uniform tax on all spot conversions of one currency into another," the goal being to "particularly deter short-term financial round-trip excursions into another currency" (ibid.: 155). Because he was skeptical that such moves "by traders in the game of guessing what other traders are going to think" could guide economies toward efficiency, Tobin viewed short-term trading as harmful on the margin.

If that was true, a "Tobin tax," as the proposal has come to be known, could restore trading to its socially beneficial level—at least in the friction-free setting of theoretical welfare economics.

As U.S. and international financial markets liberalized in the 1980s, other academic economists joined Tobin in his advocacy for an FTT. Harvard's Lawrence Summers, who would become Secretary of the Treasury during the Clinton administration, coauthored a 1989 article making "a cautious case" for a tax on securities transactions (Summers and Summers 1989). His argument, similar to Tobin's, was that short-term trading causes volatility without bringing stock prices closer to their fundamental (i.e., true) values (ibid.: 170–71). He saw further evidence of a "market failure" in the legions of talented graduates then flocking into the securities business, and the vast resources devoted to investment research relative to corporate profits (ibid.: 174). Summers also noted that many countries with developed financial markets, such as Britain, Japan, the Netherlands, and Switzerland, had an FTT (ibid.: 177).

Not all economists are enthusiastic about FTTs, though. In his review of the British tax system, James Mirrlees (2011) argued against transactions taxes, including FTTs. He contended that, while "their continued use reflects the ease with which such taxes can be levied, . . . they are unattractive from an economic point of view" (ibid.: 151). By discouraging mutually beneficial transactions, FTTs hinder the movement of assets into the hands of those who value them most, creating inefficiency. Nor are they obviously progressive, falling "arbitrarily heavily on those who, for whatever reason, engage in more transactions" (ibid.). Mirrlees also said those who believe FTTs punish financial intermediaries confuse legal with economic incidence. Much as proponents might hope otherwise, FTTs fall primarily on savers in the form of lower returns.

Decline and Rebirth of FTTs

At the time Keynes was writing, the United States already levied an excise tax on the issuance and subsequent transfer of stock (Keightley 2010: 21). This tax remained in place for more than 50 years before Congress repealed it in 1965. The state of New York, home to America's largest capital market, has also taxed stock transfers since 1905, but taxpayers have been able to claim a refund since 1981 (Burman et al. 2015: 6). Besides these two taxes, the

Securities and Exchange Commission levies a small *ad valorem* fee on most securities transactions, revenues from which it uses to fund its operations. Currently, the rate is $22.10 per million dollars, or 0.00221 percent (SEC 2020).

In the late 1980s, as countries throughout the world sought to make their capital markets internationally competitive, FTTs entered a period of decline (Matheson 2011: 4). Whereas Summers reported in 1989 that France, (West) Germany, Italy, and Japan imposed FTTs, by 2010 all of them had abolished or, in Italy's case, substantially reduced them (ibid.: 9). Sweden's experience with an FTT in the late 1980s offered an unusually stark illustration of its perils: In its seven-year existence, during which the range of securities to which the tax applied only expanded, the Swedish FTT caused share trading volume to decline by 30 percent, and bond trading volume by 85 percent (Wiberg 2013). Nor did Japan's FTT, which only expired in 1999, prevent a massive stock boom-and-bust between 1985 and 1990 (Stone and Ziemba 1993).

But FTTs' trend of decline reversed with the 2007–2009 financial crisis. To some regulators, the extreme volatility of financial markets during the crisis and the high cost of taxpayer-backed financial institution bailouts were evidence that the sector had grown too large. Adair Turner, then-chairman of UK regulator the Financial Services Authority, said in a September 2009 speech that "not all financial innovation, not all trading plays a useful role . . . more trading and more financial innovation can under some circumstances create harmful volatility" (Turner 2009). In a 2010 speech, Bank of England chief economist Andy Haldane implied that liquidity and information in financial markets might have become "too much of a good thing" (Haldane 2010: 7).

Although they echoed older arguments of excess volatility as a market failure, Turner's and Haldane's remarks did not persuade the British government to raise or expand the scope of stamp duty on shares. But other European countries did move to introduce or reinstate FTTs. Having abolished its earlier FTT in 2009, France imposed a new one, at a rate of 0.2 percent, which increased to 0.3 percent in 2017, on transactions in the stock of French-headquartered companies with a market value greater than €1 billion (BYN Mellon: 6). Italy raised its FTT, as did Finland and Belgium (ibid.: 5–8). Finally, earlier this year Spain passed a tax on stock transactions in Spanish-listed firms with a market cap above

€1 billion (Garcia and Blanco 2020). At the time, there were 64 companies whose stock would have been subject to this FTT, but the economic impact of Covid-19 has since caused a more than 25 percent drop in the value of Spanish equities and reduced the tax base to 57 firms.[1]

The most ambitious, and perhaps for that reason still unadopted, proposal came from the European Commission in 2011 (see European Commission 2011a). It would have taxed stock and bond transactions between financial institutions in which at least one party was located in the EU at a rate of 0.1 percent, and derivatives contracts at a rate of 0.01 percent of notional value (European Commission 2011b). But financial centers such as the United Kingdom and Luxembourg, besides fearing for their competitive position, had no interest in sharing their tax base with other countries. Owing to their opposition, the EC plan became one for just eleven—later ten—EU members (European Commission 2013). But even that shrunken version failed to take off, leaving member countries to set up their own individual FTTs. Recently, France and Germany have attempted to revive the EC proposal, albeit with a much narrower base (Asen and Miller 2019).

Tax Revenue from FTTs

Experience from around the world presents two disappointing trends for FTT proponents as far as tax revenues are concerned. Not only do FTTs tend to raise very little revenue compared with other taxes, but they consistently raise less than forecast, mainly because trading activity inevitably moves to avoid the tax.

Matheson (2011: 10) reports that France, Germany, Japan, and Italy never managed to raise more than 0.2 percent of GDP with their FTTs in the period between 1990 and 2010—and they usually raised much less than that. With total tax revenue in these countries equivalent to between 25 and 45 percent of GDP during that period, FTTs amounted at most to 0.44 percent of the tax take. Postcrisis FTTs have not improved on this performance: France's post-2012 tax raises around 0.03 percent of GDP (European Commission n.d.), whereas the Spanish government expected its new FTT to bring in

[1]Author's calculations using Spanish stock market data.

just under 0.07 percent of Spanish GDP—a figure others thought too high even before Covid-19 hit (Page and Monzón 2020).

Even in less tumultuous times, FTTs have dashed their proponents' revenue-raising hopes. The dramatically adverse impact of Sweden's FTT on stock and bond trading in that country has already been mentioned (see also Umlauf 1993). But recent French and Italian FTTs also undershot official revenue projections by 50 percent and 80 percent, respectively (Swanson 2020: 6–7). Like in Sweden, the main reason for the shortfall seems to have been a rapid shrinking of the tax base. In countries that are only small or midsize financial centers, neither listed companies nor traders have an overwhelming incentive to stay put after the introduction of an FTT. In a world of open capital markets, firms can easily list in foreign untaxed venues, and traders can shift activity into jurisdictions unencumbered by transactions taxes.

FTTs and the "Socially Optimal" Amount of Trading

Even if FTTs are not particularly useful for raising revenue, they may still be desirable in order to reduce harmful short-term trading. Just as Keynes worried in the 1930s that reductions in transactions costs had caused a predominance of speculation over enterprise, some present-day market observers are concerned that, by lowering the cost of trading, technology has drawn in new participants whose short-term orientation may have destabilizing consequences (Haldane 2010: 10–11). Often, they point the finger at high-frequency traders (HFTs), who use fast computer infrastructure and algorithmic trading to get ahead of other orders, profiting from the price difference (Bernstein 2015).

Reports that HFTs recently accounted for as much as 50 percent of equities trading volume, whereas long-term "fundamental" traders accounted for just 10 percent, might seem like evidence that we are past the point Keynes warned against, when speculation would overtake enterprise (CNBC 2017). But it is not obvious that even HFTs make financial markets less efficient. While some studies have found that they increase stock volatility and drive prices away from fundamentals (Zhang 2010), others have reached the opposite conclusion (Brogaard 2010). Still others argue the impact depends on the type of HFT, "passive" or "aggressive" (Burman et al. 2015: 22; see also Wang and Yau 2012: 4). Nor is it clear that FTTs serve to reduce any adverse impact from trading. They do tend to decrease market liquidity and trading volume, as their proponents intend (Burman et al. 2015: 24). But their impact on volatility is ambiguous, with many studies finding no or even a positive relationship between FTTs and asset price volatility (Šramko 2015: 56; Keightley 2019: 3; Wang and Yau 2012: 6–7).

Even taxes on the most short-term-oriented of traders have ambiguous effects. For example, in addition to its main FTT, France introduced a 0.01 percent tax on cancelled or modified orders within a short time period—clearly aiming at high frequency trading.[2] But the tax appears to have raised no revenue and had no impact on volatility or bid-ask spreads. Yet it did reduce trading volumes and made markets less efficient by causing prices to deviate from fundamentals (Veryzhenko et al. 2017). Contrary to proponents' assertions, it is not obvious that the market participants who first exit after an FTT's introduction are those who foment volatility (Eichengreen 2012).

What about the "Success Stories"?

While the recent experience of FTTs has been decidedly mixed, it is worth asking whether some prominent financial centers, such as Britain and Hong Kong, might have managed to make a success of this type of tax. Britain has in fact levied its FTT (stamp duty on shares) since the late 17th century, with no obvious adverse impact on its status as a global trading hub (Burman et al. 2015: 8).

Still, stamp duty's longevity on its own tells us nothing about whether a jurisdiction's success occurred thanks to, regardless of, or in spite of it. As it happens, the British rate of stamp duty dropped from 2 percent to 0.5 percent in the 1980s, just before the City of London once again became a global financial center after a period of retrenchment (Bond, Hawkins, and Klemm 2004: 4). Furthermore, since 1997 financial intermediaries have been exempt, blunting stamp duty's impact on London's attractiveness to traders and market-makers, but also weakening any moderating effect on "excessive" trading (Oxera 2007: 3). There is also some evidence of stamp duty

[2]République Française, Code Général des Impôts, Section XX bis: Taxe sur les Opérations à Haute Fréquence.

avoidance through the use of derivatives, known in the UK as "contracts for difference" (ibid.: 23). Still, the tax is not without impact, with studies of rate-cut announcements finding that they increase the prices of frequently traded shares most (Bond, Hawkins, and Klemm 2004: 18).

For its part, Hong Kong imposes stamp duty on shares at a rate of 0.2 percent, but it has no capital gains or dividend taxation, making share ownership in the territory more attractive than elsewhere (KPMG 2018: 3, 6). In Hong Kong's case as well as Britain's, it seems other public policies—such as open capital markets, a stable and transparent legal system, and moderate taxation and regulation—work to compensate for the adverse impact of FTTs. At any rate, their example offers little hope that FTTs will not drive financial activity away from other jurisdictions, even if their impact on volatility and asset price behavior is unclear.

Implications for the United States

Because much of the evidence on FTTs concerns smaller financial centers, it might be thought less relevant for the United States, the world's biggest capital market. Even with an FTT, U.S.-listed firms might find it unattractive to move if it meant losing access to this deep pool of capital. Traders could also have a difficult time avoiding the tax if it applied to a broad base, covering all transactions with at least one U.S.-based party (Miller and Tyger 2020: 3). This would imply a less elastic revenue, and potentially also a smaller decline in beneficial trading, than has been observed elsewhere.

Some expert estimates do suggest that an FTT would raise more revenue relative to GDP in the United States than in other countries. The Congressional Budget Office, for example, expects that a broad FTT at a rate of 0.1 percent on most stocks and bonds, and on payments actually made in derivatives contracts, would collect $776.7 billion over ten years (CBO 2018). That would be equivalent to 0.35 percent of 2019 U.S. GDP, more than most other countries have managed to raise, although their FTTs typically apply to a narrower base than the proposal the CBO evaluated.

These revenue estimates are uncertain, hinging not just on the U.S. economy's long-term performance, but also on the elasticity of trading volume with respect to the tax rate. Matheson (2011: 16–17) reports high elasticities for stock and futures markets from a range of countries and assets, including S&P 500 futures contracts. They suggest activity would substantially decline after the introduction of an FTT. Nor is it obvious that such a tax would end up applying to as broad a base as the CBO anticipates. On the contrary, there would be pressure to exempt assets deemed low-risk, such as U.S. Treasury bonds, and to reimburse lower-income investors, as Senator Sanders' bill provides for (Miller and Tyger 2020: 5). Exemptions like these would not only narrow the tax base, but also increase opportunities for avoidance.

Still, even if its revenue-raising prospects were brighter than elsewhere, a U.S. FTT would suffer from similar problems with such taxes in other jurisdictions. By making short-term trading more expensive, it would probably reduce trading volume and liquidity. But whether this impact would be stabilizing is unclear, as the short-term traders the FTT would penalize could be informed arbitrageurs and market-makers, or momentum-driven speculators. The tax could also disproportionately raise the cost of capital for smaller listed firms, at a time when many of them may be looking to raise investor funds to weather the ongoing recession.

Conclusion

Despite their recent comeback, the case for FTTs is no stronger today than it was in the early 2000s, when they were in a slow but steady decline. FTTs raise little revenue, no matter the optimistic promises of the politicians who advocate them. Nor do FTTs seem particularly apt for the task some economists envisage for them—namely, as instruments to reduce volatility in financial markets by driving out "socially useless" traders with a short-term orientation. Betting on an FTT seems particularly risky during the present, pandemic-induced economic crisis, as it would raise the cost of capital to businesses already struggling with uncertainty and weak demand. And if the goal is to punish financial firms or reduce that sector's size, an FTT is a poor instrument for achieving it.

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Immigration and State Institutions: Does Region of Origin Matter?

Meg Tuszynski and Dean Stansel

Some immigration opponents claim that immigrants import bad institutions and policies from their country of origin into their new home country. We argue just the opposite—namely, that immigrants are more likely to self-select into countries with better institutions than those in their home countries. Researchers have examined this issue in both a cross-country and within-country context. Their findings have been mixed. Although others have found small or nonexistent impacts of immigrants on state institutions, those papers assume that all immigrants are the same. Our approach is unique in that it divides immigrant populations in a variety of ways. We build on the previous literature that examines the relationship between immigration and institutions at the state level, where there are smaller inherent differences in economic institutions (compared to differences across countries). We do so by incorporating the regional diversity of immigrant populations, examining whether immigrants' countries of origin matter for economic outcomes in their new home country. Controlling for the diversity of immigrant populations in a way that previous researchers have not done improves our ability to assess immigration opponents' claims that immigrants from economically worse-off countries hurt U.S. economic institutions. We find virtually no evidence of an economically and statistically significant

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Cato Journal, Vol. 40, No. 3 (Fall 2020). DOI:10.36009/CJ.40.3.4.

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relationship between the levels of immigration we have experienced in recent decades and a decline in economic institutions in the United States, regardless of the region or economic conditions of recent immigrants' home countries. The limited statistically significant evidence we do find is mixed and small in magnitude. Thus, one of the key rationales used to call for immigration restrictions is not supported by our findings.

The economic impacts of immigration on native born populations have been studied extensively in the empirical literature. (This journal devoted its entire Fall 2017 issue to the topic.) For example, Akay, Constant, and Giuletti (2014) found a robust and positive effect of immigration on the subjective well-being of native populations, as measured by survey data from the German Socioeconomic Panel. Though there is some disagreement, the general consensus of the literature is that immigration is positively correlated with various measures of both subjective well-being and economic well-being (Leeson and Gochenour 2015; Kerr and Kerr 2011). Indeed, a recent meta-analysis of the literature by the National Academies of Sciences, Engineering, and Medicine (2016) found that the impact of immigrants on native wages and employment levels is small, and that immigrants have a largely positive effect on long-run U.S. economic growth. Furthermore, the report found that second- and third-generation immigrants tend to contribute more in taxes than either first-generation immigrants or native-born residents.

The link between immigration and recipient country institutions, however measured, has not been explored as extensively in the academic literature (Ashby 2007; Ashby 2010; Nejad and Young 2016; Clark et al. 2015; Powell, Clark, and Nowrasteh 2017; Padilla and Cachanosky 2018). Even assuming there are some (perhaps substantial) positive *economic* impacts of immigration, large levels of immigration might still be a net negative for destination countries if immigrants create significant negative impacts on host country institutions. Indeed, this is the concern of both Collier (2013) and Borjas (2014, 2015). According to Borjas, "For immigration to generate substantial global gains, it must be the case that billions of immigrants can move to the industrialized economies without importing the "bad" organizations, social models, and culture that led to poor economic conditions in the source countries in the first place" (2015: 968). Whether immigrants actually import their "bad" institutions, however, is ultimately an empirical question. That is the question we address in this paper.

This question is important because the concerns that Borjas and others raise—that immigrants from lower-GDP or developing countries will harm their new country's socioeconomic institutions—are often used to justify increased restrictions on immigration. If we fail to find evidence that immigrants actually do import the bad institutions from their home countries, then the argument for immigration restrictions is weakened. We will discuss what previous researchers have found on this topic and then explain how we will test their hypotheses, and ours, empirically. We provide extensive econometric results and then conclude by discussing their implications.

Immigration and Economic Efficiency

The global efficiency gains literature argues that the current level of international immigration is suboptimal due to various immigration prohibitions, and that immigrants' lives and broader macroeconomic environments would both be improved were these restrictions liberalized. Hamilton and Whalley (1984) argued that the reallocation of labor due to the removal of worldwide immigration restrictions could lead to as much as a 14.3 percent increase in world GDP. Since that time, numerous others have examined the quantitative welfare impacts of immigration. Docquier, Machado, and Sekkat (2015) have estimates that fall on the low end of the welfare gains spectrum, with efficiency gains of 7 to 18 percent of world GDP in the medium term, with a focal point around 12 percent. As Clemens (2011) details, the average estimates of welfare gains in the existing literature fall somewhere in the 50 to 150 percent of world GDP range. Though the precise estimates are fairly sensitive to particular modelling assumptions, even the more conservative models suggest staggeringly large efficiency gains as a result of the relaxation of mobility restrictions.

Still, there may be real reasons to be concerned about massive increases in international immigration. Clemens and Pritchett (2019) support a relaxation of current stringent immigration restrictions, but suggest that immigrants from poor countries might bring their low productivity with them to richer countries, thereby offsetting the substantial global efficiency gains found in Clemens (2011). They argue that there might therefore be a case for restricting this type of immigration, but clarify that current comprehensive restrictions are still inefficient. Though Collier (2013) does not run any empirical tests of his thesis, he posits that both migrants' origin and destination countries may be adversely impacted by their decision to move. He suggests that the increased diversity in the host country as a result of immigration might lower the existing level of social cohesion and mutual trust in that society.

Borjas (2015) takes Collier's argument a step further, and creates a model of the impacts of migration which incorporates these types of sociocultural externalities. In some simulations, the net gain to world GDP actually turns negative if enough people immigrate. According to Borjas (2015: 968), "For immigration to generate substantial global gains, it must be the case that billions of immigrants can move to the industrialized economies without importing the 'bad' organizations, social models, and culture that led to poor economic conditions in the source countries in the first place."

However, Borjas' argument hinges on the idea that immigrants will, in fact, bring these poor institutions with them. In many countries from which immigrants flee, those poor institutions were imposed by totalitarian dictators rather than chosen by the residents of those countries. So, it does not necessarily follow that immigrants would support implementing them in their new host countries. Indeed, the opposite seems more likely: that immigrants may self-select countries with better institutions than those in their home countries. Still, since Borjas provides no empirical evidence of this dynamic, we use this paper to provide a limited test of his thesis.

Migrating Attitudes

The other literature to which this paper contributes is the migrating attitudes literature, which argues that immigrants bring with them many of the ideas and convictions of their home country when they move to a new country. The widespread use of worldwide public opinion surveys in recent years has facilitated the development of this literature. It is widely accepted that countries with higher levels of social capital (generally proxied using survey questions related to trust) tend to perform better on a variety of economic measures (see, e.g., Coleman 1988; Putnam 1993; Knack and Keefer 1997; and Platteau 2000).

The migrating attitudes literature builds on this idea. Algan and Cahuc (2010), for example, argue that immigrants from low-trust countries are more likely to exhibit the attitudes consistent with those low-trust societies. This is problematic because, as Aghion et al. (2010) show, individuals from more distrustful societies are more supportive of extensive government regulation. They suggest that this phenomenon results from the fact that in low-trust societies, people consider mechanisms of self-regulation to be lacking, so they favor external regulation to keep untrustworthy businesses and individuals in check.

In a similar vein, Alesina and Giuliano (2014) find that, not only do societies with more familistic values tend to have lower levels of social trust, but also that migrants bring these familistic values with them when they move.[1] Strikingly, they find that "family values inherited by children of immigrants whose forebears arrived in various European countries before 1940 are related to a lower quality of institutions and lower level of development today" (ibid.:179). More recently, Bologna-Pavlik, Lujan-Padilla, and Powell (2019) found that higher levels of immigration were not associated with higher levels of corruption, and in some cases were associated with lower corruption.

The migrating attitudes literature tends to examine historical attitudes' effects on current economic outcomes, and shows how the historical attitudes of migrants influence modern institutions and development. If we can trace current economic outcomes to historical migration of immigrant attitudes, we might expect a similar trend to hold when examining more recent immigration tendencies. Alesina and Giuliano contend that historical migration patterns affect not only modern macroeconomic indicators, but also modern institutions. Here, we extend their work, and examine whether immigration trends of the recent past are related to a specific set of institutional characteristics in a cross-state context.

Immigration and Economic Freedom

This article ties most directly into the small subset of literature that examines the relationship between immigration and the policies and institutions consistent with economic freedom. Clark et al. (2015)

[1]Alesina and Giuliano use the term "amoral familism," the idea that social values are centered around support for one's close family to the detriment of one's fellow citizens.

were the first to examine this question empirically.[2] Using country-level data from the *Economic Freedom of the World Annual Report* they found that immigration had at worst no impact on economic freedom in destination countries, and at best a small positive impact. Indeed, one specification found that an immigrant stock one standard deviation higher than that of the year 1990 increased economic freedom by 0.34 points 20 years later. (Note the economic freedom score is on a 0 to 10 scale.) Padilla and Cachanosky (2018) run a similar set of tests, but focus on the impact that international immigration to the United States has on U.S. economic freedom. They find no strong relationship between immigration and a deterioration in the quality of market liberal institutions broadly, though they find evidence of a slight negative impact on the narrower measure of labor market institutions.

Powell, Clark, and Nowrasteh (2017), and Powell (2017), take a different approach to examining the relationship between immigration and economic freedom. They examine the historical case of mass migration into Israel in the 1990s. Using a synthetic control approach, they find that Israel would not have seen such a substantial improvement in its level of economic freedom absent this mass migration. Using a similar approach, Nowrasteh, Forrester, and Blondin (2019) find that the large influx of refugees from the first Gulf War into Jordan played a substantial role in improving Jordanian institutions.

We build most directly on Padilla and Cachanosky (2018), whose work is the first to examine this relationship at the state level. We extend their work in a variety of ways. First, by lumping all immigrants together, their work assumes that all immigrants have the same impact on their new home country. We utilize more detailed data that enables us to drop that unrealistic assumption and instead evaluate whether the region of the world from which the immigrants came makes a difference in terms of economic or cultural impact. It may be the case, for example, that immigrants from regions with greater economic freedom have a positive impact on the institutional environments of their destination states, while immigrants from areas with less economic freedom have a negative impact, or vice versa. Our dataset allows us to examine those potential differences.

[2] Murphy (2017) provides a useful summary.

Secondly, we use the *Economic Freedom of the World* index (Gwartney, Lawson, and Hall 2017) to control more precisely for the economic freedom scores of immigrants' origin countries (as opposed to broader regions). This allows us to examine whether immigrants from countries with lower levels of economic freedom tend to affect their destination states differently than immigrants from countries with higher levels of economic freedom. Finally, we look at immigrants from poor countries and immigrants from autocratic countries.

Our measure of economic freedom in the U.S. states comes from the *Economic Freedom of North America 2017* (EFNA) annual report (Stansel, Tora, and McMahon 2017), described in detail in the next section. We use the EFNA for two reasons. First, we are building on the existing literature that uses economic freedom to examine the impact of foreign-born populations on destination country or state institutions. Second, and more importantly, this measure of institutions has been found to be robustly related to a variety of beneficial outcomes in both a cross-country and cross-state setting.[3]

The vast majority of empirical studies that use economic freedom as a variable employ it as an independent variable. Only recently have scholars begun to consider what factors might cause economic freedom to vary across different locations.[4] Since it is clear from the literature that economic freedom can be associated significantly with a variety of positive outcomes, determining what factors might impact a state's environment for economic freedom could be helpful to policymakers.

Theoretically, the relationship between immigration and state-level economic freedom could be either positive or negative. We know from the literature that good institutional quality acts as a "pull" factor, attracting potential immigrants (Ashby 2007; Cebula and Clark 2011), and that poor institutional quality acts as a "push" factor, causing immigrants to leave their home countries (Beine, Docquier, and Schiff 2008). Though immigrants might actively choose to leave countries with dysfunctional economic institutions, they still might

[3]For a review of the country-level literature see Hall and Lawson (2014). Stansel and Tuszynski (2018) provide a similar review for the state-level literature.

[4]Powell (2018) examines this topic in general, and Lawson, Murphy, and Powell (2020) provide a survey of that growing literature.

bring with them some of the poverty-causing institutional and cultural characteristics from their home countries (Collier 2013).

However, it might also be the case that immigrants who are escaping places with poor institutional quality work actively to avoid bringing these sorts of institutions; that is to say, they come to a new location specifically in order to escape those poor circumstances and benefit from the relatively better institutional environment. In fact, Alesina, Harnoss, and Rapoport (2016) find that immigrants have a strong positive effect on their destination countries, with their measure of "birthplace diversity" related to a variety of measures of economic prosperity. This builds on earlier work by Peri (2012), who finds a positive relationship between immigrants' birthplace diversity and the relative productivity of their destination states in the U.S.; and Ager and Brückner (2013), who find a similar relationship in their study of the United States' "age of mass migration".[5]

Because the arrow of causality could run in either direction, we employ a variety of techniques to help mitigate any potential endogeneity concerns. In various specifications, we experiment with different structures of lagged independent variables, we employ changes instead of levels, and we control for the prior economic trend.

Econometric Model

To examine the relationship between immigration and institutional quality, we created a four-period panel reflecting the years 1980, 1990, 2000, and 2010.[6] Our dependent variable is the economic freedom score of each U.S. state, drawn from the *Economic Freedom of North America* index (EFNA) (Stansel, Tora, and McMahon 2017). The EFNA measures "the extent to which the policies of individual provinces and states [are] . . . supportive of economic freedom, the ability of individuals to act in the economic sphere free of undue restrictions" (ibid.: v). We use the EFNA subnational index, which incorporates the policies of state and local governments, but not the federal government. The Appendix provides further explanation of

[5]It is worth noting that, while Ager and Brückner find that diversity increases output during this period, in some counties the polarization that sometimes follows immigration did lead to a decrease in output.

[6]The EFNA index data only goes back to 1981. We use the 1981 value for the year 1980. Because institutions change slowly over time, this should not materially affect our results.

this index. We measure each state's overall economic freedom score as well as each of the three subcomponents of economic freedom included in the index: government spending, taxes, and labor market freedom. The latter is done to test whether any particular metric of economic freedom is driving our results.

Our immigration data comes from the U.S. Census Bureau. The 1980, 1990, and 2000 figures come directly from the corresponding Census data for those years. Data for 2010 come from the 2010 American Community Survey's 5-year population estimates. We divide each state's stock of immigrants for every year by the state's total population, and use the foreign-born percentage of the population as our key independent variable of interest. As you can see in Table 1, only three states (Maine, Montana, and Vermont) saw a decline in their immigrant populations from 1980 to 2010. None saw any decline from 1990 to 2010. In 2010, the foreign-born population ranged from a low of 1.3 percent in West Virginia, to a high of 27.2 percent in California, and averaged 8.5 percent.

In addition to examining the relationship between overall immigrant populations and state institutions, we also account for the region from which those immigrants came. In order to give Borjas and other similar scholars the best chance of being right in their assertion that immigrants may harm host-country institutions, we divide our data in a number of different ways. We first examine immigrants as a share of each state's population by their region of birth. The areas we include are Europe, Asia, Africa, South America, and North America (not including the United States). We use lagged independent variables in these first several specifications. To further address concerns about endogeneity, we use *changes* in immigration and economic freedom over a 10-year period in place of the *level* of immigration and economic freedom. We also regress the change in economic freedom on the lagged values of the change in our immigration variables. So, for example, we look at the relationship between the change in immigrants as a percent of state population from 1990 to 2000 and the change in that state's economic freedom score between 2000 and 2010.

We next run several specifications that control for each state's prior trend in economic freedom. Due to data availability, we are unable to use panel methods in our specifications that control for these trends. We use simple OLS, with the change in EFNA from 2000 to 2010 as the dependent variable, and both the level of

TABLE 1
Foreign Born, Percent of
State Population, 1980–2010

State	1980	1990	2000	2010	Change, 1980-2010
Alabama	1.00	1.08	1.97	1.97	0.97
Alaska	4.04	4.51	5.93	7.20	3.16
Arizona	5.99	7.59	12.79	14.16	8.17
Arkansas	0.98	1.06	2.76	4.26	3.28
California	15.13	21.70	26.17	27.19	12.07
Colorado	3.95	4.32	8.60	9.82	5.87
Connecticut	8.62	8.50	10.86	13.23	4.61
Delaware	3.17	3.34	5.73	8.23	5.06
Florida	10.86	12.85	16.71	19.17	8.31
Georgia	1.67	2.67	7.05	9.60	7.93
Hawaii	14.20	14.68	17.52	17.71	3.51
Idaho	2.48	2.87	4.95	5.85	3.37
Illinois	7.21	8.33	12.31	13.63	6.42
Indiana	1.85	1.70	3.07	4.45	2.59
Iowa	1.64	1.56	3.11	4.13	2.50
Kansas	2.03	2.54	5.01	6.31	4.28
Kentucky	0.94	0.93	1.99	3.05	2.11
Louisiana	2.03	2.07	2.59	3.56	1.53
Maine	3.86	2.96	2.88	3.31	−0.55
Maryland	4.64	6.56	9.79	13.18	8.54
Massachusetts	8.73	9.54	12.17	14.55	5.82
Michigan	4.50	3.82	5.27	5.94	1.44
Minnesota	2.64	2.58	5.29	7.00	4.36
Mississippi	0.93	0.79	1.40	2.16	1.23
Missouri	1.74	1.63	2.70	3.66	1.92
Montana	2.33	1.72	1.82	1.96	−0.37
Nebraska	1.97	1.78	4.36	5.91	3.93
Nevada	6.72	8.72	15.84	19.32	12.61
New Hampshire	4.45	3.71	4.38	5.25	0.80
New Jersey	10.29	12.50	17.55	20.34	10.05
New Mexico	4.02	5.31	8.22	9.72	5.70
New York	13.61	15.85	20.38	21.74	8.13
North Carolina	1.33	1.74	5.34	7.37	6.03
North Dakota	2.27	1.47	1.89	2.40	0.13

(Continued)

TABLE 1 *(Continued)*
FOREIGN BORN, PERCENT OF
STATE POPULATION, 1980–2010

State	1980	1990	2000	2010	Change, 1980-2010
Ohio	2.80	2.39	2.99	3.83	1.03
Oklahoma	1.86	2.08	3.82	5.25	3.38
Oregon	4.09	4.90	8.47	9.70	5.61
Pennsylvania	3.38	3.11	4.14	5.58	2.20
Rhode Island	8.87	9.48	11.38	12.64	3.77
South Carolina	1.48	1.43	2.89	4.70	3.23
South Dakota	1.39	1.11	1.79	2.33	0.94
Tennessee	1.05	1.21	2.79	4.38	3.33
Texas	6.02	8.97	13.91	16.10	10.08
Utah	3.45	3.40	7.10	8.21	4.76
Vermont	4.10	3.12	3.82	3.98	−0.13
Virginia	3.32	5.04	8.06	10.82	7.50
Washington	5.79	6.62	10.42	12.69	6.91
West Virginia	1.13	0.88	1.07	1.30	0.17
Wisconsin	2.66	2.48	3.61	4.58	1.91
Wyoming	2.05	1.69	2.27	3.06	1.02

SOURCE: U.S. Census Bureau. Data for 1980, 1990, and 2000 come from the corresponding Censuses for those years. Data for 2010 comes from the American Community Survey, 5-year estimates.

EFNA in 2000 and the change in EFNA between 1980 and 2000 as key independent variables. We also use as independent variables immigrants from countries more than one standard deviation below the United States in terms of economic freedom, immigrants from poor countries (the percentage of immigrants from countries below median world income), and immigrants from autocratic countries.[7]

[7]We assign economic freedom to countries using the *Economic Freedom of the World* data. Data for both median and average income per capita come from the World Bank's GDP per capita figures. We determine autocratic countries using the Polity IV index.

Due to data availability, five of our regression sets are simple cross sections.[8] In the other six sets, we employ standard fixed effects panel methods in order to test the relationship between immigration and the institutions of economic freedom. Our basic model is:

$$efna_{i,t} = \alpha + \beta\, efna_{i,t\text{-}10} + \gamma\, imm_{i,t\text{-}10} + \delta\, X_{i,t\text{-}10} + \phi_t + \lambda_i + \varepsilon_{i,t}$$

where $efna_{i,t}$ denotes the level of economic freedom in state i in period t. We control for each period's initial level of economic freedom to reflect the fact that it is relatively difficult for a state to subsequently improve its economic freedom score if it starts out at an already high level. The lagged value of the economic freedom score for state i in period t is denoted by $efna_{i,t\text{-}10}$.[9] The lagged value of immigration as a share of the population in state i in period t is denoted by $imm_{i,t\text{-}10}$. This is our key independent variable of interest. In alternative specifications, we use the total share of immigrants and the share of immigrants by region of origin. Our vector of potential covariates is denoted by $\varepsilon_{i,t\text{-}10}$. We include a full set of time and state fixed effects, denoted by ϕ_t and λ_i respectively. This allows us to control for both common trends over time that affect all states, and time-invariant factors that are specific to particular states. Our error term, $\varepsilon_{i,t}$, captures all omitted factors, and has an expected value of zero for all i and t.

We use the same set of control variables as Padilla and Cachanosky (2018). Our vector of controls, $X_{i,t\text{-}10}$, is:

1. The logged value of real personal income per capita (in 2010 dollars);
2. A measure of state political ideology, drawn from Berry et al. (2010);
3. The percent of state population living in urban areas;
4. The percent of the population aged 25 and older with at least a high school diploma; and
5. The percent of the population that identifies as African American.

[8]Regressions 6 and 10, which control for the prior trend in economic freedom, are cross sections because we only have data every 10 years from 1980–2010, so we lack enough data to use panel methods. Regressions 11–13 use country-level data, which is most complete for the years 2000 and 2010. Consequently, we are only able to use a cross-section in this case.

[9]We use a variety of lag structures. For brevity, we use the t-10 subscript here to represent all of these different lag structures.

Our real personal income per capita data is drawn from the Bureau of Economic Analysis' Regional Economic Accounts database. Following the convention in this literature, we use the logged value of this variable, and lag it by 10 or 20 years, depending on our specification. For our state political ideology variable, we use the NOMINATE ideology measure from the Berry et al. (2010) dataset. Unlike other metrics of ideology, this measure does not reflect any sort of self-identification, but is instead a measure of "operational ideology." This measure helps draw finer ideological distinctions between states than a simple measure like vote counts or percent of the legislature controlled by Democrats would draw. Ideology is measured on a 0 to 100 scale, with more liberal states receiving higher values. The final three control variables are all drawn from the U.S. Census Bureau, with data for years 1980, 1990, and 2000 coming from the relevant decennial census, and data for the year 2010 coming from the American Community Survey's 5-year estimates. Hero and Preuhs (2007) maintain that variables reflecting the urban population and the share of the population 25 and older with at least a high school diploma reflect the relative cosmopolitanism of the different states. More cosmopolitan states are more likely to be more accepting of immigrants. They also find evidence that spending on welfare provisions is lower in states with larger African American populations. We include this as a control variable, since this could affect the "government spending" subcomponent of economic freedom. Descriptive statistics for all variables are reported in Table 2.

Econometric Results: All Immigrants

Table 3 reports our results from our fixed effects panel regressions, with all independent variables lagged by 10 years. The panel is strongly balanced. The first specification uses a state's overall economic freedom score as the dependent variable of interest. The next three use the three individual components that make up the index: Area 1 (government spending), Area 2 (taxes), and Area 3 (labor market freedom). We find a marginally significant and very weak negative relationship between the lagged values of the foreign born percent of states' populations and states' overall economic freedom scores ten years later. This is similar to what Padilla and Cachonosky (2018) found (though they found no relationship between immigration and economic freedom in some of

TABLE 2
Descriptive Statistics

Variable	Mean	SD	Min	Max	N
Economic Freedom Index	6.60	0.75	4.04	8.55	200
EFNA Area 1: Government Spending	7.18	1.16	2.91	9.37	200
EFNA Area 2: Taxes	6.63	0.82	3.72	8.65	200
EFNA Area 3: Labor Market Freedom	5.99	1.27	2.16	8.08	200
Foreign Born as Percent of Population	6.20	5.31	0.79	27.19	200
European Immigrants as Percent of Population	1.37	1.17	0.22	5.71	200
Asian Immigrants as Percent of Population	1.72	2.16	0.26	14.59	200
African Immigrants as Percent of Population	0.21	0.29	0.01	1.97	200
South American Immigrants as Percent of Population	0.33	0.58	0.02	3.39	200
North American Immigrants as Percent of Population	2.40	2.79	0.08	14.52	200
Share Living in Urban Areas	70.10	14.77	32.20	95.00	200
State Government Ideology	50.70	12.94	17.56	73.62	200
Share 25+ with At Least HS Diploma	79.15	9.49	53.10	96.60	200
Share African American	9.82	9.36	0.20	37.02	200
Log of Personal Income Per Capita	10.39	0.22	9.84	11.04	200
Percent Foreign Born, 1 St-Dev Below US, 2000	1.11	1.19	0.17	6.10	50
Percent Foreign Born, 1 St-Dev Below US, 2010	1.73	1.54	0.25	6.71	50
Percent Foreign Born, Below Median Income, 2000	2.11	2.14	0.28	10.65	50
Percent Foreign Born, Below Median Income, 2010	3.29	2.83	0.47	11.05	50
Percent Foreign Born from Autocracies, 2000	0.76	0.78	0.09	4.46	50
Percent Foreign Born from Autocracies, 2010	1.01	0.94	0.15	4.78	50

their 10-year lagged specifications). A one-percent increase in the foreign born percent of state population is associated with only a 0.05 point decrease in the state EFNA score 10 years later.[10] This is a very small change. It is only about 1/15th the size of the standard deviation of EFNA (0.75), and in most cases would not change a state's overall U.S. economic freedom ranking by more than one place, if at all. For example, it would not move New York out of last place nor New Hampshire out of first place. While there is limited evidence of a statistically significant relationship, the magnitude of that relationship is so small that it is what we will refer to as economically insignificant, because in practical terms it is not significant.

To examine whether one particular component of the EFNA index is driving these results, we use each of its three subcomponents as dependent variables. There is no statistically significant relationship between the foreign born percent of state population and either the government spending component (Area 1) or the tax component (Area 2) of economic freedom. Only in Area 3, the labor market freedom component, is there a statistically significant negative relationship with the foreign born percent of state population, though it too is very small in magnitude: A one percent increase in immigrants' share of a state's population is associated with a decline of 0.07 points in its labor market freedom score 10 years later. This change is only about 1/18th of a standard deviation of EFNA labor market freedom scores. Since this subcomponent is one-third of a state's overall economic freedom score, it amounts to a change of only about 0.023 points in a state's overall score—less than half the size of the already very small change discussed above from regression (1). This result is consistent with the findings of Padilla and Cachanosky (2018) who found a weak, but statistically significant, relationship between immigration and the subcomponent of economic freedom

[10]Using the 10-year lag, the standard deviation of foreign-born population is 4.8 percent. There were only five observations (out of 150) of a 10-year change in foreign born that was larger than that SD of 4.8 percent, and the mean level of foreign born across the entire sample was only 6.2 percent. For 60 percent of our sample, a 4.8 percent increase in foreign-born share would be larger than the existing foreign-born population. Thus, a one standard deviation increase would be a very unusually large change, doubling the foreign-born share in most cases. For that reason, we're using a 1 percent change in foreign-born to calculate our marginal effects rather than a one standard deviation change.

TABLE 3
Immigration and Economic Freedom, 10-Year Lags

LHS	(1) EFNA	(2) Area 1	(3) Area 2	(4) Area 3
LHS Lag	−0.08	−0.09	−0.06	−0.05
	(0.08)	(0.08)	(0.07)	(0.09)
Foreign Born as Percent of Population	−0.05*	−0.04	−0.04	−0.07***
	(0.02)	(0.04)	(0.03)	(0.02)
Log of Personal Income Per Capita	−0.90	−0.04	−1.83**	−0.88
	(0.48)	(0.99)	(0.64)	(0.48)
Share Living in Urban Areas	0.00	−0.00	0.00*	−0.00
	(0.00)	(0.00)	(0.00)	(0.00)
State Government Ideology	−0.00	0.00	0.00	−0.01*
	(0.00)	(0.00)	(0.00)	(0.00)
Share 25+ with At Least HS Diploma	−0.01	−0.02	−0.01	−0.00
	(0.01)	(0.02)	(0.01)	(0.00)
Share African American	0.00	−0.00	−0.01	0.01
	(0.01)	(0.02)	(0.01)	(0.01)
Constant	17.04***	9.96	25.69***	15.72**
	(4.50)	(9.37)	(6.37)	(4.68)
Year F.E.	Y	Y	Y	Y
State F.E.	Y	Y	Y	Y
Within R^2	0.56	0.75	0.32	0.89
Number of Observations	150	150	150	150

*Significant at 90 percent, **significant at 95 percent, ***significant at 99 percent. Robust standard errors (heteroskedasticity-consistent estimators) in parenthesis.

Note: All variables reflect levels. The right-hand side variables are lagged by 10 years.

associated with labor market freedom (although the point estimates for this relationship were not statistically significant across all of Padilla and Cachanosky's specifications).

Because it is unclear over what time horizon we should expect immigrants to impact a state's institutional environment, we next run the same set of regressions using 20 year lags for our independent variables instead of 10 year lags. Using a different lag structure also allows us to see if immigrants impact state institutions differently over different periods of time. As Williamson (2000) notes, institutions are slow to change, with different sorts of institutions expected to change at different rates. Table 4 presents the results of our regressions with 20 year lags. Our results are quite similar.

With respect to states' overall economic freedom, the point estimate for the foreign born percent of state population is still negative, very small, and only marginally statistically significant. A one percent increase in the foreign born percent of state population is associated with an 0.06 point decline in its economic freedom score 20 years later, or only about 1/13th of a standard deviation of the overall

TABLE 4
Immigration and Economic Freedom, 20-Year Lags

LHS	(5) EFNA	(6) Area 1	(7) Area 2	(8) Area 3
LHS Lag	−0.11	−0.21	−0.12	−0.16*
	(0.16)	(0.19)	(0.08)	(0.06)
Foreign Born as Percent	−0.06*	−0.08	−0.05	−0.04*
of Population	(0.03)	(0.06)	(0.04)	(0.02)
Log of Personal Income	−0.45	0.30	−0.65	−0.35
Per Capita	(1.05)	(1.97)	(1.01)	(0.54)
Share Living in Urban	0.00	0.00	0.00	0.00
Areas	(0.00)	(0.00)	(0.00)	(0.00)
State Government	−0.00	−0.00	−0.00	0.00
Ideology	(0.00)	(0.01)	(0.00)	(0.00)
Share 25+ with At Least	−0.01	−0.03***	0.00	0.00
HS Diploma	(0.00)	(0.01)	(0.00)	(0.00)
Share African American	0.03	−0.00	−0.11	0.20***
	(0.07)	(0.14)	(0.07)	(0.06)
Constant	12.66	8.29	15.02	9.10
	(9.96)	(19.01)	(10.18)	(5.15)
Year F.E.	Y	Y	Y	Y
State F.E.	Y	Y	Y	Y
Within R^2	0.67	0.83	0.30	0.40
Number of Observations	100	100	100	100

*Significant at 90 percent, **significant at 95 percent, ***significant at 99 percent. Robust standard errors (heteroskedasticity-consistent estimators) in parenthesis.

Note: All variables reflect levels. The right-hand side variables are lagged by 20 years.

economic freedom scores. As with the 10 year lag results, this fails to attain economic significance. That small of a change would move neither the top state out of first place nor the bottom state out of last place.

Once again, the only one of the index's three subcomponents showing a statistically significant relationship with the foreign born percent of state population is labor market freedom (Area 3), but it is now even smaller and only marginally significant. A one percent increase in the foreign born share of state population is associated with an 0.04 point decline in its labor market freedom score. Since that component is one-third of the overall EFNA index, this represents a decline of only about 0.013 points in a state's overall score.

Though our specifications in Tables 3 and 4 attempt to control for endogeneity by lagging all of our independent variables, and by using year and state fixed effects, we further attempt to control for endogeneity in Table 5 by using *changes* instead of *levels* as our dependent and independent variables. We once again lag all of our independent variables by 10 years. (For example, we compare the change in the foreign born percent of state population from 1990–2000 with the change in economic freedom from 2000–2010.)

Unlike in Tables 3 and 4, the relationship between the lagged change in the foreign born share of state population and the change in its overall economic freedom score is not even marginally significant. When we examine the three subcomponents of the index, we do find a marginally significant relationship between immigration and both the tax and labor market subcomponents of economic freedom, but the coefficients are again very small.

We attempt to further mitigate concerns about endogeneity by controlling for prior trends in states' economic freedom scores. Here, our dependent variable is the change in EFNA between 2000 and 2010, and we include as a control variable both the level of state economic freedom in 2000 and the change in state economic freedom between 1980 and 2000. In Table 6, which uses the foreign born share of state population as the key variable of interest, we find no relationship between immigrant populations and changes in economic freedom.

Econometric Results: Immigrants by Region of Origin

We find that the overall foreign born share of a state's population has essentially no economically significant relationship to the

TABLE 5
IMMIGRATION AND ECONOMIC FREEDOM, 10-YEAR LAGGED CHANGES

LHS	(9) EFNA, 10-year Change	(10) Area 1, 10-year Change	(11) Area 2, 10-year Change	(12) Area 3, 10-year Change
Change in Foreign Born as a Percent of Population	−0.11	−0.14	−0.11*	−0.09*
	(0.07)	(0.18)	(0.06)	(0.05)
Change in Log of Personal Income Per Capita	−1.96*	−3.39	−1.36	−1.14
	(1.07)	(2.03)	(1.52)	(0.78)
Change in Share Living in Urban Areas	−0.03*	−0.11**	0.01	0.00
	(0.02)	(0.05)	(0.02)	(0.02)
Change in State Government Ideology	0.00	0.01	0.00	−0.00
	(0.00)	(0.01)	(0.00)	(0.00)
Change in Share 25+ with At Least HS Diploma	0.00	0.01**	0.00	−0.00
	(0.00)	(0.01)	(0.01)	(0.00)
Change in Share African American	−0.01	−0.02	−0.02	−0.01
	(0.01)	(0.02)	(0.02)	(0.01)
Constant	0.75***	0.71*	0.39	1.15***
	(0.21)	(0.42)	(0.29)	(0.15)
Year F.E.	Y	Y	Y	Y
State F.E.	Y	Y	Y	Y
R^2	0.76	0.69	0.15	0.90
Number of Observations	100	100	100	100

*Significant at 90 percent, **significant at 95 percent, ***significant at 99 percent. Robust standard errors (heteroskedasticity-consistent estimators) in parenthesis.

NOTE: All variables reflect 10-year changes. The right-hand side variables are lagged, reflecting the preceding 10-year period.

TABLE 6
Controlling for Prior Economic Freedom Trend

LHS	(13) EFNA, 2000-2010 Change	(14) Area 1, 2000-2010 Change	(15) Area 2, 2000-2010 Change	(16) Area 3, 2000-2010 Change
EFNA 2000	−0.18**	−0.14**	−0.11	−0.16***
	(0.09)	(0.07)	(0.07)	(0.06)
EFNA, 1980-2000 Change	−0.27***	−0.39***	−0.13	−0.13**
	(0.09)	(0.09)	(0.09)	(0.06)
Foreign Born as Percent of Population, 2000	−0.01	0.01	−0.01	−0.02
	(0.01)	(0.02)	(0.01)	(0.01)
Share Living in Urban Areas, 2000	−0.00	−0.01	0.00	0.00
	(0.00)	(0.01)	(0.01)	(0.00)
State Government Ideology, 2000	0.00	0.01	0.00	−0.00
	(0.00)	(0.01)	(0.00)	(0.00)
Share 25+ with At Least HS Diploma, 2000	0.00	−0.01	0.01	0.01
	(0.01)	(0.03)	(0.01)	(0.01)
Share African American, 2000	−-0.01	−0.01	−0.01	0.00
	(0.01)	(0.01)	(0.01)	(0.01)
Log of Personal Income Per Capita	0.03	0.99	−1.15**	0.11
	(0.45)	(0.77)	(0.52)	(0.21)
Constant	0.75	−8.91	11.64**	−0.47
	(3.86)	(6.95)	(4.69)	(2.22)
R^2	0.426	0.455	0.430	0.280
N	50	50	50	50

*Significant at 90 percent, **significant at 95 percent, ***significant at 99 percent. Robust standard errors (heteroskedasticity-consistent estimators) in parenthesis.
Note: All variables reflect levels, except for EFNA Change.

presence of policies and institutions that are consistent with economic freedom. However, unlike previous studies, we next examine whether or not immigrants' region of origin matters in terms of states' economic freedom. Tables 7–9 replicate the first three sets of results (Tables 3–5) by replacing the overall foreign born share of a state's population with the percent of its population born in each of the following five regions: Europe, Asia, Africa, South America, and North America (not including the United States).

As Table 7 shows, of those five regions, the only one that has an even marginally statistically significant effect on a state's overall economic freedom score is North America. As with the results discussed above, this marginal effect is very small. A one percent increase in immigrants from North America is associated with a 0.06 point decrease in states' overall economic freedom scores 10 years later, a change too small to move the top state out of first place or the bottom state out of last place. This result seems to be driven by the highly significant but very weakly negative relationship between North American immigrants and states' labor market freedom scores (Area 3). However, that relationship also fails to achieve economic significance due to its very small magnitude. Since Area 3 represents only one-third of a state's overall EFNA score, the marginal effect here of a one-percent change in the foreign-born share of a state's population on its overall economic freedom score is only 0.027. The relationship between immigration and government spending (Area 1) is marginally statistically significant, but also of very small magnitude.

While our main variable of interest is the 10 year change in a state's overall economic freedom score, there were a few other marginally and moderately significant coefficients for the individual subcomponents of the EFNA index, all of which were quite small. The largest one shows that a 1 percent increase in the European born share of a state's population is associated with a full one point decline in the EFNA's government spending subcomponent (Area 1) ten years later. Because that subcomponent makes up only one-third of the overall economic freedom score, it is equivalent to a 0.33 point change in a state's overall score. This would not change the rank of the overall least-free state (New York) but it would move the most-free state (New Hampshire) from first to fourth. In contrast, we find a positive relationship between the African born share of a state's population and its labor market freedom score, with a one-percent

TABLE 7
Immigrant Region of Origin and Economic Freedom, 10-Year Lags

LHS	(17) EFNA	(18) Area 1	(19) Area 2	(20) Area 3
LHS Lag	−0.12	−0.25**	−0.03	−0.03
	(0.08)	(0.08)	(0.07)	(0.09)
European Immigrants, Percent of Population	−0.31	−1.00**	0.14	−0.11
	(0.18)	(0.32)	(0.22)	(0.11)
Asian Immigrants, Percent of Population	−0.05	0.19	−0.17*	−0.13**
	(0.05)	(0.10)	(0.07)	(0.04)
African Immigrants, Percent of Population	0.23	0.07	0.24	0.35**
	(0.24)	(0.41)	(0.32)	(0.13)
South American Immigrants, Percent of Population	−0.15	−0.47	−0.11	0.11
	(0.12)	(0.26)	(0.13)	(0.10)
North American Immigrants, Percent of Population	−0.06*	−0.10*	0.01	−0.08***
	(0.02)	(0.04)	(0.03)	(0.02)
Log of Personal Income Per Capita	−1.07*	0.28	−1.73**	−1.45**
	(0.49)	(0.90)	(0.63)	(0.54)
Share Living in Urban Areas	0.00	0.00	0.00	−0.00
	(0.00)	(0.00)	(0.00)	(0.00)

(Continued)

TABLE 7 *(Continued)*
Immigrant Region of Origin and Economic Freedom, 10-Year Lags

LHS	(17) EFNA	(18) Area 1	(19) Area 2	(20) Area 3
State Government Ideology	−0.00	0.00	0.00	−0.00*
	(0.00)	(0.01)	(0.00)	(0.00)
Share 25+ with At Least HS Diploma	−0.01	−0.01	−0.01	−0.00
	(0.01)	(0.02)	(0.01)	(0.00)
Share African American	−0.00	−0.00	−0.00	0.01
	(0.01)	(0.01)	(0.01)	(0.00)
Constant	19.26***	−1.42**	24.46***	21.63***
	(4.60)	(0.45)	(6.31)	(5.32)
Year F.E.	Y	Y	Y	Y
State F.E.	Y	Y	Y	Y
Within R^2	0.59	0.79	0.37	0.90
Number of Observations	150	150	150	150

*Significant at 90 percent, **significant at 95 percent, ***significant at 99 percent. Robust standard errors (heteroskedasticity-consistent estimators) in parenthesis.
Note: All variables reflect levels. The right-hand side variables are lagged by 10 years.

TABLE 8
Immigrant Region of Origin and Economic Freedom, 20-Year Lags

LHS	(21) EFNA, 20-year lags	(22) Area 1, 20-year lags	(23) Area 2, 20-year lags	(24) Area 3, 20-year lags
LHS Lag	−0.14	−0.25	−0.09	−0.15**
	(0.16)	(0.19)	(0.08)	(0.07)
European Immigrants, Percent of Population	0.11	0.58	−0.18	−0.07
	(0.26)	(0.55)	(0.26)	(0.17)
Asian Immigrants, Percent of Population	0.03	0.36	−0.21	−0.05
	(0.14)	(0.27)	(0.14)	(0.10)
African Immigrants, Percent of Population	0.98	0.66	0.96*	1.24**
	(0.84)	(2.00)	(0.53)	(0.59)
South American Immigrants, Percent of Population	−0.04	0.43	−0.85**	0.23
	(0.50)	(1.04)	(0.40)	(0.22)
North American Immigrants, Percent of Population	−0.14	−0.35	0.06	−0.12**
	(0.12)	(0.22)	(0.12)	(0.06)
Log of Personal Income Per Capita	−0.65	0.01	−0.28	−1.13**
	(1.29)	(2.39)	(1.33)	(0.52)
Share Living in Urban Areas	0.00	−0.00	0.00	0.00
	(0.00)	(0.00)	(0.00)	(0.00)

(Continued)

TABLE 8 (*Continued*)
Immigrant Region of Origin and Economic Freedom, 20-Year Lags

LHS	(21) EFNA, 20-year lags	(22) Area 1, 20-year lags	(23) Area 2, 20-year lags	(24) Area 3, 20-year lags
State Government Ideology	−0.00	−0.00	−0.00	0.00
	(0.00)	(0.01)	(0.00)	(0.00)
Share 25+ with At Least HS Diploma	−0.01*	−0.03***	0.00	0.00
	(0.00)	(0.01)	(0.00)	(0.00)
Share African American	−0.00	−0.01	−0.09	0.09
	(0.10)	(0.21)	(0.09)	(0.09)
Constant	15.01	10.70	11.19	17.99***
	(13.06)	(24.60)	(13.69)	(5.04)
Year F.E.	Y	Y	Y	Y
State F.E.	Y	Y	Y	Y
Within R^2	0.69	0.85	0.35	0.47
Number of Observations	100	100	100	100

*Significant at 90 percent, **significant at 95 percent, ***significant at 99 percent. Robust standard errors (heteroskedasticity-consistent estimators) in parenthesis.

Note: All variables reflect levels. The right-hand side variables are lagged by 20 years.

TABLE 9
Immigrant Region of Origin and Economic Freedom, 10-Year Lagged Changes

LHS	(25) EFNA, 10-year Change	(26) Area 1, 10-year Change	(27) Area 2, 10-year Change	(28) Area 3, 10-year Change
Change in European Immigrants, Percent of Population	−0.39	−0.62	−0.46	−0.10
	(0.41)	(0.76)	(0.56)	(0.28)
Change in Asian Immigrants, Percent of Population	−0.18	0.01	−0.70***	0.16
	(0.30)	(0.65)	(0.21)	(0.22)
Change in African Immigrants, Percent of Population	−0.68	−1.56	−0.76	0.28
	(0.55)	(1.02)	(0.81)	(0.49)
Change in South American Immigrants, Percent of Population	−0.00	−0.75	0.59	0.15
	(0.57)	(0.95)	(0.63)	(0.34)
Change in North American Immigrants, Percent of Population	−0.10	−0.13	0.01	−0.18***
	(0.08)	(0.20)	(0.08)	(0.06)
Change in Log of Personal Income Per Capita	−2.44**	−4.30*	−2.66*	−0.36
	(1.16)	(2.18)	(1.52)	(0.84)
Change in Share Living in Urban Areas	−0.03*	−0.10**	0.01	−0.00
	(0.02)	(0.05)	(0.02)	(0.02)

(Continued)

TABLE 9 *(Continued)*
IMMIGRANT REGION OF ORIGIN AND ECONOMIC FREEDOM, 10-YEAR LAGGED CHANGES

LHS	(25) EFNA, 10-year Change	(26) Area 1, 10-year Change	(27) Area 2, 10-year Change	(28) Area 3, 10-year Change
Change in State Government Ideology	0.00	0.01	−0.00	0.00
	(0.00)	(0.01)	(0.00)	(0.00)
Change in Share 25+ with At Least HS Diploma	0.00	0.01**	0.00	−0.00
	(0.00)	(0.01)	(0.01)	(0.00)
Change in Share African American	−0.02	−0.02	−0.02**	−0.01*
	(0.01)	(0.02)	(0.01)	(0.01)
Constant	0.79**	0.79	0.64	0.95***
	(0.32)	(0.59)	(0.43)	(0.25)
Year F.E.	Y	Y	Y	Y
State F.E.	Y	Y	Y	Y
R^2	0.78	0.71	0.30	0.91
Number of Observations	100	100	100	100

*Significant at 90 percent, **significant at 95 percent, ***significant at 99 percent. Robust standard errors (heteroskedasticity-consistent estimators) in parenthesis.

NOTE: All variables reflect 10-year changes. The right-hand side variables are lagged, reflecting the preceding 10-year period.

increase in a state's African born population associated with a 0.35 point *increase* in this area of the index. However, the implied 0.117 change in the overall EFNA score is too small to move the first and last state's positions. The other two significant coefficients have even smaller marginal effects.

When we used a longer, 20 year lag (Table 8), we found no statistically significant relationship between a state's economic freedom and its immigrant population from any of the five regions, and all but one of the significant results from Table 7 lost (or at least declined in) significance. That exception is that a one-percent increase in the African born share of a state's population is associated with an even larger (and equally significant) *increase* in labor market freedom of 1.24 points twenty years later. The implied 0.41 change in the overall index score, the largest marginal effect that we found in all of our results, would be large enough (if negative) to move New Hampshire from the first to the fourth most free U.S. state, but would still not dislodge New York from the bottom spot. This positive coefficient for African immigrants was also found for tax freedom (Area 2), while an increase in South American immigrants yielded a negative point estimate for that area. Both these coefficients, if negative, imply a marginal effect large enough to move New Hampshire from first to fourth.

The regional results using 10 year lagged changes for our independent variables in Table 9 gave us similar results to those for the overall foreign born share of state population in Table 5. We found no evidence in any of the five regions of a statistically significant relationship between the lagged change in the foreign born share of a state's population and the change in its overall economic freedom. We did find one region (Asia) to be significantly associated with a decline in tax freedom (Area 2) and one (North America) to be significantly associated with a decline in labor market freedom (Area 3). Neither of these were economically significant in the sense that their marginal effects would not have dislodged the top or the bottom state from its current position.

In Table 10, we attempt to further mitigate concerns about endogeneity by controlling for the prior trend in each state's economic freedom. Here, our dependent variable is the change in a state's EFNA score between 2000 and 2010, and we include as a control variable both its level of economic freedom in 2000 and the change in its economic freedom between 1980 and 2000. Only African immigrants have a significant relationship to the change in a state's overall economic freedom between 2000 and 2010, and that relationship is strongly positive. Asian immigrants have a strongly positive relationship to the change in the subcomponent associated with government spending (Area 1); and both African and South American immigrants have a strongly positive relationship to the change in labor market freedom (Area 3). North American immigrants have a slight negative relationship to states' labor market freedom scores, but the overall point estimate of this coefficient is very small.

In Table 11, we examine the impact of immigrants from countries with very low economic freedom (more than one standard deviation below the United States), as measured by the *Economic Freedom of the World* index (Gwartney, Lawson, and Hall 2017). If immigration critics were correct, we would expect to see a large and statistically significant negative coefficient here. However, we find no significant relationship at all between an increase in immigrants from very unfree countries and the economic freedom of their new home states 10 years later.

In Table 12, our key independent variable of interest is a state's population of immigrants from countries with income levels below median world income. There is only a slight relationship between an increase in immigrants from these countries and the taxation subcomponent of economic freedom (Area 2). Once again, the point estimate is small; so, though we find statistical significance here, it is of little economic significance. As a robustness check, we also looked at immigrants hailing from countries with income levels below *average* world income (table omitted). The results were substantially the same.

Finally, in table 13, we examine the impact of immigrants from autocratic countries on state-level economic freedom 10 years later. If immigration critics were correct, we would expect to see a large and statistically significant negative coefficient here. However, as is the case for countries with low economic freedom, we find no statistically significant relationship at all.

Conclusion

Some opponents of immigration suggest that immigrants will import the bad institutions and policies from their countries of origin into their new home countries. Researchers have tested that

TABLE 10
Controlling for Prior Economic Trend, Immigrant Region of Origin

LHS	(29) EFNA, 2000-2010 Change	(30) Area 1, 2000-2010 Change	(31) Area 2, 2000-2010 Change	(32) Area 3, 2000-2010 Change
EFNA 2000	−0.15	−0.05	−0.12*	−0.14**
	(0.11)	(0.10)	(0.07)	(0.06)
EFNA, 1980-2000 Change	−0.31***	−0.54***	−0.11	−0.21***
	(0.10)	(0.13)	(0.10)	(0.07)
European Immigrants, Percent of Population, 2000	−0.01	0.20	0.01	−0.05
	(0.09)	(0.17)	(0.08)	(0.04)
Asian Immigrants, Percent of Population, 2000	0.02	0.13***	−0.04	0.00
	(0.02)	(0.04)	(0.03)	(0.01)
African Immigrants, Percent of Population, 2000	0.39**	0.48	0.11	0.52***
	(0.17)	(0.32)	(0.25)	(0.10)
South American Immigrants, Percent of Population, 2000	0.03	−0.15	−0.05	0.15***
	(0.10)	(0.19)	(0.10)	(0.05)
North American Immigrants, Percent of Population, 2000	−0.02	−0.04	0.01	−0.04***
	(0.01)	(0.03)	(0.02)	(0.01)
Share Living in Urban Areas, 2000	−0.01	−0.02**	0.00	0.00
	(0.01)	(0.01)	(0.01)	(0.00)

(Continued)

TABLE 10 *(Continued)*
CONTROLLING FOR PRIOR ECONOMIC TREND, IMMIGRANT REGION OF ORIGIN

LHS	(29) EFNA, 2000-2010 Change	(30) Area 1, 2000-2010 Change	(31) Area 2, 2000-2010 Change	(32) Area 3, 2000-2010 Change
State Government Ideology, 2000	0.00	0.00	0.01	−0.00
	(0.00)	(0.01)	(0.00)	(0.00)
Share 25+ with At Least HS Diploma, 2000	0.00	−0.02	0.02	0.00
	(0.01)	(0.03)	(0.01)	(0.01)
Share African American, 2000	−0.01	−0.01	−0.01	0.00
	(0.01)	(0.01)	(0.01)	(0.00)
Log of Personal Income Per Capita	−0.03	0.39	−1.23**	−0.51
	(0.71)	(0.77)	(0.58)	(0.31)
Constant	4.35	−2.13	12.06**	6.42**
	(6.17)	(6.89)	(5.59)	(3.06)
R^2	0.499	0.549	0.473	0.597
N	50	50	50	50

*Significant at 90 percent, **significant at 95 percent, ***significant at 99 percent. Robust standard errors (heteroskedasticity-consistent estimators) in parenthesis.

NOTE: All variables reflect levels, except for EFNA Change.

TABLE 11
Countries More Than One Standard Deviation Less Free Than U.S.

LHS	(33) EFNA, 2010	(34) Area 1, 2010	(35) Area 2, 2010	(36) Area 3, 2010
EFNA 2000	0.84***	0.75***	0.87***	0.82***
	(0.10)	(0.11)	(0.07)	(0.07)
Foreign Born, from Low-EF Countries, Percent of Population, 2000	−0.02	−0.04	−0.06	0.02
	(0.06)	(0.09)	(0.07)	(0.04)
Share Living in Urban Areas, 2000	−0.00	−0.01	0.00	0.00
	(0.00)	(0.01)	(0.00)	(0.00)
State Government Ideology, 2000	0.00	0.01	0.00	−0.00
	(0.00)	(0.01)	(0.00)	(0.00)
Share 25+ with At Least HS Diploma, 2000	0.01	−0.01	0.01	0.01
	(0.01)	(0.03)	(0.01)	(0.01)
Share African American, 2000	−0.00	−0.01	−0.00	0.00
	(0.01)	(0.01)	(0.01)	(0.01)
Log of Personal Income Per Capita	−0.44	0.13	−1.11*	−0.03
	(0.64)	(0.89)	(0.69)	(0.30)
Constant	4.58	0.02	11.40*	0.37
	(5.76)	(8.28)	(6.35)	(2.67)
R^2	0.78	0.644	0.821	0.838
N	50	50	50	50

*Significant at 90 percent, **significant at 95 percent, ***significant at 99 percent. Robust standard errors (heteroskedasticity-consistent estimators) in parenthesis.

Note: All variables reflect levels. The right-hand side variables are lagged by 10 years.

TABLE 12
Countries Below Median World Income

LHS	(37) EFNA, 2010	(38) Area 1, 2010	(39) Area 2, 2010	(40) Area 3, 2010
EFNA 2000	0.86***	0.77***	0.85***	0.83***
	(0.09)	(0.11)	(0.07)	(0.07)
Foreign Born, From Poor Countries, Percent of Population, 2000	0.02	0.08	−0.07*	0.02
	(0.03)	(0.06)	(0.04)	(0.02)
Share Living in Urban Areas, 2000	−0.00	−0.02*	0.01	−0.00
	(0.00)	(0.01)	(0.01)	(0.00)
State Government Ideology, 2000	0.00	0.00	0.01	−0.00
	(0.00)	(0.01)	(0.00)	(0.00)
Share 25+ with At Least HS Diploma, 2000	0.01	0.00	0.01	0.01
	(0.01)	(0.03)	(0.01)	(0.01)
Share African American, 2000	−0.00	−0.01	−0.01	0.01
	(0.01)	(0.01)	(0.00)	(0.01)
Log of Personal Income Per Capita	−0.59	−0.25	−1.16**	−0.02
	(0.49)	(0.77)	(0.49)	(0.24)
Constant	5.99	3.82	11.70***	0.33
	(4.57)	(7.57)	(4.55)	(2.36)
R^2	0.78	0.66	0.83	0.84
N	50	50	50	50

*Significant at 90 percent, **significant at 95 percent, ***significant at 99 percent. Robust standard errors (heteroskedasticity-consistent estimators) in parenthesis.

Note: All variables reflect levels. The right-hand side variables are lagged by 10 years.

TABLE 13
Autocratic Countries

LHS	(41) EFNA, 2010	(42) Area 1, 2010	(43) Area 2, 2010	(44) Area 3, 2010
EFNA 2000	0.85***	0.75***	0.89***	0.81***
	(0.09)	(0.10)	(0.07)	(0.06)
Foreign Born, From Autocratic Countries, Percent of Population, 2000	0.02	0.08	−0.02	0.02
	(0.05)	(0.08)	(0.08)	(0.05)
Share Living in Urban Areas, 2000	−0.00	−0.01	0.00	0.00
	(0.00)	(0.01)	(0.00)	(0.00)
State Government Ideology, 2000	0.00	0.01	0.00	−0.00
	(0.00)	(0.01)	(0.00)	(0.00)
Share 25+ with At Least HS Diploma, 2000	0.01	−0.00	0.02	0.01
	(0.01)	(0.03)	(0.01)	(0.01)
Share African American, 2000	−0.00	−0.01	−0.01	0.00
	(0.01)	(0.01)	(0.00)	(0.01)
Log of Personal Income Per Capita	−0.55	−0.08	−1.39**	0.05
	(0.45)	(0.75)	(0.58)	(0.22)
Constant	5.61	2.06	13.91***	−0.33
	(4.27)	(7.28)	(5.27)	(2.28)
R^2	0.78	0.65	0.82	0.84
N	50	50	50	50

*Significant at 90 percent, **significant at 95 percent, ***significant at 99 percent. Robust standard errors (heteroskedasticity-consistent estimators) in parenthesis.

Note: All variables reflect levels. The right-hand side variables are lagged by 10 years.

hypothesis at the national level and have generally found it lacking. In contrast, we argue that immigrants are more likely to self-select into countries with better institutions than those in their home countries. We build on Padilla and Cachanosky (2018), who were the first to test this hypothesis at the subnational level, by including several more refined measures of states' immigrant populations. Rather than just using the overall foreign-born percentage of each U.S. state's population, which assumes that all immigrants have the same effect on their new home states, we also utilize the percent of immigrants from each of five different geographic regions, from countries significantly less free than the United States, from poor countries, and from autocratic countries. This allows us to control for the diversity of immigrants and thereby examine whether or not immigrants' region of origin matters.

Using a variety of specifications, we find no evidence of an economically significant relationship between the overall foreign-born share of a U.S. state's population and changes in its economic freedom. Those results are robust to a variety of specifications, including different lag structures, lagged changes, and controls for prior trends in states' economic freedom. While in some specifications we do find some limited evidence of statistical significance, the magnitude of their marginal effect is too small to attain economic significance. These findings are similar to those of Padilla and Cachonosky (2018), who find no strong or consistent relationship between increases in immigrant population and changes overall economic freedom. Like Padilla and Cachanosky, the strongest relationship (in terms of statistical significance) that we find is between increases in the foreign-born share of a state's population and changes in the labor market freedom subcomponent of its economic freedom score. However, this coefficient is very small; thus, it fails to achieve economic significance.

When we refine our measure of the foreign-born share of a state's population by using immigrants' region of origin, we again find no evidence of an economically significant relationship between immigrant populations from any of the five regions (Europe, Asia, Africa, South America, and North America) and states' overall economic freedom scores. The one statistically significant result implies a marginal effect that is too small to attain economic significance. When looking at immigrants from poor countries, and immigrants from autocratic countries, we are unable to find any relationships that are both statistically and economically significant.

Because the state-level data for immigrants as a share of the population is only available at 10 year intervals, it is possible that our results are clouded by idiosyncrasies in the stock of immigrants related to the specific years we use in our panels. We try to mitigate this problem by using year fixed effects, lagged changes, and controls for prior trends in states' economic freedom, but it is possible that we have not totally eradicated it. Additionally, since institutions change slowly over time, it might be the case that our data limitations don't allow us to take a significantly long-term view of this phenomenon. If we were able to examine the relationship over a longer time horizon, it might be the case that we would find different results. Still, it is encouraging that many of our significant results seem to fade when using a 20 year rather than a 10 year time horizon.

Finally, we live in an environment in which international migration is highly controlled. In our sample, the immigrant share of a state's population has a mean of 6.2 percent, and ranges from a low of less than 1 percent to just over 27 percent. Borjas' (2015) simulations, which imply that immigrants will import their origin country's inferior institutions, assume a world of massively higher immigration rates. It might be that our results would be somewhat different were we to see significantly higher levels of immigration. Still, like Padilla and Cachanosky (2018), we find virtually no evidence of an economically significant relationship between the levels of immigration we have experienced in recent decades and a decline in United States economic institutions. This provides some limited evidence that Borjas' concerns that we should restrict immigration to avoid harming our institutions are exaggerated.

Appendix: Description of *Economic Freedom of North America* Index

Subnational Index

Area 1: Government Spending

1A: General Consumption Expenditures by Government (as Percent of Income)
1B: Transfers and Subsidies (as Percent of Income)
1C: Insurance and Retirement Payments (as Percent of Income)

Area 2: Taxes

2A: Income and Payroll Tax Revenue (as Percent of Income)
2B: Top Marginal Income Tax Rate and the Income Threshold at which It Applies
2C: Property Tax and Other Taxes (as Percent of Income)
2D: Sales Tax Revenue (as Percent of Income)

Area 3: Labor Market Freedom

3A: Minimum Wage (as Percent of Per Capita Personal Income)
3B: State & Local Government Employment (as Percent of Total Employment)
3C: Union Density (Percent of Total Employment)

Data for each variable is standardized on a 0 to 10 scale, with 10 representing most free and 0 representing least free. The scores for the variables within each of the areas is averaged to get three area scores, which are then averaged to get an overall score.

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Economic Liberalizations Around the World Since 1970: Shock Therapy Versus Gradualism

Kerianne N. Lawson and Robert A. Lawson

Since 1970 many countries have engaged in economic liberalization. They have lowered taxes, deregulated, removed barriers to international trade, reduced corruption, improved monetary stability, and privatized state-owned enterprises. While it is generally held that economic liberalization has improved economic performance (see, e.g., de Haan et al. 2006; Hall and Lawson 2014), there is still debate over how quickly reforms should be implemented. In particular, the question is whether the reforms should be enacted quickly via shock therapy or gradually.

This article examines 77 countries with the most significant economic liberalizations since 1970, as measured by changes in the Economic Freedom of the World (EFW) index. Measures of both the speed and comprehensiveness of the reforms are presented. Our empirical evidence suggests that faster reforming nations economically outperformed slower reformers. We do not find evidence that more comprehensive reforms, as opposed to more narrowly targeted reforms, had much of an impact on ensuing economic growth.

Cato Journal, Vol. 40, No. 3 (Fall 2020). DOI:10.36009/CJ.40.3.5.

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Shock Therapy Versus Gradualism

Jeffrey Sachs (2012) explains and defends his participation in the use of shock therapy (aka "Big Bang") reforms in Bolivia, Poland, and Russia. He compared his approach to that of an emergency room doctor facing a patient on the verge of death from multiple ailments. In his view, treating the patient quickly, even rashly, is the only way to save the patient's life. In addition, given the speed with which distributional coalitions (Olson 1965) may form to disrupt or derail any reform process, a fast reform may be the only politically viable option. During a crisis period, such as that facing the nations Sachs dealt with, there is often only a short political window during which reforms can take place. This idea seems to be the motivation for Milton Friedman's (1962: ix) famous dictum: "Only a crisis—real or perceived—produces real change."

Despite Sachs's arguments, the consensus seems to be that the Big Bang approach, especially as it applied to Poland and Russia, was a failure, though it isn't clear if it was a failure of the reforms to work economically or a failure of political will to see them through (Marangos 2003; Hall and Elliott 1999; Rutland 2013). In contrast, other scholars have pointed to the slower-paced reforms enacted in China, and the economic success that has followed, as evidence in favor of gradualism (e.g., Liew 1995).

One interesting thesis, which we shall explore in this article, is the idea that there was a big difference in the character of reforms undertaken in the Big Bang nations compared with gradual reformers. In comparing Russia with China, Kazakevitch and Smyth (2005: 69) argue that the Big Bang reforms tended to be top-down, macroeconomic reforms such as monetary and financial stabilization, and that those reforms did not reach down to a microeconomic level that would foster "genuine market forces and competition."[1]

Perhaps it was not so much that the reforms were too fast in Poland and Russia, but that the reforms were too narrow. Perhaps China's reforms have not succeeded because they were slow, but because they were broad and both macro- and microeconomic in nature. If fast reforms tend to be narrow, and if slow reforms tend to

[1]In support of this general idea, Bolen and Sobel (2020) show that countries with more balanced levels of economic freedom across the areas have better growth.

be broad, it may be hard distinguishing one from the other without a larger sample of countries to draw inferences from. The main purpose of this article is to examine this question.

Measuring Economic Liberalization

Our measure of economic reform will be based on the Economic Freedom of the World (EFW) index (Gwartney et al. 2018), which is one of the most widely used measures of the of the consistency of a nation's policies and institutions with free-market capitalism. It currently generates a 0–10 rating, with higher ratings indicating greater economic freedom, for 162 nations for 2016. Data are available annually back to 2000 and in five-year intervals back to 1970, though the sample of countries gets smaller as you go back in time.

There is little question that we have seen a worldwide shift toward freer markets over the past 40 years or so. Among the 102 nations with EFW ratings in both 1980 and 2016, the average developed nation's rating increased to 7.71 from 6.43 (equivalent to 0.99 standard units), and the average developing nation's rating rose to 6.65 from 4.91 (1.35 standard units).[2] In fact, only one country, Venezuela, experienced any meaningful decrease in the EFW index over this period.[3] The bottom line is that there has been a wave of market liberalization going on in almost all corners of the globe over the past several decades, and this liberalization was most emphatically not just about the breakup of the Soviet Union and Eastern Bloc. These events as well as the Reagan and Thatcher revolutions were emblematic of a much wider global phenomenon.[4]

Our first task is to identify and characterize the countries with the biggest economic liberalizations since 1970. To that end, we first identified every country that experienced a 2 unit or more increase in the EFW index rating over any time period between 1970 and 2016. Then we identified the shortest time period over which this

[2]The EFW index's "Panel Dataset" is used exclusively throughout this article.

[3]Venezuela's rating fell by a whopping 3.59 units, and its ranking fell from 15th to dead last out of the 102 economies with continuous data since 1980. Ironically, the only other economy to exhibit a decline of any magnitude was top-rated Hong Kong, whose rating fell by a trivial 0.10 units.

[4]Grier and Grier (2020) offer an interesting examination of the determinants of various liberalizations over the past several decades.

2 unit change took place. For example, suppose a country had the following data points: 2000: 3.0; 2001: 3.5; 2002: 4.5: 2003: 5.2; 2004: 5.4. The 2000–03 period of time, three years, would be the fastest 2 unit (or more) increase in the EFW rating.[5]

Table 1 shows the 77 countries whose EFW rating increased by 2 units (or more), the time period during which their reforms took place, the starting and ending EFW index values, and the standard deviation of the changes in the five subareas of the EFW index; the latter will be explained below. The list is sorted based on how fast the reform process took.

There are some limitations to this approach that should be acknowledged. First, the EFW index is available only in five-year intervals from 1970 to 2000 so the reform lengths can only be 5, 10, 15, . . ., 30 years in length during these years. This obviously adds some imprecision to the reform length in the earlier years versus the post-2000 period, after which the data become available annually. Second, many countries may have been reforming before they were incorporated to the EFW index. This is especially true of the former communist nations, most of which were not added until 1995 or, in some cases, even much later. We know many began reforming immediately after the breakup of the Soviet Union in 1991, but we may not be able to capture these reforms here. As an example, Georgia does not even appear on the list in Table 1, even though it is widely regarded as one of the biggest (and fastest) reforming nations (Lawson, Grier, and Absher 2019; Burakova and Lawson 2014)—because Georgia doesn't appear in the EFW index until 2003, which is after some reforms had already taken place. Likewise, it is possible some countries are in the midst of a 2 unit increase in the EFW index at the end of the period under study, but would not be yet counted as a reforming nation with this measure. Third, some reforming countries may have continued reforming after the initial 2 point increase occurred, while others may have backslid some. This particular slicing of the data does not distinguish among these countries.[6]

[5]No country can appear twice on this list. If a country experienced a 2 unit change over more than one time period of the same length, then the time period with the smallest EFW index change was selected to the that country's reform period.

[6]Sobel (2017) provides a more in-depth discussion of some of these issues. Of particular interest to this paper, he did not find evidence that faster reforming nations had any greater tendency to slide backwards relative to slower reforming nations.

TABLE 1
Length, Timing, and Standard Deviation of Reforms for the 77 Countries Experiencing a 2 Unit Increase in the EFW Index, 1970–2016

Country	Reform Length	Reform Began	Reform Ended	Pre-Reform EFW	Post-Reform EFW	Standard Deviation of Reforms
Argentina	5	1990	1995	4.20	6.74	1.95
El Salvador	5	1990	1995	4.51	7.19	0.97
Nicaragua	5	1990	1995	2.79	5.84	1.86
Peru	5	1990	1995	4.02	6.57	1.40
Rwanda	5	1995	2000	3.87	6.03	1.58
Uganda	5	1990	1995	2.77	4.99	1.78
Latvia	6	1995	2001	5.38	7.51	2.54
Zambia	6	1995	2001	4.43	6.49	2.79
Zimbabwe	6	2006	2012	2.98	5.07	2.37
Romania	7	1995	2002	3.85	6.31	2.17
Ukraine	7	1995	2002	3.34	5.42	2.31
Bulgaria	8	1995	2003	4.72	6.78	2.92
Slovak Rep	9	1995	2004	5.41	7.52	1.71
Bolivia	10	1985	1995	3.41	6.50	3.14
Chile	10	1975	1985	3.53	5.70	2.84
Dominican Rep.	10	1990	2000	4.30	6.74	2.07

(Continued)

TABLE 1 (*Continued*)
Length, Timing, and Standard Deviation of Reforms for the 77 Countries Experiencing a 2 Unit Increase in the EFW Index, 1970–2016

Country	Reform Length	Reform Began	Reform Ended	Pre-Reform EFW	Post-Reform EFW	Standard Deviation of Reforms
Egypt	10	1990	2000	4.31	6.35	1.86
Ghana	10	1980	1990	3.03	5.14	2.19
Guatemala	10	1985	1995	4.75	7.01	2.34
Hungary	10	1990	2000	4.99	7.00	1.54
Iceland	10	1985	1995	5.47	7.61	2.65
Israel	10	1985	1995	3.96	5.97	2.38
Jamaica	10	1990	2000	5.37	7.42	1.70
New Zealand	10	1985	1995	6.10	8.68	1.12
Nigeria	10	1990	2000	3.37	5.38	1.43
Paraguay	10	1985	1995	4.59	6.61	1.82
Philippines	10	1985	1995	4.95	7.14	1.19
Poland	10	1990	2000	3.47	6.54	1.86
Portugal	10	1985	1995	5.20	7.23	1.08
Tanzania	10	1985	1995	3.52	5.56	2.63
Trinidad & Tob.	10	1985	1995	4.59	6.97	2.17
Albania	11	1995	2006	5.04	7.14	2.49
Lithuania	12	1995	2007	5.53	7.53	2.87
Congo, Dem. R.	14	1995	2009	3.40	5.40	3.57

(*Continued*)

TABLE 1 *(Continued)*
Length, Timing, and Standard Deviation of Reforms for the 77 Countries Experiencing a 2 Unit Increase in the EFW Index, 1970–2016

Country	Reform Length	Reform Began	Reform Ended	Pre-Reform EFW	Post-Reform EFW	Standard Deviation of Reforms
Slovenia	14	1995	2009	5.02	7.02	2.89
Bangladesh	15	1980	1995	3.29	5.34	1.05
Brazil	15	1985	2000	2.96	5.89	2.59
Costa Rica	15	1985	2000	4.93	7.36	1.64
Italy	15	1985	2000	5.43	7.46	0.96
Madagascar	15	1995	2010	4.31	6.40	1.92
Malta	15	1990	2005	5.49	7.59	0.97
Mauritius	15	1980	1995	4.59	7.27	2.33
Russia	15	1995	2010	4.54	6.54	3.12
South Africa	15	1985	2000	4.90	6.98	1.16
Syria	15	1985	2000	3.32	5.48	1.21
Turkey	15	1980	1995	3.70	5.88	1.97
United Kingdom	15	1975	1990	5.76	7.86	1.81
Algeria	16	1990	2006	3.63	5.68	2.16
Croatia	16	1995	2011	4.87	6.91	2.46
Guinea-Bissau	16	1990	2006	3.17	5.29	2.59
Iran	16	1985	2001	3.72	5.96	1.97

(Continued)

TABLE 1 *(Continued)*
Length, Timing, and Standard Deviation of Reforms for the 77 Countries Experiencing a 2 Unit Increase in the EFW Index, 1970–2016

Country	Reform Length	Reform Began	Reform Ended	Pre-Reform EFW	Post-Reform EFW	Standard Deviation of Reforms
Mexico	17	1985	2002	4.60	6.69	2.01
Sierra Leone	17	1990	2007	3.79	5.96	3.21
Burundi	18	1995	2013	3.89	5.98	2.09
Greece	18	1985	2003	5.10	7.39	1.20
Cyprus	19	1985	2004	5.58	7.61	1.04
Botswana	20	1980	2000	5.09	7.19	1.07
China	20	1980	2000	3.86	5.89	1.82
Indonesia	20	1970	1990	4.21	6.22	1.50
Ireland	20	1975	1995	5.77	8.01	1.01
Pakistan	20	1975	1995	3.62	5.74	0.66
Spain	20	1980	2000	5.61	7.67	0.97
Sweden	20	1980	2000	5.52	7.56	0.52
Korea, South	21	1985	2006	5.57	7.65	1.20
Kuwait	21	1980	2001	4.98	7.16	3.51
Panama	21	1980	2001	5.50	7.53	1.32
Jordan	23	1990	2013	5.62	7.66	0.71
Kenya	23	1980	2003	4.83	6.87	1.69

(Continued)

TABLE 1 *(Continued)*
Length, Timing, and Standard Deviation of Reforms for the 77 Countries Experiencing a 2 Unit Increase in the EFW Index, 1970–2016

Country	Reform Length	Reform Began	Reform Ended	Pre-Reform EFW	Post-Reform EFW	Standard Deviation of Reforms
Australia	25	1975	2000	5.85	7.99	1.18
Austria	25	1975	2000	5.81	7.86	0.60
Ecuador	25	1970	1995	3.92	6.24	2.01
Tunisia	26	1985	2011	4.85	6.97	1.44
Norway	27	1980	2007	5.71	7.71	1.12
India	28	1975	2003	4.36	6.39	1.07
Morocco	30	1980	2010	4.37	6.38	1.44
Togo	33	1980	2013	3.84	6.23	1.78
Taiwan	39	1975	2014	5.71	7.74	0.60

Source: Authors' calculations based on data from Gwartney et al. (2018).

Despite these criticisms, the approach taken here to identify the time period during which a country experienced a 2 point change in the index is a reasonably simple and neutral approach to identifying reforming nations across the board.

Table 2 reports descriptive statistics for the variables in Table 1 (as well as for some additional variables used in the empirical analysis below). The average length of time for a country to improve its EFW rating was about 15 years —with the fastest period being 5 years and the slowest 39.

A number of countries reformed very quickly. The economic liberalizations of Argentina, El Salvador, Nicaragua, Peru, Rwanda, and Uganda took only 5 years to increase by 2 points on the EFW index. They all did so between 1990 and 1995, except for Rwanda, which did so between 1995–2000. Similarly, most of the formerly communist nations reformed quickly in the early- and mid-1990s as they underwent the "Big Bang" or shock therapy market reforms. Latvia, Lithuania, Romania, Ukraine, Bulgaria and Slovak Republic all gained 2 points or more in under a decade, beginning in 1995. Despite all the talk of shock therapy in Poland and Russia, our data say that it took 10 years and 15 years, respectively. Poland, though not Russia, did receive an EFW rating in 1990 so this is not an artifact of not having complete data in Poland's case at least.

At the other end of the spectrum, it took Taiwan a full 39 years (1975–2014) to garner a 2 point increase in the EFW rating. In fact, a number of the world's most celebrated liberalizations also took the slow approach to the liberalization race. China (1980–2000), Botswana (1980–2000), Ireland (1975–95), and Sweden (1980–2000) took 20 years to accomplish the task. South Korea (1985–2006) took 21 years and India took 28 years (1975–2003).

The final column of Table 1 reports the standard deviation of the changes in the five sub-areas of the EFW index. The five areas are: (1) Size of Government; (2) Property Rights and the Legal System; (3) Sound Money; (4) Freedom to Trade Internationally; and (5) Regulation of Credit, Labor, and Business. The Size of Government area, which reflects fiscal policy, and the Sound Money area, which reflects monetary policy, are mostly macroeconomic in nature, though each as microeconomic importance as well. The other areas, especially the Property Rights and Regulation areas are more microeconomic. The Trade area is more of a combination of both.

TABLE 2
Descriptive Statistics

Variable	Obs.	Mean	Std. Dev.	Min.	Max.
Reform Length	77	14.94	7.12	5.00	39.00
Pre-reform EFW	77	4.50	0.89	2.77	6.10
Post-reform EFW	77	6.69	0.85	4.99	8.68
Change in EFW	77	2.19	0.26	2.00	3.09
Standard Deviation of Reforms	77	1.83	0.73	0.52	3.57
Growth Rates, Reform Period Plus 5	77	0.0241	0.0181	−0.0097	0.0860
Pre-reform GDP Per Capita	73	6,845	8,989	263	48,538
Education Spending (%GDP)	76	3.51	1.56	0.70	8.70
Investment (%GDP)	71	20.43	6.53	5.08	34.52

This standard deviation found in Table 1 is a measure of how narrow (or conversely how broad) the liberalization process was. If a country increased its score exactly 2 points in each of the five areas, this would yield a standard deviation of 0, indicating that the reform process was perfectly across the board. A high standard deviation would indicate that the critical improvements were occurring in just one or perhaps two areas. The average value for this measure was 1.83, with a minimum value of 0.52 (Sweden) and a maximum value of 3.57 (Democratic Republic of Congo). Countries like Sweden experienced nearly across-the-board increases in the EFW areas, while counties like the Democratic Republic of Congo really improved only in one of the areas. In fact, the latter country's Sound Money area rating increased by over 8 points as the country exited a hyperinflation period, while the other areas saw little change.

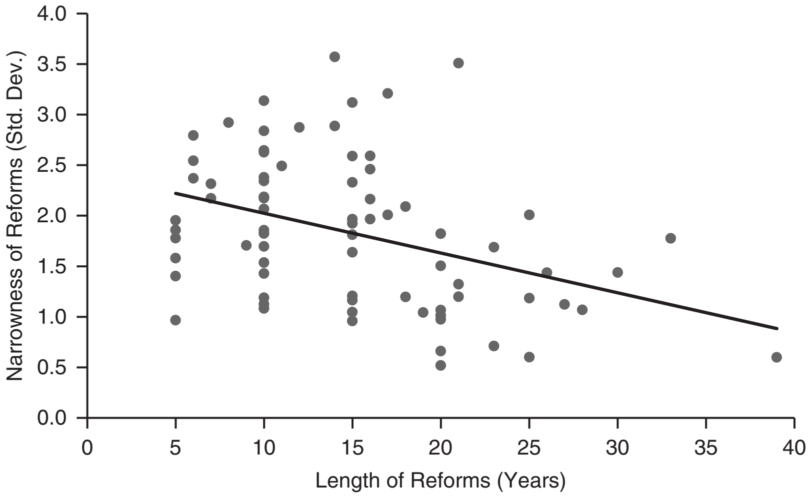
Of particular note is Russia, whose standard deviation measure of 3.12 was the 5th highest among the 77 countries in the sample. Russia's reforms were in fact not very comprehensive according to this measure. In looking at the underlying data, essentially all of the increase in Russia's rating was a result of a 7.22 increase in the Sound Money area and a 2.28 increase in the Regulation area. In contrast, China's reforms were more comprehensive. Its standard deviation of 1.82 was about average for the sample, and was the result of solid increases in three of the five areas of the EFW index (Sound Money 1.94, International Trade 4.05, and Regulation 2.68).

One question worth asking is whether or not countries that reformed more quickly also did so in just a few areas? The answer is yes. Figure 1 shows a clear negative relationship between the reform length (horizontal axis) and the narrowness of the reforms (vertical axis). Thus, as we suspected, *countries that took a long time to reform tended to enact a more comprehensive set of reforms.*

Regression Analysis

Having identified the 77 countries that undertook significant economic liberalizations over the past five decades, the next step is to evaluate their relative economic performance. For each country, we have obtained the average annual growth rate in real, per capita GDP over the reform period plus five years. For example, Argentina's

FIGURE 1
Negative Relationship Between Length and Narrowness of Reforms



Note: The estimated regression line is STDdA 5 2.41 2.04*rID. The t-stat on the beta coefficient is 23.57.

reforms occurred from 1990–95, so the growth rate for Argentina was calculated for 1990–2000.[7]

As shown in Table 2, the average growth rate of these reforming nations during their reform periods (plus 5 years) was 2.41 percent, which is a very solid growth rate in real, per capita terms. The economic success was not guaranteed however with several (all African) nations experiencing slight negative growth rates. As expected, China's growth rate, at 8.6 percent per year, was the highest in the sample.

Which reforming nations did better? Table 3 reports the results of three OLS regressions. The dependent variable is the growth rate of the reforming country over its reform period plus five additional years. As explanatory variables, we have three standard control variables: (1) GDP per capita (measured in ppp US$) at the beginning of the reform period; (2) gross investment to GDP at the beginning of the period; and (3) education spending relative to GDP at the

[7]Some countries had small adjustments to this rule because of data availability. For example, Taiwan's reform period ends in 2014. We used the 2017 ending point for the growth rate calculation, since 2019 is obviously not yet available.

TABLE 3
Economic Growth Among Liberalizing Nations:
2 EFW Unit Changes

Dependent Variable: Average Annual Growth, Reform Period Plus 5 Years

Variable	(1)	(2)	(3)
Reform Length	−0.00113***		−0.00106***
	(3.04)		(2.77)
Standard Deviation of Reforms		0.00530	0.00304
		(1.40)	(0.83)
Pre-reform EFW	0.00641*	0.00633	0.0746*
	(1.75)	(1.56)	(1.92)
Change in EFW	0.00456	0.00320	−0.00320
	(0.47)	(0.31)	(0.32)
Pre-reform GDP Per Capita (Logged)	−0.00291	−0.00167	−0.0304
	(1.22)	(0.68)	(1.27)
Education Spending (%GDP)	0.00003	0.00031	−0.00009
	(0.02)	(0.19)	(0.06)
Investment (%GDP)	0.00078*	0.00045	0.00082*
	(1.88)	(1.08)	(1.97)
Adjusted R-Squared	0.093	0.012	0.088
Number of Observations	67	67	67

Note: t-statistics in parentheses.

beginning of the period. The level of income at the beginning of the period is expected to be negatively related to growth as growth rates are expected converge (or regress to the mean) with poorer countries growing more rapidly than richer countries. The latter two control variables are intended to control for investments in physical and human capital; both are expected to be positively related to growth.[8]

[8]We lose some observations because of missing data among some of the control variables. Data were obtained from the World Bank's World Development Indicators online databank. Because the specification is a cross section, fixed or random effects could not be included. As a test of robustness, the coefficient standard errors were clustered by the decade of the end of the reforms, but the results were qualitatively similar to the ones presented here.

The two main variables of interest are: (1) number of years it took to reform by 2 points on the EFW index; and (2) the standard deviation of the reforms. In addition, we have included the level of the EFW index at the beginning of the reform period and the change in the EFW score during the reform period. Gwartney et al. (2006) have shown that the *level* of the EFW index is correlated with growth. Others, however, have debated whether EFW level variable should be included along with the *change* in the EFW index (Cole and Lawson 2007; De Haan and Sturm 2006; De Haan and Sturm 2007; Lawson 2006; Lawson and Murphy 2018). We see no harm in including it here as a control variable. We do not really expect much from the EFW change variable, as all of the countries in the sample have reformed by at least 2 points and there is not much variation above that level.

Turning to Table 3, the first regression runs the reform length without the standard deviation of the reforms; the second regression runs the standard deviation of the reforms without the reform length; and the third regression runs both. The same controls are used in all three regressions.

The overall explanatory power of the models is quite weak throughout, which is perhaps not too surprising given the similarities among these countries as reforming nations. The control variables, more or less, perform as expected. The coefficient on the level of the EFW at the beginning of the period is generally positive indicating that more economically free countries generally grew faster independent of the reforms, while the change in EFW is insignificant. The initial level of GDP per capita is negatively related to growth, as expected, though it is insignificant. Investment in physical capital is positive as expected, though human capital investment is not.

Of the two variables of interest, we find that the reform length is negatively related to growth, while the standard deviation of the reforms is insignificant statistically (though positive). A seven-year longer reform period, which is about one standard deviation, corresponds to about 0.8 percent in lower annualized growth. Thus, this is evidence in support of Jeffrey Sach's view that faster reforms are preferred over slower ones. Finally, contra the argument advanced by Kazakevitch and Smyth (2005), there is no strong evidence here to support the view that broader or more microeconomic reforms are better than more narrow macroeconomic reforms.

TABLE 4
Economic Growth Among Liberalizing Nations:
1 EFW Unit Changes

Dependent Variable: Average Annual Growth, Reform Period Plus 5 Years

Variable	(1)	(2)	(3)
Reform Length	−0.00099		−0.00089
	(1.48)		(1.41)
Standard Deviation of Reforms		0.00420	0.00382
		(1.00)	(0.92)
Pre-reform EFW	0.00897***	0.00857***	0.00944***
	(2.99)	(2.85)	(3.10)
Change in EFW	0.00713	0.00644	0.00553
	(0.97)	(0.85)	(0.73)
Pre-reform GDP Per Capita (Logged)	−0.00242	−0.00243	−0.00247
	(1.19)	(1.19)	(1.22)
Education Spending (%GDP)	−0.00012	−0.0005	−0.00045
	(0.12)	(0.28)	(0.27)
Investment (%GDP)	0.00023	0.00006	0.00017
	(0.57)	(0.14)	(0.43)
Adjusted R-Squared	0.054	0.039	0.052
Number of Observations	79	79	79

Note: t-statistics in parentheses.

Robustness Checks

As a robustness check, we considered countries that experienced a 1, 1.5, and 2.5 point increase in EFW rating.[9] Using the same regression analysis as we did with countries that had a 2 point increase, we see similar results in these specifications presented in Tables 4 and 5. These results support our findings in Table 3 and suggest that it was not simply the 2 point increase that mattered for our results; rather, any meaningful increase in the EFW rating can

[9]We do not include the table of regression results for the countries with a 2.5 increase in EFW rating. This specification had 46 observations and while the signs of the coefficients did not change from the previous three regression tables, it did not yield any significant results.

TABLE 5
ECONOMIC GROWTH AMONG LIBERALIZING NATIONS:
1.5 EFW UNIT CHANGES

Dependent Variable: Average Annual Growth, Reform Period Plus 5 Years

Variable	(1)	(2)	(3)
Reform Length	−0.00112**		−0.00098**
	(2.26)		(1.93)
Standard Deviation of Reforms		0.00612**	0.00464
		(1.74)	(1.31)
Pre-reform EFW	0.00976***	0.00716***	0.01018***
	(2.74)	(2.20)	(2.86)
Change in EFW	0.00408	0.00482	0.00524
	(0.50)	(0.58)	(0.64)
Pre-reform GDP Per Capita (Logged)	−0.00187	−0.00080	−0.00165
	(0.83)	(0.35)	(0.73)
Education Spending (%GDP)	−0.00073	−0.00109	−0.00092
	(0.51)	(0.75)	(0.64)
Investment (%GDP)	0.00024	0.00006	0.00023
	(0.56)	(0.15)	(0.56)
Adjusted R-Squared	0.050	0.026	0.059
Number of Observations	85	85	85

NOTE: t-statistics in parentheses.

represent an economic liberalization. When looking at our two variables of interest, the reform length remains significant and negative throughout, indicating that countries with faster reforms tended to grow more quickly than those with slower reforms. Likewise, the standard deviation of the reforms did not seem to be related to growth. This result means that the nature of the reform, or how comprehensive the reform was, did not have any meaningful impact on growth.

Conclusion

Although there is something of a consensus that economic liberalization works to deliver faster growth rates, there is less agreement on whether reforms should be undertaken quickly or slowly, or if they need to be across the board or can be done more narrowly. Using the Economic Freedom of the World (EFW) index, we have identified 77 countries undertaking significant economic reforms since 1970. We find that countries that reformed more quickly grew more rapidly relative to slower reforming nations during and just after the period of their reforms. We did not find that broad macro- and microeconomic reforms were more growth enhancing than large but more narrowly targeted macroeconomic reforms.

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The Fall of Chile

Axel Kaiser

> Now, at long last, Chile has all three things: political freedom, human freedom and economic freedom. Chile will continue to be an interesting experiment to watch to see whether it can keep all three or whether, now that it has political freedom, that political freedom will tend to be used to destroy or reduce economic freedom.
>
> —Milton Friedman (1991)

> The neoliberal experiment—in Chile—is completely dead. It is likely to be replaced by a welfare state that will attempt to follow the Nordic countries.
>
> —Sebastian Edwards (2019)

The "Economic Miracle" of the Chicago Boys

Following the failed Marxist experiment of Chilean President Salvador Allende, a free-market revolution led by the so-called Chicago Boys in the 1970s and 1980s created the conditions necessary for the country to experience an "economic miracle"

Cato Journal, Vol. 40, No. 3 (Fall 2020). DOI:10.36009/CJ.40.3.6.

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that captured worldwide attention.[1] As Nobel laureate economist Gary Becker (1997) put it, Chile became "an economic role model for the whole underdeveloped world." This performance, said Becker, "became still more impressive when the government was transformed into a democracy." Along the same lines, Nobel laureate economist Paul Krugman argued that the reforms introduced by the Chicago Boys "proved highly successful and were preserved intact when Chile finally returned to democracy in 1989" (Krugman 2008: 31). Indeed, from 1990 to 2010 a left-wing coalition called "Concertación" came to power. Despite having been comprised of opponents to the military dictatorship and by many former members of Salvador Allende's government, Concertación kept in place the foundations of the free-market system. A pragmatic view prevailed, leading to the recognition and adoption of the economic legacy of the Pinochet years. As Alejandro Foxley, the first finance minister of the democratic period explained:

> The mature countries are countries that don't always start from scratch. We had to recognize that in the previous government, the foundations had been established for a more modern market economy, and we would start from there, restoring a balance between economic development and social development. And that's what we did [Foxley 2001].

For conservatives in the west, Chile's economic reforms were a symbolic victory in the fight against socialism and progressivism. As historian Niall Ferguson (2008: 216) has pointed out, the "backlash against welfare started in Chile." Moreover, according to Ferguson, the Chilean economic reforms such as the privatization of its social security system were "far more radical than anything that has been attempted in the United States, the heartland of free market economics. . . . Thatcher and Reagan came later" (ibid.). Along the same

[1]In the 1950s the Catholic University and the University of Chicago began an exchange program that enabled Chilean students to pursue postgraduate studies at the Department of Economics of the University of Chicago. These students came to be known as the "Chicago Boys," a label that was also applied to other students who graduated from American universities other than Chicago and took part in the implementation of free-market reforms under the Pinochet regime.

lines William Ratliff and Robert Packenham (2007) have argued that Chile was the first country in the world to make "that momentous break with the past away from socialism and extreme state capitalism" preceding "Margaret Thatcher's Britain and Ronald Reagan's United States." For Marxist intellectual David Harvey (2005: 7–8), "the first experiment of neoliberal state formation occurred in Chile after Pinochet's coup" providing "helpful evidence to support the subsequent turn to neoliberalism in both Britain (under Thatcher) and the US (under Reagan)."

George H. W. Bush's visit to Chile in 1990 affirmed the symbolism of the Chicago Boys' success story. On his arrival in Santiago, Bush (1990) declared that "Chile's peaceful return to the ranks of the world's democracies" was cause for "pride and celebration." He went on to emphasize the importance of the free-market revolution that had taken place under the military government of General Pinochet: "Chile's record of economic accomplishment is a lesson for Latin America on the power of the free market. Nowhere among the nations of this continent has the pace of free-market reform gone farther, faster than right here in Chile." Along the same lines, former British Prime Minister Margaret Thatcher (1999) declared that Pinochet's regime had turned Chile "from chaotic collectivism into the model economy of Latin America."

The available data overwhelmingly support these views. Chronic inflation, which had peaked at over 500 percent in 1973, fell below 10 percent by the 1990s and under 5 percent by the 2000s (World Bank 2019). Between 1975 and 2015 per capita income in Chile quadrupled to $23,000, the highest rate in Latin America (CNP 2016). As a result, from the early 1980s to 2014 poverty fell from 45 percent to 8 percent (CNP 2016). Several indicators show that this "economic miracle" benefited the majority of the population. For example, in 1982 only 27 percent of Chileans had a TV set. By 2014, 97 percent did (CNP 2016). The same is true for refrigerators (from 49 percent to 96 percent), washing machines (from 35 percent to 93 percent), cars (from 18 percent to 48 percent), and other items. More importantly, life expectancy rose from 69 to 79 years in the same time period and housing overcrowding fell from 56 percent to 17 percent. The middle class as defined by the World Bank, grew from 23.7 percent of the population in 1990 to 64.3 percent in 2015 and extreme poverty fell from 34.5 percent to 2.5 percent (Libertad y

Desarrollo 2017: 3). On average, access to higher education grew by a factor of five in the same time period mostly benefiting the bottom quintile, which saw its access to higher education increase by eight times (PNUD 2017: 20). This is consistent with the growth of income in the different socioeconomic groups. While between 1990 and 2015 the income of the richest 10 percent grew a total of 30 percent, the income of the poorest 10 percent saw an increase of 145 percent (PNUD 2017: 21). In turn, the Gini index fell from 52.1 in 1990 to 47.6 in 2015 (PNUD 2017: 37). If income inequality is measured within the different generations the reduction is even greater (Sapelli 2014). Other measures of inequality also show a narrowing of the gap between the rich and the rest of the population. The Palma index, which measures the income inequality of the richest 10 percent relative to the bottom 40 percent, fell from 3.58 to 2.78 in the same time period while the ratio between the incomes of the bottom and the top quintiles decreased from 14.8 to 10.8 (PNUD 2017: 21) In addition to this decline in income inequality, a 2017 OECD report showed that Chile had more social mobility than all other OECD countries (2018).[2] Chile also held the highest position among Latin American nations in the 2019 UN Human Development Index (PNUD 2019).

In short, thanks to the free-market reforms introduced by the Chicago Boys and maintained by the democratic regimes that came later, Chile became the most prosperous country in Latin America, which mostly benefitted the poorest members of the population.

Explaining Chile's "Paradox"

To many, the enormous economic and social progress that Chile has achieved in the last four decades seems to be in full contradiction with the crisis that broke out in October 2019, characterized by mass demonstrations, coordinated violence by small groups, and demands by the political left and others to abandon Chile's free-market model. The crisis upended Chilean politics and society, leading to a planned

[2]According to the study, it was more likely for people with parents in the bottom 25 percent of the income scale to move to the top 25 percent of the income scale in Chile than in any other OECD country.

referendum on writing a new constitution.[3] Some have described Chile's current situation as a "paradox" (Edwards 2019). Indeed, it seems paradoxical that a country that has achieved so much prosperity has bitterly turned against the very institutions that made that prosperity possible.

Part of the explanation for the rage showed by the Chilean population has to do with the collapse in public trust of traditional civic and state institutions, including democracy. Between 2009 and 2015 people who believed that Chile's democracy worked well or very well plummeted from 26 percent to 10 percent, and those who believed that it worked poorly rose from 16 percent to 32 percent (Aninat and González 2016: 3). From 2015 to 2019, the first group shrank further to 6 percent and the second group rose to 47 percent. (CEP 2019). Institutions such as the Catholic Church, radio broadcasters, the police and armed forces, political parties and businesses have experienced similar or in some cases even more dramatic declines in public trust (Aninat and González 2016: 4).

Chile has also experienced a systematic decline in Transparency International's Corruption Perception Index, which assigns countries with higher public perceptions of corruption a lower ranking. From 2012 to 2018, the South American country's corruption perception index fell every single year—that is, the public viewed it as progressively more corrupt—ultimately dropping a total of six positions to

[3]In October 2019, Sebastián Piñera's government announced a small increase in the price of public transportation fares in Santiago. Demands for a withdrawal of the increase became widespread after the new fare was implemented. Initially, the government showed no willingness to reconsider what it correctly called a "technical" measure. As a result, hundreds of students began to evade payment of the subway. On October 18, two weeks after the price increase had been announced, the country exploded. Coordinated groups burned and destroyed almost 80 subway stations bringing Santiago's public transportation system to a halt. Riots and massive attacks on public and private property followed unleashing chaos in the capital city. By the end of the day, the situation was so desperate that Mr. Piñera had no choice but to declare a state of emergency and put the military in control. Massive demonstrations followed and Piñera gave in to the demands of the left to substantially increase the size of government and to create a new constitution through a constitutional assembly or a convention. The referendum that would initiate the constitutional process was supposed to take place in April 2020 but it was postponed to October 2020 due to the outbreak of the coronavirus crisis.

become the 27th least corrupt country among 183 nations (Libertad y Desarrollo 2019). Even more troubling are the results of a 2017 OECD report on the level of trust Chile's population has in its judicial system. Chile scored last among all of the nations the OECD surveyed, with the exception of the Ukraine, lagging behind countries like Brazil, Mexico, Colombia and Russia, among others (OECD 2017). A more general survey in 2019 showed that 58 percent of Chileans believed that state institutions in Chile were corrupt (Datavoz 2019: 4). In a 2017 United Nations Development Programme (UNDP) study, 34 percent of Chileans surveyed declared to have been mistreated by a public employee (PNUD 2017: 211).

Not only corruption but also chronic inefficiency contributed to the loss of legitimacy of state institutions. According to the 2016 World Economic Forum Competitiveness Index, government inefficiency was the main obstacle to doing business in Chile (World Economic Forum 2016: 144–45). All these problems have led to major proposals for reforming Chile's inefficient state apparatus, which is a crucial step for strengthening its democracy.[4]

Without a doubt, the recent decline in public trust of Chile's private and state institutions contributed to the climate of discontent and frustration that manifested in the crisis that broke out in October 2019. But this alone cannot explain Chile's departure from the free market formula that made it so successful. If Chile's elites and general population truly understood that free market institutions are crucial for the country's continued path to prosperity, then large groups among the protesters and the intellectual and political elites would not be demanding drastic changes to what is derogatorily referred to as Chile's "neoliberal" system.

If, as Friedrich Hayek believed, ideas and ideologies are the main drivers of social evolution (Hayek 2006: 98), then Chile is a clear example of how ideas hostile to economic freedom and favorable to state interventionism can gain traction, which in Chile's case undermined the legacy of the Chicago Boys. Indeed, material equality, the old obsession of the left, became the creed of the majority of Chile's political and intellectual class. Material equality was also endorsed by the Catholic Church, a large part of Chile's business community and

[4]See Centro de Estudios Públicos (2017).

highly influential among its cultural elites. The results of this egalitarian narrative were gradual institutional changes that over the years, leading to declining rates of economic growth. As René Cortázar, former minister in Michelle Bachelet's first administration, put it:

> Growth, which had enabled a sharp increase in wages, employment and consumption, and that had allowed the emergence of new middle sectors, began to be taken, by many, for granted. It was forgotten that accelerated growth was not an attribute of the national soul; that in general our development had been mediocre; and that only the implementation of good quality rules of the game, and the construction of consensus around them, had made it possible to jump to the first place in the region [Cortázar 2019: 11].

Cortázar, an MIT economist at the center-left think tank CIEPLAN, crucially noted that the "emphasis was placed only on distributive aspects" adding that "distributive results were criticized with bitterness" although wages were rising like never before (Cortázar 2019: 12). By far the most aggressive egalitarian government along the lines denounced by Cortázar was Bachelet's second term (2014–18), in which several statist reforms were passed with the aim of "terminating neoliberal vestiges," as Bachelet herself put it.[5] Bachelet's labor, tax, and educational reforms, combined with an extremely hostile narrative against businesses and market ideas, caused one of the most unprecedented economic downturns in decades. Indeed, between 2014 and 2017 Chile's average economic growth rate was 1.8 percent, the lowest since the early 1980s and almost a third of the rate of 5.2 percent achieved in the previous four years of Sebastián Piñera's 2010–14 administration (Bergoeing 2017: 7).[6]

Many on the left tried to blame Bachelet's poor economic performance on international factors, but during her "anti-neoliberal" administration the world enjoyed an average growth rate of 3 percent.

[5]See www.latercera.com/noticia/bachelet-habia-vestigios-del-modelo-neoliberal-los-ido-terminando-traves-las-reformas.

[6]Even though Chile experienced high economic growth under Piñera's first administration, the capacity of the Chilean economy to grow did not reverse its declining trend. From 1990 to 2016, potential GDP declined from close to 7.5 percent to around 4 percent (see Le Fort Varela 2016).

As economist Raphael Bergoeing pointed out, international conditions were favorable to Chile's economic growth under Bachelet. Moreover, a moderate estimate indicates that in absence of Bachelet's statist reforms Chile would have grown at rates of 4 percent a year (Bergoeing 2017: 7). The climate of uncertainty that Bachelet created was clearly reflected in the rates of investment. Since data collection began in the early 1960s, until Bachelet's administration, Chile had never shown four consecutive years of decreasing investment (ibid.: 12).[7]

A crucial document for understanding the Bachelet administration's anti-liberal philosophy was a book written by five members of her brain trust shortly before she was elected for a second time. The book was titled *The Other Model: From the Neoliberal Order to a Regime of the Public* (*El otro modelo. Del orden neoliberal al régimen de lo público*), and the cover showed five workers destroying a brick (Atria et al. 2013).[8] "The brick" was the name given to the economic program written by the Chicago Boys in the early 1970s and implemented after the fall of Allende. The message of the cover—and the book itself—was clear: the Chicago Boys' economic model had to be terminated, and Bachelet, who was the star speaker at the book's launch in 2013, should lead that process. According to *The Other Model*, neoliberalism and individualism had created an unequal, selfish, and unjust society where a privileged few had access to things that should be considered rights for everyone. In the view of the authors, governments were responsible for making sure that no differences existed when it came to economic goods such as education, pensions, or anything else the authors defined as a "social right." The authors further argued that it was only when the market logic had been expelled from these spheres that an equal and fair society based on solidarity could emerge. Although it did so in different terms, *The Other Model* presented and defended a socialist ideology and political system. Bachelet's second government embodied this radical ideology, and the reforms followed.

Due to the persistence of the egalitarian narrative over the years, large parts of the public bought into the idea that neoliberalism had

[7]The prediction of Chile's central bank referred to in the article turned out to be accurate.

[8]For a rebate of the myths, fallacies and errors of *The Other Model*, see Kaiser (2015).

led to more inequality and injustices even though income inequality was actually decreasing. When, in February 2020, Bachelet, as the United Nations High Commissioner for Human Rights, declared that inequality was the cause of the demonstrations in Chile and Ecuador, she reinforced the perception of large parts of Chile's population.[9] Indeed, according to opinion polls published in December 2019, Chileans believed that the main reason for the social crisis had been the high level of income inequality (CEP 2019). ECLAC's 2015 Index of Perceived Inequality showed that Chile was the country with the highest perceived income inequality in Latin America. In addition, the same index showed that the perception that income distribution was unfair had increased over the years.

If the consensus among elites was that inequality was Chile's main problem before the social crisis, it is no surprise that after the crisis broke out this consensus was reinforced. In reference to the popular explanation for the crisis, Carlos Peña, an influential center-left scholar, observed: "If we take at face value the immediate reactions of these days, the cause of the phenomena would be injustice and especially the unquestionable inequality that affects Chilean society" (Peña 2020: 11–12).[10] Peña himself correctly noted, however, that the country had never been more prosperous and equal than in present times. This meant that the well-established idea that economic inequality had been the cause of the social crisis was "intellectually incorrect" (ibid.: 13). Instead, Peña rightly argued, it

[9]See www.latercera.com/mundo/noticia/bachelet-pide-que-se-fijen-responsabilidades-por-violaciones-de-ddhh-cometidas-durante-protestas-en-chile-y-ecuador/EFXRNNTG5RGUVAZC4WJ6AOLHVI.

[10]There is another cause of the social crisis that Peña correctly mentioned in his work—namely, the excessive emotionality of the younger generations. According to Peña, Chilean students nowadays lack normative frameworks capable of orienting their lives beyond their mere subjectivity. As a result, they have grown intolerant, showing a tendency to break the socially accepted rules of conduct (Peña 2020: 142). This argument closely resembles Jonathan Haidt and Gregg Lukianoff's analysis of the American youth in their work *The Coddling of the American Mind* (2018). It should also be mentioned that another cause for frustration among middle class young people and their families is what can be called the "paradox of progress." This refers to the fact that the economic returns on higher education—the main driver of social mobility in Chile over the last decades—have declined along with its massification. In other words, the same process that has allowed millions to move upward in the income scale has made the goal of a high income and the social status associated with it more elusive (Klapp and Candia 2016).

was the perception of inequality that had changed. Thus, even if inequality had decreased in Chile, people had become more sensitive to it because the feeling that the existing inequality was legitimate had eroded (ibid.: 128–29). It was precisely this feeling of unfairness, to a large extent created by egalitarian narratives, which paved the way to the disastrous reforms of Bachelet's second administration. In turn those reforms created additional frustration with the system by bringing the train of economic progress to a halt. After Bachelet, Piñera came to power a second time by promising to bring back "better times," in the words of his campaign slogan. After failing to deliver, the social crisis erupted.

Part of the reason why the crisis will be so hard to resolve in Chile is that opinion makers do not realize that its origins are mainly ideological. It is through this lens that the widespread attacks on the free market have to be understood. Center-left sociologist Eugenio Tironi was correct when he argued that the massive demonstrations of 2019 were ideologically opposed to the economic model of the Chicago Boys (Tironi 2020: 26–27). Like Peña and many others, however, Tironi did not seem to understand that perceptions of that model's legitimacy had been eroded by the egalitarian ideologies that intellectuals like himself and others had popularized. This shifted the country's political and economic institutions almost entirely towards redistributionism.

As Douglass North (1988: 15) observed, ideologies refer to the "subjective perceptions that people have about what the world is like and what it ought to be." Insofar as ideologies entail a prescriptive component, they "affect people's perception about the fairness or justice of the institutions of a political economic system" (ibid.). Moreover, because the ideologies and beliefs available in a given culture ultimately define the form of government that determines the formal rules of the game—namely, property rights and enforcement characteristics—it is not a surprise, said North (1993), that efficient economic markets are so exceptional.

North (1990: 110–11) also argued that ideology is key to understanding the poor economic performance of Third World countries, since their ideologies usually promote policies that provide institutional constraints and discourage productive activity. Indeed, in the case of Chile, the nation's egalitarian ideology led to changes in its formerly free market institutional framework, transforming its system into one increasingly incapable of delivering beneficial economic results. This fueled egalitarian narratives even further because, as is typical of ideological dogmatists, proponents of the egalitarian system refused to change their views. Against all evidence, frequent repetition of the idea that the country's troubles were the result of extreme inequality and social injustice ended up convincing many people that the system had to be socialized further. As psychologist Daniel Kahneman has argued, "a reliable way of making people believe in falsehoods is frequent repetition because familiarity is not easily distinguished from truth" (2012: 62).

The Death of *Concertación* and the Collapse of Market Consensus

In a sense, the Chicago Boys' economic model was doomed to be dismantled with the passing of time. The fact that the governments that came after the Chicago Boys accepted their reforms does not mean that these administrations had a profound understanding of the positive nature of market forces, let alone a genuine moral commitment to economic freedom. Patricio Aylwin, the first president after the Pinochet years, best reflected the center-left view on the market when in the early 1990s, he declared:

> The market can stimulate wealth creation but it is not fair when it comes to wealth distribution. The market has no social or ethical considerations. The market is usually tremendously cruel and favors those who are more powerful and compete under better conditions while it worsens the misery of the poorest because it increases social inequalities [Otano 2006: 417].

The lack of real commitment to economic freedom on the political and intellectual left—as well as on growing segments of the right—allowed more radical socialist narratives to gain greater acceptance. The influence of socialist groups grew so powerful that the center-left political parties responsible for administrating the Chicago Boys' market reforms felt too ashamed to vindicate the enormous prosperity that market forces achieved under their own governments. With almost no exceptions, they never defended their legacy from the attacks by the radical left.

Legal scholar and former Concertación minister Jorge Correa explained that one of the causes of the demise of the moderate

Concertación, which in turn enabled the rise of the radicalized left wing coalition Nueva Mayoría,[11] was that its members were "ashamed" to say that they were "supporters of the market. . . . Never did we really dare to defend with clear theses what we were embracing in practice" (Correa 2018: 223). Recognizing the importance of the battle of ideas in political warfare, the former minister added: "The defeat was cultural rather than political. It's impossible to be successful in politics if you feel ashamed, even less so if you don't dare to show your set of ideas" (ibid.). Concertación, he concluded, "committed suicide . . . she stopped believing in herself, defending her work" (ibid.).

The center right did not really engage in a strong defense of market principles either. Piñera best expressed the compromising tone the center right took toward egalitarian ideologies during his first administration. In a famous speech given in 2010, he declared:

> I think that, first of all, Chileans do not tolerate the excessive degrees of inequality that have crossed our society for so long. And they have rebelled against excessive inequality, because Chile is the country with the highest per capita income in Latin America, but it is also the country, along with another country, with the highest relative inequality in Latin America. And, therefore, they are asking for a fairer society, a more egalitarian society, with fewer inequalities, or with greater equality of opportunities, because the inequalities that we experience in Chile are excessive, and I feel that they are immoral, because they are attacking the essence of a society, which is its cohesion and internal harmony.[12]

Following this vision, in his second administration, Piñera launched a program to expand social benefits to the middle class called C*lase Media Protegida* (Protected Middle Class). The program reflected a social democratic philosophy that validated the idea that

[11]Nueva Mayoría was the coalition of leftwing political parties that succeeded the Concertación and which came to power with Bachelet in her second administration. Although it incorporated all former members of Concertación, it also included far leftwing political parties such as the old Communist Party. It also made alliances with the new far left populist coalition Frente Amplio.

[12]Speech available at www.lasegunda.com/Noticias/Politica/2011/07/667325/Texto-completo-del-discurso-del-Presidente-Sebastian-Pinera-en-el-aniversario-del-diario-La-Segunda].

the government's role was to take care of the population's well-being. Thus, Piñera moved Chile one step further along the path toward becoming a welfare state.[13]

Along these lines, after the social crisis broke out in October 2019, Piñera made a speech apologizing to the Chilean people for the injustices of the country's economic system, and announcing a massive increase in government spending:

> It is true that the problems have not occurred in the last days, they have been accumulating for decades. It is also true that the different governments were not able to recognize this situation in all its magnitude. This situation of inequity, of abuse, has already meant a genuine and authentic expression of millions and millions of Chileans. I recognize this lack of vision and I apologize to my compatriots.[14]

Piñera further declared that "there were many coincidences, both in the diagnosis and in the solutions" of the crisis with the leaders of the left—the same politicians who were blaming "neoliberalism" and inequality for the crisis.

The unwillingness of Concertación—and many center right politicians such as President Sebastián Piñera—to clearly defend the free market precipitated the collapse of the political and social consensus upon which Chile's economic institutions had been based. This climate opened the door for a complete transformation of Chile's economic model, the degree of which will only be clear with the passing of time and once the new constitutional experiment Chile set in motion in 2019 is complete. In any case, and regardless of the exact

[13]See https://clasemediaprotegida.gob.cl.

[14]See www.youtube.com/watch?v=JlPfH76A_BI. Former presidential candidate Joaquin Lavin, one of the most emblematic and popular centre-right politicians in the country went even further than Piñera. In a column published in *El Mercurio*, he argued that Chile needed to "change its development model" because it had created two separate countries just like the Berlin Wall had created two separate Germanys. Lavin called for a social "reunification" and attacked Chile's economic elite for hindering social mobility. He also denounced the "horizontal inequality" that in his opinion characterized Chilean society. By this concept, Lavin was referring to inequalities in health care, housing and education. In Lavin's view, these injustices had to be "terminated" trough more efficient government spending, higher levels of taxation and different public policies than those implemented thus far (Lavin: 2019).

outcome of the constitutional question, if there is anything that the fall of Chile can teach the world, it is that, once again, the power of ideas and ideologies is far greater than the appeal of facts. In other words, Chile confirms the old classical liberal lesson that there is no hope for the survival of the free market absent the moral case for economic liberty. That case, which must be accepted by the minds of the public, must also be made, at least in part, by the intellectual, political, and economic elite.

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U.S. Policy Options Toward China: An Appraisal

Simon Lester

Most Americans will agree that the Chinese government has behaved badly in a number of ways, although they may not agree on exactly which Chinese government behavior is a problem. Perhaps it's the treatment of ethnic or religious minorities, such as the Uighurs or Tibetans or Christians; maybe it's the crackdown on protests in Hong Kong and failure to uphold the "one country, two systems" principle; or assertiveness in territorial disputes; or censorship; or protectionist trade practices; or intellectual property theft; or cyber-hacking; or spying; or most recently, being slow to disclose the emergence of the coronavirus and engaging in a propaganda war regarding who is at fault. It's a long list, and everyone has their own priorities.

But while there is loose agreement on the existence of a problem, there is great difficulty in coming up with an appropriate response. What can or should the United States government do about any of this? Is it possible to change the behavior of other governments? Is the U.S. government in a position to do it? Is it appropriate to do so?

The average American probably doesn't put a lot of thought into the issue. Foreign policy is low on the list of people's concerns (Hrynowski 2020). As a result, if the general sentiment in the United States is becoming anti-China due to Chinese government behavior (with a big assist from prodding by certain politicians and assorted

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Cato Journal, Vol. 40, No. 3 (Fall 2020). DOI:10.36009/CJ.40.3.7.

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China hawks in Washington), as it has been (Devlin, Silver, and Huang 2020), the small community of foreign policy experts who have influence over these issues will have a good deal of power to push an aggressive response toward the Chinese government. The American voting public is not likely to be checking the details of the various options carefully.

This lack of scrutiny is a problem, because finding the right approach to responding to the behavior of the Chinese government is one of the most important foreign policy choices of our time. We may or may not be moving into a "great power competition," but regardless, the state of the U.S.-China relationship will be a crucial factor in international relations and governance for decades to come. How the U.S. government responds to the Chinese government's actions is a key element affecting that relationship.

China's Recent Moves Toward Greater Authoritarianism and Foreign Policy Assertiveness

Over the years, optimism about the prospects for a Chinese shift toward democracy and protection of rights has waxed and waned. The Tiananmen crackdown was a low point; China's entry into the World Trade Organization (WTO) was a high point.

In support of the vote on granting China permanent normal trade relations as part of its accession to the WTO, President Clinton and several high-ranking officials in his administration talked up the possibility of democratic progress in China, although their comments were vague, and more hopeful than certain. Clinton himself said:

> By joining the WTO, China is not simply agreeing to import more of our products; it is agreeing to import one of democracy's most cherished values: economic freedom. The more China liberalizes its economy, the more fully it will liberate the potential of its people—their initiative, their imagination, their remarkable spirit of enterprise. And when individuals have the power, not just to dream but to realize their dreams, they will demand a greater say [Clinton 2000].

In recent years, though, the Chinese government has taken a number of steps backward. Beijing has tightened controls over freedom of thought and freedom of speech. The Unirule Institute, China's leading market-liberal think tank, was forced to close

(Kuo 2019). And Fudan University had to remove "freedom of thought" from its charter. In its place, there is now a phrase about following the Communist Party's leadership, casting doubts on how much academic freedom exists in China (Reuters 2019).

On the geopolitical front, Beijing has been taking a more assertive approach all around the world, with its own region seeing the strongest moves. It has increased military activities near the Taiwan Strait (Thim 2018) and been more aggressive in the South China Sea and East China Sea (Council on Foreign Relations 2020a, 2020b). Moreover, the Chinese leadership seems intent on destroying the "one country, two systems" principle that it agreed to for the governance of Hong Kong. A new national security law to be imposed on Hong Kong would make secession, subversion, terrorism and foreign interference a criminal act, and give the mainland government unprecedented power to operate on the island. This will further undermine Hong Kong's self-governance, and Western-style rule of law and freedoms could virtually disappear under the new policy (Wong and Kahn 2020; Mahtani et al. 2020; Wong, Cheung, and Cheng 2020).

In addition, during the COVID-19 pandemic, China has launched an extensive propaganda campaign to boost its public image, among other things by engaging in "Mask Diplomacy" (Wen and Hinshaw 2020) and pledging millions of dollars in donations to the World Health Organization (Reuters 2020). These efforts have backfired, though, and Americans' views of China have continued their decline as two in three Americans now have a negative view of China (Devlin, Silver, and Huang 2020). Overall, anyone hoping for China to move toward economic and political freedom will be disappointed by the developments of the last few years.

The Trump Administration's Approach to China

Trump and his administration have vacillated between approaches to China, with a recent trend toward a more aggressive one. In January 2020, Trump came out with praise for China, tweeting: "China has been working very hard to contain the Coronavirus. The United States greatly appreciates their efforts and transparency. It will all work out well. In particular, on behalf of the American People, I want to thank President Xi" (Trump 2020). Later, however, he ramped up his criticism of China, stating: "It could have been stopped in China before it started and it wasn't, and the whole world is suffering because of it" (Mason and Spetalnick 2020). Likewise, in the case of Hong Kong, he initially appeared to support Beijing, but more recently has shown support for the pro-democracy movement (see Trump 2019).[1] At the same time, he has long been critical of China for its trade practices (Stracqualursi 2017).

Beyond Trump himself, the Trump administration is full of "China hawks" who constantly push for confrontation with Beijing. Trade policy adviser Peter Navarro is famous for his "Death by China" book and movie. Meanwhile, Secretary of State Mike Pompeo has persistently criticized China and called it a "central threat" to the United States (Santora 2020).

The administration's aggressiveness can be seen, among other places, in Trump's issuance of a joint declaration with Japanese Prime Minister Shinzo Abe in 2017, confirming that the Senkaku Islands fall under Japan's administration and are covered by the Japan-U.S. Security Treaty (White House 2017). The administration also sent a record-high number of patrols to the South China Sea in 2019, ramping up its effort to challenge China's territorial claims (Power 2020). Finally, the administration has been countering China's aggressive actions along the Taiwan Strait by sending warships and aircraft to the region (Doornbos 2020; Ali 2019) and approving more arms sales to Taiwan to show its support (Browne 2020).

What we have with Trump and his administration, then, is an initial split between two extremes in the approach to China, with Trump being conciliatory on some issues, and the hawks pushing for aggressiveness. More recently, there has been a move toward even greater assertiveness by both Trump and others within the administration.

Instead of blanket U.S. aggression toward China, though, what is needed is a nuanced and thoughtful approach to the many real concerns that exist. Where are the biggest problems with the behavior of the Chinese government? What could plausibly be done about them? We should be able to find something in between being an occasional cheerleader for Xi Jinping and pushing the United States into a cold (or hot) war with China.

[1]Years prior to becoming president, Trump praised the "strength" of the Chinese government's 1989 Tiananmen Square crackdown (Haltiwanger 2019).

A Better Way to Deal with the China Problem

Future U.S. presidents will need to figure out an effective way to deal with various aspects of the Chinese government's bad behavior. There are no easy answers, but I will offer some suggestions.

U.S. Policy Should Focus on Cooperating with Friends and Allies Rather Than Sanctioning Rivals.

Sanctions are a favorite tool of U.S. policymakers. Due to U.S. influence over the global financial system, they can target foreign countries or individuals with financial penalties that are designed to affect behavior.

Sanctions might assuage a few people's anger and give the impression that something is being done. But do they actually change behavior? Their success rate in achieving their goals is not great (Taylor 2017). It can be difficult to use them effectively even on small countries, as 60 years of Cuba sanctions have shown (these sanctions may have even helped strengthen communist rule there). The likelihood that they will work on a major power such as China is even lower—especially if the United States is acting alone. A more effective approach would be to work with like-minded countries to achieve our shared goals. In essence, we should cooperate with our allies rather than penalize our opponents.

Many of the differences with China are over values: free speech, a free press, religious rights, representative democracy, to name a few. Values vary around the world, and there is nobody we agree with on everything. We don't even agree with ourselves a lot of the time, as domestic values differ internally and change over time. But within a broad range, we can find countries who agree with us on core values—namely, democracy, rights protections, rule of law, the role of markets, and transparency. We should identify those countries and undertake international projects that reinforce those values. For example, there could be a project on the role of the judiciary, examining how courts can best promote these values. This approach highlights and elevates our values, and can be used to convince other countries outside of the like-minded club of their merits.

Along the same lines, we could engage in more trade liberalization with countries that share our core values. Penalties directed at China are confrontational; a trade liberalizing agreement among other countries is less so. Importantly, we should not characterize such an initiative as an effort to "constrain China." It is about moving ourselves forward, not holding others back. In essence, this would be the Transpacific Partnership model, but it would be less focused on China, in terms of its geography and its content. It would include a renewed effort to liberalize trade with the European Union, as well as a trade agreement with the newly independent United Kingdom.

Some U.S. policymakers seem reluctant to work with allies. Their view may be that as the world's most powerful country, we don't need anyone's help. But that perspective is out of date by decades. The United States will never have the level of power it did in the 1950s, when much of Europe and Japan had been ravaged by war. We need to put the delusions of a "great power competition" aside and think about the distribution of power in today's world, and the appropriate U.S. role, more realistically.

We Should Jointly Condemn China's Bad Behavior, But Do So Diplomatically Based on Facts

There are many actions that have been taken by the Chinese government that deserve condemnation: mistreatment of ethnic minorities, crackdowns on proponents of democracy in Hong Kong, and abuses of power by the Chinese Communist Party (CCP), among others. Unfortunately, much of the rhetoric on these issues coming from "China hawks" in the United States is wildly misleading and inflammatory, and probably helps the CCP by allowing it to portray its critics as unhinged. The CCP can highlight their statements to Chinese citizens, in order to show how evil and dangerous the United States is.

For example, Senator Tom Cotton puts forward conspiracy theories about the origins of COVID-19, saying we cannot rule out "deliberate release" of the virus. He qualifies this allegation by saying it is "very unlikely" (Cotton 2020). However, putting "very unlikely" suggestions out there for public consumption, and repeating them, is often how conspiracy theories work. Statements like this one are probably intended for domestic audiences, but they are heard by Chinese people as well, and they have implications for the power of the Chinese government. In all likelihood, they enhance it, as the government can put them on display for its citizens, to portray its critics as crazy.

What we need to do here is tone down the inflammatory rhetoric. In this regard, one thing we should do is stop talking about the "Chinese" as a problem, which suggests something bad about the people or the culture and has led to racist acts against Asian-Americans here in the United States. Instead, we should focus clearly on the "Chinese government" or the CCP.

Nonetheless, we should still look for ways to push Beijing toward a more open and democratic system where the rights of its citizens are better protected. Imposing our values on others is a risky proposition, and it should be pursued carefully and in limited circumstances. Every country has its own unique characteristics, history, and beliefs. Most people resist outside criticism of their government and society, and this can stir up nationalist feelings and resentment, and make them resistant to change (Terman 2016). We need to pick our battles carefully and fight those battles based on an objective assessment of what the Chinese government is actually doing. Putting all the inflammatory rhetoric aside, what exactly is happening to ethnic and religious minorities in China? A recent series in the *New York Times*, based on leaked Chinese government documents, addressed this issue in an objective manner. Documentary evidence, rather than social media speculation and hyperbole, should inform our response. In addition, we need to have a wide range of countries on board, otherwise our effort will not be effective.

With all these caveats in mind, on the treatment of minorities, Hong Kong, democracy, freedom of speech, and other issues, there should be an effort to make the case to the Chinese government (and the Chinese people) that liberalization, openness, and rights will make their society better. Such an approach may not seem fruitful at the moment, but governance in China has evolved before and is likely to evolve again. Dialogue on these issues may be possible again someday.

Keep the Movement of People Between the United States and China Flowing

There is a great deal of fear these days about Chinese influence on our own system, in part related to Chinese citizens who live and work in the United States. But we should have confidence in our system and its appeal to others. When people interact, they learn more about each other. As Chinese people come to America, meet Americans, and see our system, many of them will see the benefits (indeed, many

Chinese people who come to the United States to study end up staying here). They may not immediately be converted to believers in democracy and limited government, but they are likely to end up feeling more positive about the United States (Tea Leaf Nation Staff 2015). On Twitter and on cable news, it often seems like American society is falling apart. But the actual lives of most Americans are very different, and most people who come here from other countries will have a generally good experience. At the very least, these exchanges of people will help facilitate the spread of accurate information about America, which Chinese citizens are not likely to get from their own state-controlled media.

We Should Respond Most Aggressively to Issues That Directly Affect Americans

If Chinese individuals or companies have engaged in cyber-hacking, the U.S. government should prosecute them vigorously. Direct harm to Americans justifies stronger action by the U.S. government. There is no reason for the Chinese government or Chinese people to be upset by this, as long as due process is provided.

Similarly, the actions of the Chinese government related to the spread of the coronavirus should be scrutinized closely. Everyone needs to be assured that the Chinese government, at all levels, is doing everything it can to prevent this from happening again. To this end, while the Chinese government is unlikely to move toward greater transparency and openness internally, it must do so in its relations with other governments, in particular in relation to the origins and spread of COVID-19.

By contrast, issues such as the status of democracy and free speech in China are important, but do not affect Americans in the same way. Actions taken in these areas should be more circumspect. To some extent, there is a territorial principle involved here. Actions that affect Americans or the American system merit a more aggressive response than those that are mostly contained in China.

We Need to Set a Better Example with Our Own Domestic and International Behavior

Persuading others to live up to high standards works better if you yourself do so. In recent years, the United States has failed in this regard on many fronts. Internally, the integrity of our elections and the strength of our rights protections have been lacking, and the press seems to be under attack constantly these days. Externally, we talk a lot about democracy, but we sometimes support autocrats or use military force to get what we want from others.

If we are looking to influence the behavior of other countries, we need to think about our own actions. As things stand now, while we may think of ourselves as moral and good and a model for others to follow, much of the world does not see us that way. That undermines our ability to convince anyone of anything. A recent *Washington Post* article asked, "Why can't the world do a better job of calling out racism in China?" (Fish 2020). A big part of the answer is the continued racism in the rest of the world, including the United States.

Conclusion

These suggestions are designed to improve U.S.-China relations, by changing the way U.S. policymakers approach these issues. None of them will, on its own, repair that fraying relationship. We will spend the coming decades managing it delicately. But the suggestions could help prevent it from becoming too tense and acrimonious, or devolving into a more dangerous conflict, even a new Cold War. Josh Rogin (2020) talks about "a new consensus on how to handle Beijing," involving "broad agreement that the United States should pursue an aggressive approach grounded in all-out strategic competition." He then adds: "If you believe confronting China's bad behavior is akin to recklessly steering the United States into a new Cold War, this new consensus is a bad thing." But the goal of U.S. policymakers should be something very different: How can they confront and criticize the Chinese government in a productive way, without triggering a Cold War?

Some people in the foreign policy community seem to have given up on China at this point. One narrative making the rounds is that people claimed that letting China into the world trading system would lead to democracy, and since that has not happened yet, the previous approach to China was a mistake. As McMaster (2020) notes:

> Since the heady days of Deng Xiaoping, in the late 1970s, the assumptions that had governed the American approach to our relationship with China were these: After being welcomed into the international political and economic order,

> China would play by the rules, open its markets, and privatize its economy. As the country became more prosperous, the Chinese government would respect the rights of its people and liberalize politically. But those assumptions were proving to be wrong [see also White House 2020].

Such a view is too simplistic. The transition from authoritarianism to democracy has taken place in many ways around the world. Each country proceeds at its own pace. There is no single model. Chinese reforms will happen in their own way on their own time. We may be able to help facilitate them to some degree with a carefully calibrated approach. But in order to do so, we need to move away from both President Trump's occasional endorsements of the current Chinese political system and from the overheated and counterproductive rhetoric of many of the China hawks.

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The American News Media's Volatile Perspectives on China

Ted Galen Carpenter

In the decades since the founding of the People's Republic of China (PRC) in 1949, wild swings have occurred in the way that American media outlets view that country. At most times, a herd mentality is evident, as a large percentage of news stories portray China in one particular fashion, although there always are some dissenters from the dominant narrative. The nature of that narrative sometimes shifts rapidly and dramatically, however. During some periods, the prevailing perspective has been extremely hostile, with nearly all accounts seeing the PRC as a monstrous oppressor domestically and an existential security threat to the United States. That was the case for more than two decades following the communist revolution, until Richard Nixon's administration suddenly altered U.S. policy in 1971–1972, and Washington no longer treated the PRC as a rogue state.

For the next three decades, the media tended to view China in a more benign fashion. During the 1970s and 1980s, China's image in the American press was that of a useful, de facto diplomatic and even military ally of the United States against the Soviet Union. A considerable number of news stories, editorials, and op-eds also noted that China was emerging as a significant U.S. trading partner. When the Cold War ended, the rationale for a strategic partnership

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Cato Journal, Vol. 40, No. 3 (Fall 2020). DOI:10.36009/CJ.40.3.8.

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no longer applied, but journalistic accounts emphasized the PRC's rising economic importance to America. Not even the Tiananmen Square massacre in 1989 derailed either Washington's cooperative relationship with Beijing or the media's reasonably positive view of China, although there appeared to be a bump in wariness and skepticism within the journalistic community.

During George W. Bush's administration, the roster of dissenters favoring a more hawkish policy toward Beijing began to grow. One catalyst for the media's shift was the sense that the PRC was becoming more a serious economic competitor to the United States than an essential trading partner. Even though both countries were prospering greatly from the relationship, a greater number of stories appeared featuring allegations of "unfair" PRC trade practices, including cases of intellectual property theft and currency manipulation to make Chinese goods more competitive.

Negative media accounts were not confined to the economic arena. More journalists began to see the PRC not just as a worrisome trade competitor, but as an emerging U.S. military rival, if not an outright adversary. Beijing's surging defense budgets and increasingly assertive behavior in such arenas as the Taiwan Strait and the South China Sea fed those concerns in the media. Press uneasiness about the PRC's behavior continued to rise throughout President Barack Obama's administration, although a majority of news stories and opinion pieces still presented the U.S.-China relationship as positive and mutually beneficial.

A more noticeable split in press coverage has developed over the past three years, with a hawkish perspective gaining strength and challenging the once-dominant pro-engagement view in the media. The Trump administration's hardline trade policies led primarily to a sharp (sometimes partisan) debate, with journalistic advocates of the status quo condemning the president's apparent willingness to wage a trade war, while economic nationalists saw the firmer stance as long overdue. However, it is Beijing's behavior outside of the economic arena that has sparked a surge in both public and media hostility.

Two events were especially important catalysts. One was the successful move by President Xi Jinping's regime in May 2020 to impose a new national security law that menaced Hong Kong's guaranteed political autonomy. That move reinforced already strong condemnation in the American press about Xi's growing repression within the PRC, including squelching even the mildest forms of political and economic dissent. The other crucial catalyst for the increasingly negative portrayals of the PRC was Beijing's handling of the coronavirus pandemic in the spring of 2020. Complaints erupted throughout the American news media about the PRC's secrecy and duplicity regarding the spread of the virus, as well as attempts by Chinese officials to shift blame onto the United States for the pandemic. Public hostility toward Beijing has risen sharply—as confirmed in opinion polls—and media accounts reflect that shift.

Security hawks and economic nationalists have gone on the offensive in the media. Proponents of the overall U.S.-China relationship are still active and influential, but there is now a cautious, defensive, and at times almost apologetic tone to many of their news stories and editorials. They seek to prevent fatal damage to the relationship, even as they feel compelled to criticize PRC leaders for their conduct regarding both Hong Kong and the coronavirus.

Negative press views of China seem to be reaching their highest levels since the period immediately following the Tiananmen Square crackdown. In some ways, the extent of negativity may be higher than at any time since Nixon's outreach to the PRC. There certainly is less evidence of group think and a herd mentality throughout the media. For perhaps the first time since the communist revolution, there appears to be a vigorous debate between factions of roughly equal strength about how the United States should deal with China.

The Early Years: Pervasive Anger and Hostility

China's communist revolution in 1949 came as an alarming shock to the American people in general and news outlets in particular. Americans could scarcely believe that a leader they regarded as an admirable figure and an important member of the free world, Chiang Kai-shek, had lost a civil war and been overthrown. Dean Rusk, who served as deputy undersecretary of state for far eastern affairs in the Truman administration, ruefully recalled that the press and public reaction to the fall of China, was akin to "that of a jilted lover" (Rusk 1990: 158).

Even before World War II, American news publications lionized Chiang. Historian Barbara Tuchman (1971: 187–88) noted that "Generalissimo and Mme. Chiang Kai-shek as 'Man and Wife of the Year' for 1937 gazed at Americans in sad nobility from the cover of *Time*, sober, steady, brave and true." *Time*'s publisher, Henry Luce, had been born in China of missionary parents, and not only did he take a great interest in China's affairs, he was a staunch anti-communist and admirer of Chiang. *Time* and the rest of Luce's vast magazine empire were important components of the powerful "China Lobby," which influenced public opinion and U.S. government policy to continue supporting Chiang and persist in an utterly uncompromising policy toward the new regime in Beijing (Koen 1960).

Media leaders were not pleased when a communist regime displaced their hero. Even moderate members of the mainstream media, such as the *New York Times* and the *Boston Globe*, criticized the Truman administration for failing to prevent the communist takeover. Conservative publications were decidedly more strident than the *New York Times* or other liberal establishment types in condemning administration policies. Three right-of-center media platforms during that time, the *Washington Times-Herald*, the *Chicago Tribune*, and the *Wall Street Journal* advocated an extremely hawkish stance regarding the overall threat that international communism posed to the "free world" (Chamberlin 1948). Those newspapers joined with the Luce magazines to excoriate the Truman administration for its handling of developments in China. Two of those newspapers, the *Times-Herald* and the *Tribune,* were owned by Col. Robert McCormick, a long-time conservative Republican stalwart, and members of his extended family (Smith 1997). Criticisms of the Truman administration's handling of China developments became ever more pointed and vitriolic in those publications.

Once Chiang's regime fell, it became utterly perilous for anyone in the media or government service to dispute the dominant conservative narrative that Washington's incompetence had "lost" China. The corollary was that a policy to isolate the PRC was essential along with vigorous U.S. diplomatic and military support for Chiang's exile regime on Taiwan (Carpenter and Innocent 2015: 48–61). Indeed, the prevailing narrative by the 1960s portrayed the PRC as an even more dangerous and repulsive threat than the Soviet Union to America's security and way of life. That view even penetrated popular culture. A best-selling novel and subsequent movie, *The Manchurian Candidate*, was based on a paranoid premise that Communist China was able to infiltrate and manipulate America's political system by utilizing a brainwashed prisoner of war. In Ian Fleming's book *Goldfinger*, the conspirators behind that arch-nemesis of hero James Bond were Russians. But in the 1964 movie based on the book, the villains were changed to Chinese.

The assumption that China was an existential threat was especially strong among right-wing media outlets once it became apparent in the mid-1960s that Beijing was intent on building a nuclear arsenal. *National Review*, the flagship publication of the conservative movement, published two editorials in 1965 warning that China's communist leaders could not be deterred the way the United States deterred the Soviet Union. The second editorial appeared with the pro-war headline "Bomb the Bang." *National Review*'s editors admonished U.S. officials not to sit passively "like a man who watches and waits while the guillotine is constructed to chop his head off" (Carpenter 2015).

Moderate and liberal publications did not go as far as recommending preemptive war against the PRC, but they saw no opportunity for a policy of peaceful coexistence with Mao Zedong's regime either. The onset of China's bizarre, fanatical Cultural Revolution in the late 1960s made the notion of a dialogue with that government seem even more farfetched. However, a major policy change was on the horizon, and that development would be the catalyst for a dramatic shift in the media's perception of China.

Nixon's Policy Change Initiates Benign Media Illusions About China

Both U.S. policy and media attitudes toward China shifted abruptly in July 1971 when President Richard M. Nixon announced that he would travel to the PRC the following February to hold talks with that country's communist rulers. His visit culminated with the issuance of the Shanghai Communique, which began the profound transformation of U.S.-China relations. Nixon's initiative marked the abandonment of the U.S. campaign to isolate and demonize the PRC. Media accounts were mostly favorable, although many were still cautious about whether the rapprochement would achieve meaningful, substantive results. Other journalists were extremely supportive. Liberal *New York Times* columnist James Reston (1972) stated that the trip to China and the signing of the Shanghai Communique was Nixon's finest hour.

An Associated Press sampling of editorial comments in newspapers across the nation found far more support than criticism of the president's policy (Associated Press 1972). That stance was particularly evident among liberal-leaning publications. The *Boston Globe* stated that "with this good start, it remains to be seen how far the two nations can proceed together on the road to peace." The *Chicago Sun Times* exuded pleasure: "If all this is not superior to trading insults mixed with myths, we'd like to know what is." The *St. Louis Post-Dispatch* noted that "many Americans may be viewing Communist China in a positive light for the first time." Such a development, the editors concluded, was in itself "a notable advance in international amity and a heartening portent." Those and other newspapers expressed caution that much additional diplomatic labor was necessary before the bilateral relationship was fully transformed, but they gave the president high marks for his initial foray. Only a handful of right-wing publications expressed outright opposition to the notion of a U.S. rapprochement with the PRC (Buckley 1972).

Los Angeles Times diplomatic correspondent and long-time China observer James Mann noted that after Nixon's outreach to Beijing, "China was America's partner in fighting the Cold War," and that for America's policymaking elite, "China was considered a special relationship" (Mann 2000: 5). Most portions of the U.S. news media came to accept Washington's 180-degree policy turn regarding Beijing. Now that policymakers no longer viewed "Red China" as a grave threat and an ideological bogeyman, Mann observed, some journalistic accounts even went to the opposite extreme and minimized the Beijing regime's ongoing domestic repression.

Such kid-glove treatment built gradually, though. Conservatives especially were divided or ambivalent about the new U.S. relationship. When long-time anticommunist hawk Sen. Henry Jackson (D-WA) reversed course and called for normalization of relations with China to better combat the Soviet Union, William F. Buckley's *National Review*, accused Jackson of "moral blindness," pointing out that the PRC was "a far more totalitarian state than the Soviet Union" (*National Review* 1974). Other right-wing publications featured critics of Washington's growing military assistance to Beijing. Writing in the pages of *Commentary*, military analyst Edward Luttwak (1978: 43) posed some provocative and unpopular questions to policymakers. "Is it our true purpose to promote the rise of the People's Republic to superpower status?" he asked. "Should we become the artificers of a great power which our grandchildren may have to contend with?"

Most American journalists, though, adopted an increasingly benign view of the PRC in their coverage during the 1970s and 1980s. Harry Harding, a prominent scholar on China, states that by the mid and late 1980s "American euphoria about developments in China reached its zenith" (Harding 1992: 169). Press accounts reflected that view, and the attitude prevailed until China's communist regime committed the massacre at Tiananmen Square in June 1989.

In a 2014 retrospective, the editors of the *New York Times* conceded that its reporters and columnists had been too upbeat about prospects for political reform in the PRC. "Before the violence of June 4, [*Times* reporter Nicholas D.] Kristof and others had been optimistic about the prospect of a more open, more democratic China." Kristof agreed with that assessment. "Looking back at what I wrote 25 years ago, I'd say the tone was right but the timing way too optimistic," Kristof said. "The Communist party indeed has diminishing control over people's lives," but he noted that despite economic and social pluralism, there is "still not a whisker of political pluralism" (*New York Times* 2014). Given the regime's dramatic tightening of controls under Xi Jinping, Kristof was still too optimistic in 2014.

Harsh Initial Post-Tiananmen Square Coverage Gradually Moderates

The PRC's brutal Tiananmen Square crackdown produced a flurry of angry stories in the American press. *New York Times* reporter Sheryl Wudunn managed to disguise herself as a local and get close to the action on that fateful night. Her report provided a searing eyewitness account of the regime's appalling behavior:

> Tens of thousands of Chinese troops retook the center of the capital this morning from pro-democracy demonstrators, killing scores of students and workers and wounding hundreds more as they fired submachine guns at crowds of people who tried to resist. . . . Most of the dead had been shot, but some had been run over by armored personnel carriers that forced their way through barricades erected by local residents [in Timperlake and Triplett 1999: 26].

The initial press coverage was universally harsh. When information leaked that President George H. W. Bush had sent National

Security Advisor Brent Scowcroft on a secret fence-mending mission to Beijing, the media erupted with condemnations. A *Washington Post* editorial stated that the president "should not be making placatory gestures to a blood-stained Chinese government" (*Washington Post* 1989). A short time later, the *Post* published an op-ed by the recently retired U.S. ambassador to China, Winston Lord. Although a thoroughly moderate member of the U.S. foreign policy establishment, Lord was unsparingly caustic in his assessment of the president's handling of the Tiananmen Square atrocity: "Let us conduct necessary business with the Beijing authorities in workmanlike fashion, not with fawning emissaries" (Lord 1989).

Yet as widespread as the negative press treatment of the PRC was immediately following the Tiananmen Square bloodletting, the intense outrage was relatively short-lived. The incident also had surprisingly little impact on U.S. government policy, especially with respect to the expanding bilateral economic ties, and that attitude of returning to business as usual subtly influenced the media coverage. Bill Clinton campaigned against the "butchers of Beijing" in 1992, but once in office, his policy differed little in substance for those of Reagan and Bush. And as bilateral relations gradually returned to normal, media coverage became calmer and focused increasingly on the beneficial economic ties. Even when the PRC fired missiles into the Taiwan Strait in 1995 in a futile effort to disrupt Taiwan's first genuinely free election, and the United States sent an aircraft carrier task force to the area in a show of support for Taipei, press reports generally avoided hyperbole.

There were, to be sure, dissenters in the 1990s. Conservative hawks frequently attacked President Clinton's policies toward China. An especially persistent and virulent critic was *Washington Times* defense and national security reporter Bill Gertz. He even impugned the loyalty of Clinton and other administration officials, saying that "highly effective Chinese political influence and intelligence operations against the United States had led the president and his advisers to try to fool the American people into believing that China poses no threat" (Gertz 1999: 81). Among his specific accusations, Gertz charged that the administration had accepted cash payments from the Chinese government and had assisted the PRC in developing its nuclear weapons.

There was very thin support for the latter allegation, but the former had at least some validity. In early 1997, the *Washington Post* reported that Justice Department investigators had discovered evidence, including some based on electronic surveillance, indicating that Chinese officials had tried to steer campaign contributions to the Democratic National Committee and the Clinton campaign. Although only circumstantial evidence ultimately emerged, James Mann contended that "the swirl of accusations and news stories about the scandal had an impact. They put Clinton on the defensive concerning China and prompted the administration to hold temporarily in abeyance its plans for a far-reaching improvement in relations with Beijing" (Mann 2000: 351). Mann's conclusion about the scandal's impact on policy was a bit exaggerated. There was just a modest effect, and outside of right-wing press outlets, only a modest negative impact on the media's perspective

Gertz's broader complaint was that government and corporate ties to China were endangering America's security. In 2000, Gertz published a book, partly based on his *Washington Times* articles, which provided a detailed presentation of the right-wing case for a more confrontational U.S. policy toward the PRC (Gertz 2000). Worries about the impact of extensive government and corporate ties to Beijing would reemerge with even greater virulence during the second decade of the 21st century, and Gertz was hardly the only analyst to voice them.

Mainstream media treatments at the time, though, adopted a markedly different approach. Nicholas Kristof was an especially vocal spokesman for a mild, conciliatory China policy. His arguments typified the views of journalists who defended and promoted maximum U.S. engagement with China. Such an approach, even after Tiananmen Square, he contended, maximized the likelihood of the PRC becoming less repressive domestically and being a responsible actor internationally (Kristof and Wudunn 1995). Despite some anger and concern surrounding the campaign contribution scandal, a moderately favorable and optimistic perspective regarding China generally characterized mainstream media coverage throughout the 1990s and into George W. Bush's administration. There was some residual pessimism and skepticism about prospects for political reform in the PRC. After Vice President Al Gore's trip to China in 1997, a *New York Times* editorial observed that "Mr. Gore seemed to go out of his way . . . to praise 'a significant advance in democracy' that few others have been able to detect" (*New York Times* 1997). But the views that *Times* columnist Thomas Friedman expressed were more typical of the mainstream media's perspective. "China's going to have a free press," he predicted confidently. "Globalization will drive it" (Friedman 2000: 183). Former *New York Times* and *Washington Post* correspondent Patrick Tyler was more cautious about those prospects, but he warned nevertheless that a more confrontational U.S. policy "is profoundly against the interests of a stable international order" (Tyler 1999: 426).

Press Criticism of China Slowly Rises Again During the Bush and Obama Years

A more negative tone began to creep into media analyses of PRC behavior during George W. Bush's administration. In a major campaign address in 1999, candidate Bush used the term "strategic competitor" to describe China (Lippman 1999). It was a term than evoked an image midpoint between friend and enemy, but even such a nuanced relationship got off to a very bad start in April 2001 when a PRC fighter plane and a U.S. surveillance aircraft collided near China's coast, killing the Chinese pilot and forcing the damaged American spy plane to land on Hainan Island. Public and press irritation at Beijing soared when Chinese authorities initially refused to release the plane or crew. Although a diplomatic compromise eventually resolved the spat, some U.S. publications vented their fury at the PRC government.

An article by prominent neoconservative writers, William Kristol and Robert Kagan, in the *Weekly Standard* was especially caustic. The authors described the conciliatory U.S. response as "a national humiliation." Kristol and Kagan saw much wider, dangerous ramifications from such conduct. "As the Chinese understand better than American leaders, President Bush has revealed weakness. And he has revealed fear: fear of the political, strategic, and economic consequences of meeting a Chinese challenge. Having exposed this weakness and fear, the Chinese will try to exploit it again and again, most likely in a future confrontation over Taiwan" (Kristol and Kagan 2001).

They also stressed a theme that would become increasingly visible in right-wing and economic nationalist articles about the U.S.-China relationship. "The Chinese believe, with good reason, that the American business community has a hammerlock on American policy toward China, and that Congress will never dare cut off American business's access to the Chinese market. Congress has a chance to prove that when matters of fundamental national security are at stake, the United States can break this addiction." At the time of the 2001 incident, though, most portions of the news media expressed relief that sober diplomacy had resolved the crisis without doing serious damage to bilateral ties or escalating to a dangerous military confrontation.

Suspicions about China's behavior and motives appeared to tick up a notch in press coverage, but in the years following the spy plane incident, Bush was firmly committed to preserving and even expanding a cooperative relationship with Beijing. One very noticeable feature was that while the president frequently condemned various countries for their human rights abuses and lack of democracy, China was almost always left off the list. As the Beijing Olympics approached, Mann (2007: 89–93) found that the media treatments of China still were heavily laden with (mostly benign) simplistic clichés. Indeed, the bulk of the press coverage of the Olympics turned out to be friendly and positive.

Nevertheless, during both Bush's presidency and Barack Obama's, the number of negative articles on Beijing's distressing human rights record continued to grow. Media outlets skewered Obama in 2009 when he refused to meet with Tibet's Dalai Lama, apparently for fear of offending Beijing (*Wall Street Journal* 2009). Pressure in the press also contributed to the reversal of that decision the following year. In addition to the human rights issue, more news stories contended that economic globalization was not an unalloyed benefit—especially as it pertained to China. Complaints rose about American job losses in certain industries, and a litany of complaints about Beijing's "unfair" trade practices developed (Collins 2016). There also was a rising number of critical stories about the double-digit annual increases in the PRC's military budget, much of it used to build new, highly sophisticated weapons (Perlez 2012). The primary purpose of those weapons systems seemed especially unsettling. The development of anti-ship missiles and radars appeared to be focused on making a U.S. intervention to support Taiwan in a crisis prohibitively dangerous.

Still, even publications such as the *Wall Street Journal* that expressed growing concern about the PRC's implicit military challenge to U.S. primacy in the western Pacific defended the extensive and growing bilateral economic ties. Economic nationalists in the media asserted that such a policy was internally contradictory, arguing that massive trade flows contributed to China's economic strength, thereby enabling Beijing to build an ever more capable military that that utilized some of America's best technology (Kearns and Tonelson 2011). Such negative assessments became more visible during Barack Obama's presidency. Right-wing journalists such as Bill Gertz were especially alarmed about how the economic ties the Obama administration encouraged seemed to be aiding China's geostrategic challenge to the United States and its allies. Indeed, Gertz (2019: 34–41) accused the administration of outright appeasement on a host of issues.

Most media perspectives on bilateral relations, though, avoided discussing the possible contradiction between approving extensive technology transfers and limiting the PRC's military capabilities, as did most foreign policy scholars. Other analyses in the press tried to square the circle, using the term "congagement" to describe the supposed optimal policy—one that took China's military rise seriously and sought to contain Beijing's geopolitical ambitions while still preserving maximum bilateral economic connections and seeking to find areas of diplomatic and strategic cooperation (Wang 2016). That somewhat hazy and ambivalent media treatment persisted through Obama's time in office, although criticism and warnings from conservative journalists were becoming more numerous and strident.

China's Press Image Worsens in the Trump Years

As relations between Washington and Beijing have become more contentious during the Trump administration, media coverage exhibits some major divisions. Public opinion has turned more negative toward China because of intensifying trade disputes, the PRC government's rising authoritarianism at home under President Xi Jinping, Beijing's deteriorating human rights record—exemplified in its treatment of the Uighur minority in Xinjiang province—and its heavy-handed moves to reduce or abolish Hong Kong's political autonomy.

The PRC's attempt in the spring of 2019 to gain the power to extradite Hong Kong residents for trial in mainland courts created great suspicion among American journalists. When pro-democracy demonstrations erupted in Hong Kong in response to Beijing's extradition power play and other grievances, American media accounts across the political spectrum were sympathetic to the demonstrators and hostile to the communist authorities (Allen-Ebrahiman 2020; Olney 2019). Conservative columnist George Will typified the reaction. "Just eight years after the Tiananmen massacre," Will wrote in the pages of *National Review*, "there began what was supposed to be half a century of Hong Kong's exceptionalism preserved, after which the city might be gracefully melded with a mellowed mainland. Just 22 years later, this hope has been as refuted as the 1989 hope that the massacre would be followed by a less authoritarian, because more secure, Beijing regime" (Will 2019).

American journalists have noticed the growing authoritarianism in China, and criticism of Xi Jinping's regimentation policies are more frequent and pointed (Thayer and Han 2019). The criticism is especially vocal and emphatic about the tightening censorship measures (Lin 2018). But media discontent with the policies of Xi's regime now go beyond that issue. Civil liberties advocates are deeply alarmed about the massive degree of surveillance and data collection associated with Beijing's social credit system. Writing in *The Atlantic*, longtime promoters of global democracy Anna Mitchell and Larry Diamond unequivocally denounce that system (Mitchell and Diamond 2018).

Although Beijing's tightening autocracy generated greater criticism in the American news media, a sizable portion of the corporate media community has still held back, according good relations—especially profitable economic relations—between the United States and China a higher priority. That approach has begun to enrage conservative media outlets. A more noticeable split in media coverage along political and ideological lines has become evident in 2020 than at any time in recent decades.

China's handling of the coronavirus pandemic in the spring of 2020 has caused a surge of media criticism—especially among conservative journalists. Early on, anti-China agitation on the part of right-wing journalists went well beyond allegations that Beijing had withheld information that might have saved the lives of Americans and other victims throughout the world. Conservatives routinely referred to the coronavirus as the "Wuhan virus" or even the "Chinese virus" in an effort to whip-up greater public resentment against Beijing (Mastio 2020; Lowry 2020). Liberal journalists rejected such labels as not only inaccurate, but xenophobic and implicitly racist, and they blasted both President Trump and his right-wing media allies for using them (Flipovic 2020; Scott 2020; Dickinson 2020). Members of the media taking a soft line on China's responsibility for the onset and spread of the coronavirus were increasingly on the defensive, however.

Most of China's conservative adversaries carefully draw a distinction between blaming the Chinese people and blaming the Chinese Communist Party. Some media members even use the term "CCP virus" rather than "Chinese virus"—in part to neutralize charges of racism. Helen Raleigh, a senior contributor to *The Federalist*, emphasizes that "it's important that in our quest for justice, we distinguish between the Chinese Communist Party (CCP) and the Chinese people. At fault for the spread of the Wuhan coronavirus is the CCP" (Raleigh 2020). Josh Rogin, a moderately conservative columnist for the *Washington Post*, had earlier promoted a similar view. "Our beef is not with the Chinese people; our problem is with the CCP—its internal repression, its external aggression, and its malign influence in free and open societies" (Rogin 2020). Writing in *National Review*, Hoover Institution scholar Michael Auslin (2020) states bluntly that "the CCP, which for years has claimed to be a responsible member of the global community, showed its true colors when this crisis hit. It can no longer be denied that Xi's regime is a danger to the world. Justice demands it be held morally culpable for its dangerous and callous behavior."

Some right-wing figures contend that lax containment standards at a virology research lab outside Wuhan may have allowed the virus to be released into the outside world. Liberal publications dismiss the accusation as crude right-wing conspiracy theories (Barclay 2020; Stellino 2020). Nevertheless, such suspicions persist, and journalists trying to promote a conciliatory perspective found it acutely difficult to do so when Beijing conducted a vigorous propaganda campaign to shift the blame for the global pandemic onto the United States.

There also has been an increase in allegations from conservative writers that some journalists and media outlets are subservient to Beijing. In a March 31, 2020 article, J. Arthur Bloom, managing editor of the *American Conservative*, laid out one important aspect of the case that some of the most prominent media organizations were inhibited from leveling justifiable criticism of Beijing on an array of issues. "The companies that own the major news networks, NBC, ABC, and CBS, all do significant business in China," he emphasizes, creating an inherent conflict of interest (Bloom 2020a). In another article, Bloom documents the extensive financial connections that both the *Washington Post* and the *Wall Street Journal* maintain with the PRC government-owned *China Daily*. "We now have a figure for how much the *Washington Post* and the *Wall Street Journal* have taken from *China Daily* . . . since 2016. It's $4.6 million, and $6 million, respectively." He points out that the Chinese government undoubtedly seeks to promote its views on various issues with such large expenditures (Bloom 2020b).

Bloom is not the only conservative journalist to argue that the vast economic stakes that media outlets or their parent companies have in preserving a friendly relationship with China could be compromising the content of their news coverage. Barbara Boland, the *American Conservative*'s national security reporter, accused *Bloomberg News* of burying stories critical of China on other issues. She specifically cited the editors' decision not to run a follow-up story on the accumulation of massive wealth by members of China's political elite (Boland 2020).

Establishment journalists and analysts have sought to stem, or at least deflect, the public hostility toward China. Some of them even make an effort to turn the coronavirus issue to their advantage in terms of promoting the broader agenda of preserving international cooperation. Rather than defending the Chinese government outright (which was becoming increasingly difficult), they instead prefer to stress related themes. A key rationale is that the coronavirus constitutes an extraordinarily serious threat that requires enhanced, not reduced, bilateral and global cooperation (Flournoy and Monaco 2020).

China's critics have little patience for the newest edition of proglobalism arguments. Economic nationalist writer Alan Tonelson, editor of the *RealityChek* blog, pushed back hard on a *New York Times* story, which he described as an implicit editorial rather than a news story. Tonelson (2020) contended that "see-no-evil pre-Trump American science and tech collaboration and exchange programs were a one-way street that sent to Beijing cutting edge knowhow crucial both for defense and for national competitiveness. None of that made its way into the *Times*." He charged further that the *Times* story was another example of the mainstream media making "no effort to conceal its free-trade, globalist, liberal biases, even if it means throwing in with China."

Even as anger over Beijing's handling of the coronavirus pandemic continues to impact press coverage of China issues, another PRC action puts China's defenders in an even more awkward position. In May 2020, Xi Jinping's government imposed a national security law on ostensibly autonomous Hong Kong. The passage of that measure effectively negates the territory's autonomy, which was supposed to last until 2047—50 years after Britain's transfer of the territory to the PRC. PRC officials offer assurances that the security law is merely intended to deal with disruptive demonstrations and other manifestations of subversion and disorder (Zheng 2020). Comments in the American press are overwhelmingly skeptical, if not scornful, of such assurances. NPR's Emily Feng (2020) brands the new law as a "power grab" and points out that not only would Beijing decide who falls under the provisions of the law, but the PRC frequently refers to Hong Kong's democracy protests "as the work of 'terrorists.'"

Not surprisingly, conservatives in the press are especially categorical in denouncing Beijing's action. The editors of *National Review* not only praised the Trump administration for rescinding Hong Kong's special trade status, they called for a similar firm response on other issues:

> We obviously also need a strategy to combat Chinese belligerence elsewhere. Control of Hong Kong is only one step in China's quest to "occupy a central position in the world," as Chinese president Xi Jinping has put it. The Hong Kong security law coincides with increasingly aggressive naval exercises in the South and East China Seas and a sudden military buildup on the Sino–Indian border. The Chinese have also made clear their intention to annex Taiwan, and show no signs of rolling back their programs of industrial espionage and anticompetitive trade practices. The White House must resist China on all fronts [*National Review* 2020].

Other right-wing publications echo that view (del Guidice 2020). *Fox News* contributor Marc Thiessen pointedly condemns the new national security law, stating that "the Chinese regime is going to be able to ban pro-democracy groups, arrest people for political crimes. They're going to allow the state security service, which is the Chinese secret police that terrorizes people all over mainland China, to operate openly in Hong Kong, which they have not been allowed to do" (Garcia 2020). But moderate and liberal commentators emphasize that there is little the United States and its democratic allies can do in response, and most China policy specialists share their pessimism and sense of constraints (Wertime 2020).

It became evident in the spring of 2020 that U.S. policy toward China was going to be a major issue in the election—especially at the presidential level (Bandow 2020). The Trump and Biden camps soon traded accusations about which candidate was weaker regarding the PRC. A Biden campaign ad accused Trump of having "rolled over for the Chinese" during the early stages of the coronavirus outbreak. "Trump praised the Chinese 15 times in January and February as the coronavirus spread across the world," the ad sneeringly concluded (Hain 2020).

That approach has alienated some of the Democratic Party's usual media allies while drawing derision from right-of center outlets. The approach created a noticeable rift with some left-leaning journalists (Toosi 2020). The *Nation*'s Jeet Heer accused Biden of succumbing to the type of xenophobia that Trump epitomized. Heer (2020) was especially upset about the "rolling over for the Chinese" terminology. He even accused the former vice president of dabbling "in 'Yellow Peril' rhetoric." Some moderate Democrats reached a similar conclusion. Writing in *The Atlantic*, Peter Beinart (2020) blasted the "utter futility of Biden's China rhetoric," cautioning that trying to "out-hawk Trump" on China was "pointless, even dangerous."

Beijing's crackdown on Hong Kong, though, has made such sentiments even more out-of-step with the trend in American public opinion. Even before that episode, A Pew Research Center survey of Americans taken in late April 2020 indicated intense and growing hostility toward the PRC. The results showed that 66 percent of respondents had a negative opinion of China, while a mere 26 percent expressed a favorable attitude. It was the highest percentage of negative views toward China since Pew began asking the question in 2005 (Devlin, Silver, and Huang 2020).

Conclusion

Given the state of American public opinion, it is not surprising that media accounts regarding the PRC are becoming increasingly hostile. Advocates of a cooperative relationship between the United States and China have not given up the fight, but a pronounced split has occurred in the journalistic community, and the pro-engagement faction is weakening. The trend in media perspectives toward more extensive criticism of the PRC is apparent, and if Beijing's behavior, both domestically and internationally, does not improve, the number and influence of conciliatory stories likely will wane. Indeed, the emergence of hawkish group-think akin to that in the 1950s and 1960s is no longer out of the question.

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Assessing State Capacity Libertarianism

Ryan H. Murphy and Colin O'Reilly

Tyler Cowen (2020), in a controversial and widely discussed blog post, has argued that free economic institutions must be accompanied by state capacity to achieve maximal growth rates. He calls this "State Capacity Libertarianism," which echoes positions he has posed previously (Cowen 2007, 2018). Besley and Persson (2011) can be perhaps seen as a direct predecessor. Criticisms immediately emerged, with Henderson (2020) arguing that Cowen's specific proposals are in direct conflict with libertarianism, and with minor caveats, free economic institutions are already able to achieve the goals Cowen hopes to achieve with state capacity. Geloso and Salter (forthcoming) argue that the lack of examples of wealthy countries with weak states is due to survivorship bias, and they apply their argument to criticize Cowen (Geloso and Salter 2020). Caplan (2018), while not directly addressing State Capacity Libertarianism, argues that there is little reason to believe that the effects of state capacity are the result of strong states themselves, rather than the social and cultural factors that allowed a strong state to emerge in the first place. The purpose of this article is to put data to the question of the individual effects of state capacity and free economic institutions on economic performance, and the potential interaction between the two.

Cato Journal, Vol. 40, No. 3 (Fall 2020). DOI:10.36009/CJ.40.3.9.

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State capacity can be decomposed, primarily, into two broad sets of concepts. The first is fiscal capacity, which is the ability of a state to raise revenue should it need to; additionally, states higher in fiscal capacity are able to raise revenue in a more efficient manner. The second is to play a market-supporting role. At minimum, this is to mean legal capacity, which in libertarian terms would mean for the country to be capable of running a night watchman state efficiently and effectively. But "supporting markets" could encapsulate enforcing certain kinds of regulations, the provision of public goods, or fixing externalities. The emphasis is not how far the state goes in terms of actually performing any of these tasks, but how *well* it is able to accomplish these tasks, should it attempt to. Savoia and Sen (2015), Johnson and Koyama (2017), Berwick and Christia (2018), and Piano (2019) offer reviews of the literature from alternative perspectives.

This article's approach to assess State Capacity Libertarianism is to test the effects of economic freedom and state capacity, and their interaction, on economic growth using a series of regressions employing panel data. While panel analysis which tests the effects of institutions on economic performance is very common, the literature on state capacity tends to have a more historical flavor. In contrast, we make use of two contemporary measures of strong state institutions which have a limited time element, in addition to two less conventional measures, one of which originates with Murphy (2019) and the other of which is original to this paper. The use of a control for output per capita and country-level fixed effects accounts for some of the immediate concerns of State Capacity Libertarianism's critics: that the effect of state capacity is the result of backwards causality, or that cultural variables underlie state capacity. We do not find strong support for State Capacity Libertarianism, but we also do not find that state capacity plays no role in economic development. When considering our findings as a whole, we conclude that, as a first approximation, state capacity and economic freedom are substitutes for one another.

Before commencing with our analysis, we will first put state capacity in a broader context to help motivate our project. The state capacity perspective is actually a rather natural outgrowth of the seminal work done by North and Weingast (1989) and North (1990) which highlights the importance of the Glorious Revolution as the turning point in the modern history of Britain, and therefore, the origins of world economic growth. But while the work of North and his co-authors point most strongly to the Glorious Revolution leading to much stronger protection of property rights, the most tangible outcome of the Glorious Revolution may have been to allow the state to raise more tax revenue (Cox 2012). That is to say, the Glorious Revolution created much higher fiscal capacity.

Recognizing this, subsequent literature has found the two aspects of state capacity to be strongly intertwined (Besley and Persson 2009; Karaman and Pamuk 2013). A broad conclusion of the literature is that an external threat, such as the need to fight wars, causes states to invest in fiscal capacity, the investment of which allows states to gain other capabilities (Besley and Persson 2008, 2009, 2010; Dincecco and Prado 2012; Karaman and Pamuk 2013; Gennaioli and Voth 2015), and these institutions ultimately lead to economic growth (Acemoglu et al. 2016; Dincecco and Katz 2016). While institutions protecting property rights may appear to be what is wholly driving these positive results, provocatively, Irigoin and Grafe (2012) have gone as far as arguing that development in Spain was held back due to too little fiscal capacity relative to legal capacity. And one of the most important recent works in political economy, Acemoglu and Robinson's (2019) *The Narrow Corridor*, in effect argues that economic development requires state capacity to exist in some form of balance with the power of civil society, so that they can complement one another rather than one overwhelming the other.

State Capacity Libertarianism is the latest in a series of fusions of libertarianism with more conventional political ideologies, which began itself with Fusionism: the fusion of libertarianism with conservatism (see Meyer 1996). Much later, in reaction to the dominance of Fusionism within the libertarian movement, a series of academics and public intellectuals argued for "liberaltarianism," which blended libertarianism and left-liberalism (Lindsey 2006; Tomasi 2012: 162–63). Since then, there has been an attempt to rejuvenate the word "neoliberalism," which historically was largely used as a pejorative, as a means to somewhat moderate libertarianism in an ideologically ambiguous way, while emphasizing a belief in modern institutions (Bowman 2016; Murphy 2020: 161; Tait 2020). Cowen (2020) explicitly links State Capacity Libertarianism to liberaltarianism, while its relationship to "neo-neoliberalism" is readily apparent as well.

State Capacity Libertarianism, however, comes in direct conflict with certain strands of literature in political economy holding that state enforcement of property rights is redundant in the context of private institutions and norms (Stringham 2015; Williamson 2011) or is actively counterproductive (Benson 1990; Leeson 2014; Leeson and Harris 2018). The idea that free economic institutions must be paired with strong state institutions is anathema to this point of view. The aforementioned Geloso and Salter (2020) are working in this tradition in their criticism of State Capacity Libertarianism, while their formal work (forthcoming) confronts state capacity more directly than the tradition has confronted it previously.

The article is structured as follows: first, we discuss our measures of state capacity, the data sources, and empirical model; second, we report our regression results; third, we interpret the regression results while taking into account the effects of the interaction term; finally, we offer some concluding remarks.

Measures of State Capacity

How can state capacity be quantified? In this section we describe four measures of state capacity: (1) the Government Effectiveness measure from the *Worldwide Governance Indicators* (Kaufmann et al. 2009, 2010); (2) the average of Government Effectiveness and Control of Corruption; (3) a new index constructed using data from the *Varieties of Democracy* dataset; and (4) a measure of the strength and power of states from Murphy (2019). Each of these variables possesses a fair amount of cross-sectional and time series variation in a panel, which will be necessary for our empirical approach.

Three fundamental aspects of state capacity are emphasized in the literature: the ability of the state to support markets (which in terms of measurement closely overlaps with the quality of bureaucracies), the state's fiscal capacity, and to a lesser extent, the state's monopoly on violence. The first of these, intuitively, is inclusive of the enforcement of property rights. But more broadly, it should be thought of as the state's capability to do what attempts to do, whether that means enforcing property rights, building an electrical grid, or building a road. Sweden and Singapore are both strong in this, even though Sweden does much more than Singapore. Fiscal capacity is the degree to which the state is able to raise revenue from those living under its control. A state will not have the capacity to compensate a professional bureaucracy or provide public goods if it lacks the capacity to raise revenue through taxation. Finally, as Olson (2002) describes, without a monopoly on coercion (and control of its territory), the threat of violence or violence itself increases the risk of expropriation and reduces the incentives to invest in productive activities (North 1990; Collier 1999).

Government Effectiveness

Government Effectiveness, like other elements of *Worldwide Governance Indicators* is created using a pastiche of outside sources, which documentation separates into "representative" and "non-representative" sources. Those that are representative pertain primarily to the quality of the bureaucracy and the quality of the provision of public goods and originate with *The Economist* Intelligence Unit, the *Global Competitiveness Report*, the Gallup *World Poll*, the *Institutional Profiles Database*, the Political Risk Services' *International Country Risk Guide*, and Global Insight *Business Conditions and Risk Indicators*. In the documentation, *Government Effectiveness* is defined as,

> Government effectiveness captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.[1]

Average of Government Effectiveness and Controls of Corruption

While cross-sectional data coverage is strong, it begins only in 1996, and earlier years of *Worldwide Governance Indicators* had weaker data coverage. The measure directly addresses whether the state is able to perform the tasks it sets out for itself, but it only indirectly addresses the question of *fiscal* capacity. That is to say, it captures fiscal capacity insofar as the government would not have fiscal capacity were it couldn't raise the revenue to accomplish these tasks.

State-building, conceptually, has been a point of emphasis for Fukuyama (2004, 2011, 2014) as a key aspect of the story of economic development. Fukuyama (2014: 61–63) combines Government Effectiveness with another element of *Worldwide Governance*

[1] https://info.worldbank.org/governance/wgi/Home/Documents.

Indicators, Control of Corruption. We follow Fukuyama in using the average of the two indicators as our second measure of state capacity. The benefits and drawbacks to using this measure are similar to using Government Effectiveness alone, with the drawbacks being a lack of a lengthy time dimension and no direct measure of fiscal capacity.

A New State Capacity Index

Our third measure is a novel application of the vast database of institutional information found in the *Varieties of Democracy* (V-Dem) dataset. Our index attempts to measure the characteristics of state capacity discussed above: fiscal capacity, the provision of public goods, and a monopoly on violence. The V-Dem dataset contains measures closely related to the first three concepts, for a large number of countries, and an extremely lengthy time dimension. The creation of this measure may actually be an important contribution of this paper,[2] but it was motivated by the desire to use a denser and lengthier measure of state capacity than Government Effectiveness.[3] The better data coverage from the state capacity index constructed using the V-Dem data allows for the analysis of state capacity over many decades. All variables in the state capacity index from the V-Dem dataset are coded by multiple country experts with scholarly or professional knowledge of the country. The scores from the county experts are then aggregated by a Bayesian response measurement model.

Constructing an index from variables in the V-Dem dataset allows us to include a more direct measure of fiscal capacity. We use the variable, "state fiscal source of revenue," which measures "on which . . . sources of revenue does the central government primarily rely to finance it activities?" Governments receive a low score if the state is not capable of raising revenue or relies on outside revenue, but receives a high score if the state raises revenue through modern means of taxation. See Table 2 for a full description of the variable and the other V-Dem variables that follow.

To measure the provision of public goods, we include a variable that assesses the degree to which the national government spends on

[2]The lack of a measure of state capacity with a lengthy time dimension was previously pointed out by Savoia and Sen (2015: 455).

[3]One important component of Government Effectiveness from the *International Country Risk Guide* dates back to 1984, but the method we will use will reach far more years. ICRG data has somewhat limited time series variation as well.

"particularistic" goods or on "public goods." States receive a low score if state expenditure is clientelistic, favoring specific groups in society. States receive a higher score if they spend on public goods broadly, defined as "spending intended to benefit all communities within a society" (Coppedge et al. 2019: 149).

The third variable is closely related to the state's monopoly on coercion: a measure of state authority over its territory. This variable measures the percentage of territory that the state maintains effective control; more specifically "where it [the state] is recognized as the preeminent authority and in a contest of wills it can assert its control over political forces that reject its authority." States with contested territory, civil conflict, or regions in which their authority is challenged receive lower scores.

As an additional measure of the state's ability to accomplish tasks, we include data on educational equality. This seeks to measure "[t]o what extent is high quality basic education guaranteed to all, sufficient to enable them to exercise their basic rights as adult citizens?" We do not think that this variable is primarily about human capital. While one can debate the merits of government involvement in education, the fact is that the governments of *all* countries either attempt to provide basic schooling, or would if they had the state capacity to do so. The *variation* that exists between countries is whether the state is capable of running such a system and able to fund it.

Moreover, we construct the new state capacity index by taking the first principal component of the four measures from *V-Dem* given above. Details on the principal component analysis can be found in the Appendix. The variation that the method ought to be capturing, then, is competent governance, not human capital. In sum, this novel measure of state capacity contains rather direct measures of fiscal capacity, the state's monopoly on violence, and the quality of the bureaucracy, and the provision of public goods (or what is thought of as a public good). The novel state capacity index is available from 1970 to 2010 for a wide, unbalanced panel of countries.[4]

State Economic Modernity Index

As a final measure of state capacity, we use the "State Economic Modernity" index from Murphy (2019), which circumvents the issue

[4]As we constructed it, the index stretches back to 1970. It has the potential to go back much further for other purposes.

of measuring fiscal capacity by replacing it simply with how large the state is relative to the economy. It also zeroes in on the legal system and the protection of property rights, instead of measuring the quality of the bureaucracy or the provision of public goods that are of more tertiary importance for the support of markets. What this yields is something that is not exactly state capacity; it is better thought of as the economic institutions associated with social democracy. The data is all derived from the *Economic Freedom of the World* index, so its data coverage has a nearly perfect overlap with this variable, which is our primary other variable of interest. As such, data coverage is available for State Economic Modernity from 1970-present.

Economic Freedom Data and Empirical Model

Our other primary data of interest is economic freedom data from the *Economic Freedom of the World* dataset (Gwartney et al. 2019).[5] The dataset includes forty-three variables falling into one of five areas of economic freedom: [limited] size of government, the quality of the legal system and property rights, sound money, the freedom to trade internationally, and [limited] regulation. All data are scaled from 0–10, with "ten" always corresponding to more economic freedom. A literature review of what economic freedom causes can be found in Hall and Lawson (2014), while a literature review of what causes economic freedom can be found in Lawson et al. (2018). A wide variety of earlier research has shown the positive effect of economic freedom on output growth, revealing it to be robust and empirically important; for instance, see Gwartney et al. (1999), de Haan et al. (2006), Gwartney et al. (2006), Bennett et al. (2017), Zhang et al. (2018), and Murphy and O'Reilly (2019).

Our control variable is PPP-adjusted real GDP per capita. Our data source in regressions with a shorter panel is *World Development Indicators*, while we make use of the Penn World Table (Feenstra et al. 2015) for the lengthier panel because it has a single consistent series which is PPP adjusted.[6] Table 1 presents descriptive statistics for all variables described in this section and Table 2 provides sources.

[5]A more inclusively measured definition of libertarianism is Vasquez and Porcnik (2019). However, its time dimension is extremely limited.

[6]Our preference is to use the *World Development Indicators* data when possible. See Pinkovskiy and Xavier Sala-i-Martin (2016).

TABLE 1
Descriptive Statistics

	N	Mean	Std. Dev.	Min	Max
Economic Freedom	540	6.576	1.134	2.87	9.07
Government Effectiveness	538	0.135	0.987	−1.884	2.241
Fukuyama State Institutions	538	0.104	1.004	−1.717	2.281
State Capacity	649	0.099	1.510	−4.140	3.274
State Economic Modernity	1,052	−0.692	2.664	−6.956	6.670
LN GDP per capita, PPP (1995–2015)	529	9.099	1.236	6.351	11.695
LN GDP per capita, PPP (1970–2010)	731	8.689	1.214	6.242	11.974
Economic Growth, 1995–2015 (5yr)	529	2.193	2.584	−9.585	14.660
Economic Growth, 1970–2010 (10yr)	574	2.128	4.035	−17.318	21.182
State Fiscal Source of Rev.*	773	0.504	1.178	−2.631	2.588
Particularistic or Public Goods*	828	0.506	1.239	−3.452	3.214
State Authority over Territory*	770	91.478	10.136	33.75	100
Educational Equality*	828	0.392	1.490	−3.102	3.588

Notes: Sample changes between sets of regressions. The sample year reported above corresponds to the first sets of regressions (which is of relatively short t), unless otherwise specified. *These correspond to the years 1970–2010.
Sources: See Table 2.

To test the hypothesis that state capacity and economic freedom complement each other we estimate a panel growth regression as described by Equation 1.

$$g_{i,t+a} = \alpha efw_{it} + \beta state_{it} + \gamma efw_{it} \times state_{it} + \delta lngdp_{it} + \mu_i + \tau_t + \varepsilon_{it} \tag{1}$$

TABLE 2
Data Descriptions of State Capacity Indicators from *Varieties of Democracy*

Variable 1:	*State Fiscal Source of Revenue*
	Question: On which of the following sources of revenue does the central government primarily rely to finance its activities? Reponses: 0: The state is not capable of raising revenue to finance itself. 1: The state primarily relies on external sources of funding (loans and foreign aid) to finance its activities. 2: The state primarily relies on directly controlling economic assets (natural resource rents, public monopolies, and the expropriation of assets within and outside the country) to finance its activities. 3: The state primarily relies on taxes on property (land taxes) and trade (customs duties). 4: The state primarily relies on taxes on economic transactions (such as sales taxes) and/or taxes on income, corporate profits, and capital (Coppedge et al. 2019: 175).
Variable 2:	*Particularistic or Public Goods*
	Question: Considering the profile of social and infrastruc tural spending in the national budget, how particularistic or public goods are most expenditures? Clarification: Particularistic spending is narrowly targeted on a specific corporation, sector, social group, region, party, or set of constituents. Such spending may be referred to as pork, clientelistic, or private goods. Public-goods spending is intended to benefit all communities within a society, though it may be means-tested so as to target poor, needy, or otherwise underprivileged constituents. The key point is that all who satisfy the means-test are allowed to receive the benefit. Your answer should consider the entire budget of social and infrastructural spending. We are interested in the relative value of particularistic and public-goods spending, not the number of bills or programs that fall into either category (Coppedge et al. 2019: 149).

(Continued)

TABLE 2 *(Continued)*
Data Descriptions of State Capacity Indicators from *Varieties of Democracy*

Variable 3:	*State Authority over Territory*
	Question: Over what percentage (%) of the territory does the state have effective control? Clarification: With this question we seek to judge the extent of recognition of the preeminent authority of the state over its territory. We are not interested here in perfect control by the state, or whether it is relatively effective in comparison to other states, but an assessment of the areas over which it is hegemonic, e.g. where it is recognized as the preeminent authority and in a contest of wills it can assert its control over political forces that reject its authority. Several illustrative examples may help in this coding. During civil wars the claim of the state to rule is effectively neutralized by insurgent groups (e.g., the Tamil Tigers in Sri Lanka). There are also situations in which criminals or warlords exert control in contravention of state authority (e.g. opium growers in parts of Indochina). There are also cases of failed states where the central government cannot assert control over a share of its territory (e.g., contemporary Somalia). Here, we ask you to estimate the size of the territory that the state has effective control over, as a percentage (%) of the total territory that is officially part of the country (Coppedge et al. 2019: 175).
Variable 4:	*Educational Equality*
	Question: To what extent is high quality basic education guaranteed to all, sufficient to enable them to exercise their basic rights as adult citizens? Clarification: Basic Education refers to ages typically between 6 and 16 years of age but this varies slightly among countries (Coppedge et al. 2019: 192).

The annualized economic growth rate, from year t through year t+a, is g_{it+a}, where a can take values of 5 or 10 depending on the regression. It is regressed on measures of economic freedom, efw_{it}, and various measures of state capacity, $state_{it}$. An interaction term between economic freedom and state capacity, $efw_{it} \times state_{it}$ captures the possibility of a complementary relationship between the two concepts as suggested by State Capacity Libertarianism.

Each set of regressions includes a baseline specification with the log of GDP per capita as a control to account for growth convergence. The most complete specifications also include country and time fixed effects. Time fixed effects account for shocks common to all countries. Specifications with country fixed effects should assuage concerns of omitted time invariant factors such as geography and slow changing aspects of culture or norms, important for, for example Caplan (2018).

Worldwide Governance Indicators becomes available in 1996, and as such the baseline estimates in Table 3 through 5 are conducted on a sample from forward-looking five-year annualized growth rates from 1995 to 2010. The 1996 data stands in for 1995 and the year 2010 cross-section of observations is used to predict growth from 2010 to 2015. Estimates using the new state capacity index and "State Economic Modernity" are conducted using ten year annualized growth rates from 1970 to 2000 and the year 2000 cross-section of observations is used to predict 2000–10. After a baseline model with no interaction term, all subsequent regressions contains estimates for economic freedom, state capacity, and their interaction. The marginal effect of each set of institutions (i.e., inclusive of the interaction, and conditional on the value of the other set of institutions) will be presented graphically in the subsequent section of this article. The interaction term between them will allow us to perceive any complementarity or substitutability there are between them, thereby "Assessing State Capacity Libertarianism."

Regression Results

Table 3 provides the baseline results using Government Effectiveness as the measure of state capacity, while excluding the interaction term. In these regressions neither set of institutions is actually statistically significant in the two specifications without country fixed effects. When country fixed effects are included, as in

TABLE 3
Five Year Growth Regressions, 1995–2015,
No Interaction

	(1)	(2)	(3)	(4)
Economic Freedom	0.265	0.245	1.094***	0.763***
	(0.173)	(0.191)	(0.230)	(0.232)
Government Effectiveness	0.290	0.280	−0.890*	−0.296
	(0.228)	(0.243)	(0.499)	(0.523)
LN GDP per capita, PPP	−0.613***	−0.590***	−5.281***	−7.440***
	(0.177)	(0.179)	(0.888)	(1.299)
Constant	5.987***	5.770***	43.174***	63.955***
	(1.921)	(1.977)	(7.118)	(11.028)
Time F.E.?	N	Y	N	Y
Country F.E.?	N	N	Y	Y
R^2	0.032	0.038	0.017	0.017
N	529	529	529	529

Notes: Standard errors are robust. * Denotes confidence at 10 percent; ** denotes confidence at 5 percent; *** denotes confidence at 1 percent.

Regression 3 and Regression 4, economic freedom immediately is positive and enters with the expected sign. However, Government Effectiveness enters each of these specifications negatively, while achieving statistical significance at the 10 percent level when time fixed effects are excluded. Including Table 3 is purely expository and to be used as a point of comparison and is not itself an assessment of State Capacity Libertarianism.

Table 4 relaxes the restriction on the interaction between economic freedom and Government Effectiveness. With the inclusion of the interaction, the coefficient on Government Effectiveness is positive and statistically significant in the two specifications excluding country fixed effects. When country fixed effects are excluded, economic freedom is not statistically significant. With country fixed effects included and time fixed effects excluded, economic freedom is significant while Government Effectiveness is not (its coefficient size remains about the same, however). When both country and time fixed effects are included, both are positive and statistically significant. However, given the inclusion of the interaction term, none of

TABLE 4
Five Year Growth Regressions, 1995–2015, with Interaction

	(5)	(6)	(7)	(8)
Economic Freedom	0.153	0.111	0.939***	0.579**
	(0.155)	(0.178)	(0.224)	(0.243)
Government Effectiveness	2.453***	2.552***	1.957	2.635**
	(0.934)	(0.935)	(1.282)	(1.153)
EF-GI Interaction	−0.291**	−0.303**	−0.441**	−0.454***
	(0.124)	(0.124)	(0.176)	(0.171)
LN GDP per capita, PPP	−0.661***	−0.643***	−5.094***	−7.185***
	(0.180)	(0.181)	(0.886)	(1.306)
Constant	7.376***	7.288***	42.880***	63.209***
	(1.825)	(1.886)	(7.047)	(10.959)
Time F.E.?	N	Y	N	Y
Country F.E."	N	N	Y	Y
R^2	0.048	0.055	0.019	0.018
n	529	529	529	529
Economic Freedom Marginal Effect at Means	0.113	0.069	0.878***	0.515**
	(0.152)	(0.176)	(0.233)	(0.255)
State Capacity Marginal Effect at Means	0.541**	0.558**	−0.946*	−0.352
	(0.244)	(0.257)	(0.523)	(0.527)

Notes: Standard errors are robust. * Denotes confidence at 10 percent; ** denotes confidence at 5 percent; *** denotes confidence at 1 percent.

these individual effects should be interpreted independently; the effect of economic freedom on economic growth is contingent on the value of state capacity, and the effect of state capacity on economic growth is contingent on economic freedom

The relationship hypothesized by State Capacity Libertarianism can be assessed by considering the effects of each institutional variable across the full distribution of the other institutional variable. Before presenting the set of effects across the full distribution, for each specification we consider the effect of economic freedom at the average level of state capacity, and the effect of state capacity for the average level of economic freedom. These marginal effects at the mean values of other variables are a way of assessing if the effect is statistically significant for typical values of the other interacted variable. For example, the effect of economic freedom at the mean level of state capacity in Regression 8 is positive and statistically significant, whereas the effect of state capacity at the average level of economic freedom is not statistically significant. Marginal effects at the means will be reported for each subsequent regression in this paper.

In all four specifications of Table 4, the interaction term between the two sets of institutions is negative and statistically significant. The sign for each of the institutions remains positive in all four specifications as well. However, all three variables of interest are statistically significant in Regression 8. The effect of economic freedom on economic growth, at the mean level of state capacity, is 0.52 and is statistically significant, whereas the effect of economic freedom if not conditioned on state capacity (as in Regression 4) is 0.76. The smaller magnitude indicates that conditioning on an average level of state capacity reduces the effect of economic freedom on growth, running counter to the expectation of State Capacity Libertarianism. This marginal effect at the mean is a preview of the more complete set of effects of economic freedom at different levels of state capacity and the effects of state capacity at different levels of economic freedom, which are presented in Section IV.

Regressions 5–7 offer only weak support for what we find in Regression 8, the positive effect of each institution individually with a negative interaction. The question then is whether the pattern that is observed in Regression 8 is specific to choosing the time frame and countries we happened to observe. To begin answering that, we make a minor change in definition from Government Effectiveness as state capacity to what Fukuyama assesses (as discussed above) as strong state institutions as state capacity. This alternative measure averages the WGI Government Effectiveness indicator with the WGI Control of Corruption indicator. The results using this alternative measure can be found in Table 5, which are very similar to what we found in Table 4. The two sets of institutions perform unevenly in terms of statistical significance in the three specifications which do not include both country and time fixed effects. However, once both sets of fixed effects are included, as in Regression 12, economic freedom, Fukuyama's measure of strong state institutions, and the interaction term between the two exhibit the same signs and significance, as we saw in Regression 8.

The change in data was relatively minor between Table 4 and Table 5. Now we will change the data source for state capacity entirely, consider a different (though overlapping) period, and use a different data source for PPP adjusted Real GDP per capita. The source of the data, as discussed in Section II, is the first principal component of four variables from the *Varieties of Democracy*

TABLE 5
Five Year Growth Regressions, 1995–2015, with Interaction, Substituting Fukuyama State Institutions for Government Effectiveness

	(9)	(10)	(11)	(12)
Economic Freedom	0.235	0.218	0.932***	0.544**
	(0.148)	(0.168)	(0.222)	(0.245)
Fukuyama State Institutions	1.770*	1.822*	2.215	3.158**
	(0.993)	(0.995)	(1.413)	(1.295)
EF-FSI Interaction	−0.225*	−0.235*	−0.514***	−0.545***
	(0.131)	(0.131)	(0.187)	(0.185)
LN GDP per capita, PPP	−0.554***	−0.528***	−5.209***	−7.248***
	(0.171)	(0.172)	(0.883)	(1.293)
Constant	5.844***	5.609***	44.024***	64.073***
	(1.683)	(1.724)	(7.042)	(10.940)
Time F.E.?	N	Y	N	Y
Country F.E.?	N	N	Y	Y
R^2	0.038	0.045	0.019	0.018
n	529	529	529	529
Economic Freedom Marginal Effect at Means	0.211	0.193	0.877***	0.486*
	(0.146)	(0.166)	(0.228)	(0.254)
Fukuyama State Institutions Marginal Effect at Means	0.292	0.278	−1.170*	−0.429
	(0.232)	(0.241)	(0.635)	(0.685)

Notes: Standard errors are robust. * Denotes confidence at 10 percent; ** denotes confidence at 5 percent; *** denotes confidence at 1 percent.

dataset. Since the time dimension of *Varieties of Democracy* is so extensive, state capacity is no longer the binding constraint on the sample. As a result, the first year used is instead 1970, corresponding to the first year of *Economic Freedom of the World* data. Given the larger number of years available, we will also use ten-year annualized growth rates instead of five-year annualized growth rates, which terminates the analysis in 2010.

While the results in Table 6 do not match the same pattern of statistical significance, all point estimates have the same sign as what

TABLE 6.
Ten Year Growth Regressions, 1970–2010, with Interactions, Using Varieties of Democracy State Capacity First Principal Component

	(13)	(14)	(15)	(16)
Economic Freedom	1.122***	0.661***	1.922***	0.489
	(0.235)	(0.243)	(0.376)	(0.360)
State Capacity	2.494***	2.606***	1.823*	1.771**
	(0.763)	(0.759)	(0.929)	(0.793)
EF-SC Interaction	−0.343***	−0.351***	−0.058	−0.211*
	(0.118)	(0.117)	(0.138)	(0.122)
LN GDP per capita, PPP	−1.021***	−0.860**	−5.691***	−6.254***
	(0.388)	(0.374)	(0.915)	(0.696)
Constant	5.118*	6.749**	40.552***	52.078***
	(2.814)	(2.842)	(6.447)	(5.485)
Time F.E.?	N	Y	N	Y
Country F.E.?	N	N	Y	Y
R^2	0.143	0.210	0.033	0.009
n	329	329	329	329
Economic Freedom Marginal Effect at Means	1.020***	0.558***	1.905***	0.427
	(0.222)	(0.230)	(0.370)	(0.355)
State Capacity Marginal Effect at Means	0.502**	0.572***	1.486***	0.549
	(0.202)	(0.195)	(0.483)	(0.376)

Notes: Standard errors are robust. * Denotes confidence at 10 percent; ** denotes confidence at 5 percent; *** denotes confidence at 1 percent.

was found in Table 4. The inclusion of fixed effects diminishes the size of the point estimates, and significance is weaker in Regression 16 (although the standard errors remain roughly the same across the four specifications). Similarly, the marginal effect of economic freedom at the mean of state capacity and the marginal effect of state capacity at the mean of economic freedom are positive and significant in all specifications except Regression 16. As we see from the effect at means and will see in following section, the exact statistical significance of the regression coefficients is not of particular importance, since the marginal effects of economic freedom and state capacity, and the significance of those marginal effects, differ.

Table 7 is one final attempt at testing the hypothesis, and this test fails. Using "State Economic Modernity," as its measure of state capacity, with growth regression specifications nearly identical to Murphy (2019), we find what was found previously using the State Economic Modernity data – that its relationship with growth is not robust to the inclusion of fixed effects. The inclusion of the interaction term, as in Table 7, does not alter the relationship. In these regressions, economic freedom has a clear, robust relationship with growth, but State Economic Modernity does not.

State Economic Modernity can be interpreted as state capacity, given teeth: not only do we want the state to be capable of performing tasks, but we want the state to actually accomplish them. Whether this is a good test of "State Capacity Libertarianism" depends on how it is read—does "State Capacity Libertarianism" mean we wish to "get to Denmark?" If so, State Economic Modernity may actually be the more appropriate measure. The list of items that Cowen (2020) wishes the state to accomplish, including science subsidies and the space program, goes well beyond "supporting markets," even if we grant the existence of technological spillovers. But we do not find any evidence that this particular set of institutions matters for growth or that they somehow interact with economic freedom. The more narrowly circumscribed measures of state capacity seem to play a role, not State Economic Modernity.

Throughout Tables 4–7, we note that results *at the mean values* actually are clearly more positive for economic freedom than they are for state capacity; if one were to interpret these results were as horseraces, economic freedom would be the better of the two performers. However, in the following section, we will examine the complete meaning of the interaction between economic freedom

TABLE 7
Ten Year Growth Regressions, 1970–2010, with Interactions, Using "State Economic Modernity"

	(17)	(18)	(19)	(20)
Economic Freedom	0.516***	0.457***	0.829***	0.366***
	(0.077)	(0.089)	(0.106)	(0.119)
State Economic Modernity	0.689***	0.736***	−0.157	−0.040
	(0.227)	(0.223)	(0.149)	(0.156)
EF-SEM Interaction	−0.090**	−0.094***	0.023	−0.009
	(0.035)	(0.035)	(0.023)	(0.023)
LN GDP per capita, PPP	−0.275***	−0.285***	−3.783***	−4.959***
	(0.100)	(0.102)	(0.556)	(0.617)
Constant	0.939	2.570***	28.637***	39.908***
	(0.798)	(0.815)	(4.293)	(4.987)
Time F.E.	N	Y	N	Y
Country F.E.	N	N	Y	Y
R^2	0.121	0.163	0.06	0.011
n	605	605	605	605
Economic Freedom Marginal Effect at Means	0.557***	0.500***	0.818***	0.370***
	(0.082)	(0.095)	(0.102)	(0.114)
State Economic Modernity Marginal Effect at Means	0.162***	0.184***	−0.024	−0.091*
	(0.043)	(0.043)	(0.044)	(0.052)

Notes: Standard errors are robust. * Denotes confidence at 10 percent; ** denotes confidence at 5 percent; *** denotes confidence at 1 percent.

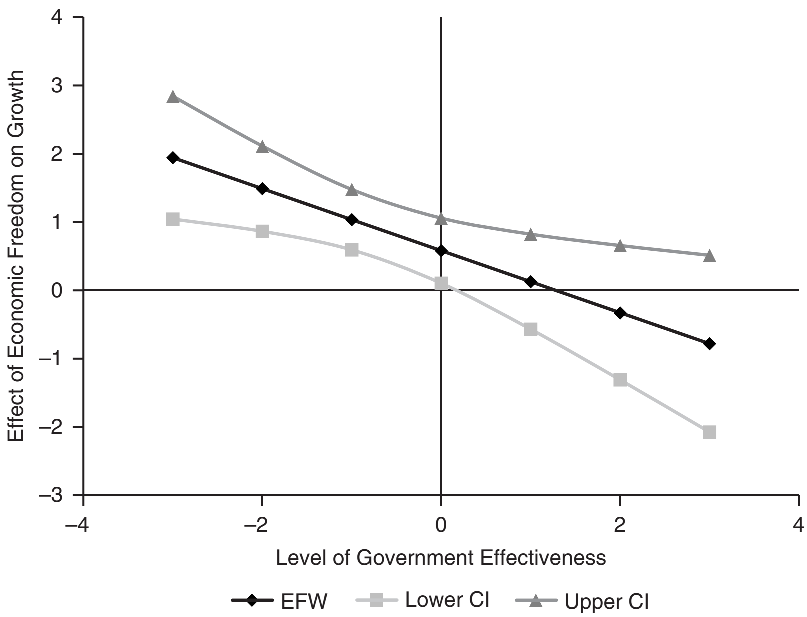
and state capacity in greater detail, which will give a sense of the effects of each variable over the "full house" of the distribution of the other, as opposed to merely the mean (see Gould 1996). We view these as the main results of the paper.

Interpretation of Marginal Effects

To fully interpret the results, we calculate the marginal effects of each set of institutions, conditional on the value of the other set of institutions. We also calculate the statistical significance of the marginal effects. We perform these calculations for the first three measures of state capacity, not "State Economic Modernity," since the pattern was not observed for the latter, and we use the specifications which include both country and time fixed effects. These specifications correspond to Regression 8, Regression 12, and Regression 16.

Government Effectiveness is expressed as a z-score. Nearly all observations will appear between a z-score of −2 and +2. We report the effect of *economic freedom*, therefore, conditional on Government Effectiveness, over the interval [−3,3]. This is found in Figure 1. The marginal effect of economic freedom is positive and statistically significant (i.e., the lower band of the 95% confidence interval is greater than zero) when Government Effectiveness takes values of −3, −2, −1, and 0. Note that the confidence bands expand around the point estimate at values further from the mean, as the estimates away from the mean are less precise due to the lack of

FIGURE 1
Marginal Effect of Economic Freedom on Growth, Conditional on Government Effectiveness

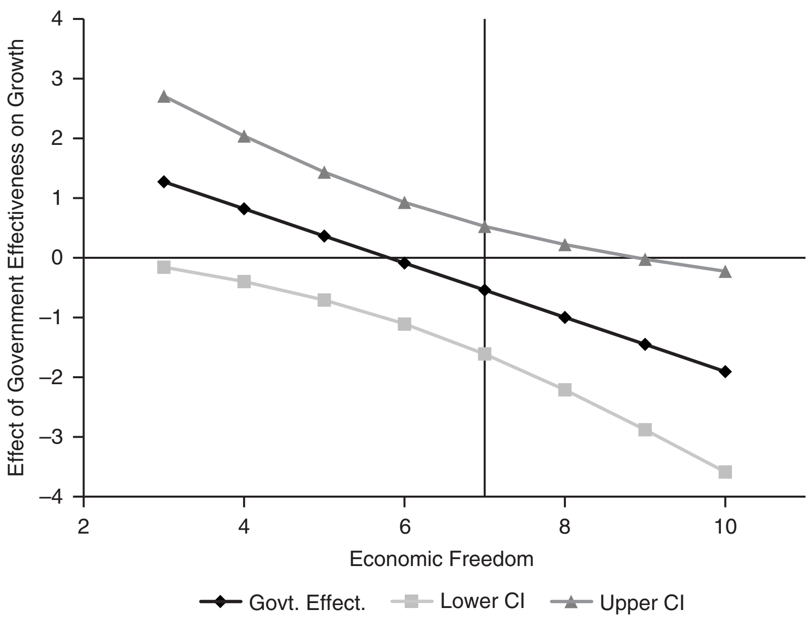


Note: Confidence interval reported is 95 percent.

density of data found there. A similar pattern will persist throughout the rest of these calculations. For the lowest values of Government Effectiveness, the effect of a unit increase in economic freedom is to increase in the average annual growth rate of almost 2 percentage points, whereas the effect is only about one half of a percentage point for middling values of Government Effectiveness. The effect is insignificant for values of Government Effectiveness above zero, with the point estimate falling to negative shortly after Government Effectiveness goes above one.

Economic Freedom can hypothetically run from 0 to 10. Few countries receive scores in practice above 8; fewer still receive scores below four. In the most recent data, one country (Venezuela) receives a score below 4 (actually 2.58); ten countries score above 8 and none score above 9. We therefore report the effect of Government Effectiveness conditional on economic freedom for values of economic freedom from three to ten. This is found in Figure 2.

FIGURE 2
Marginal Effect of Government Effectiveness on Growth, Conditional on Economic Freedom



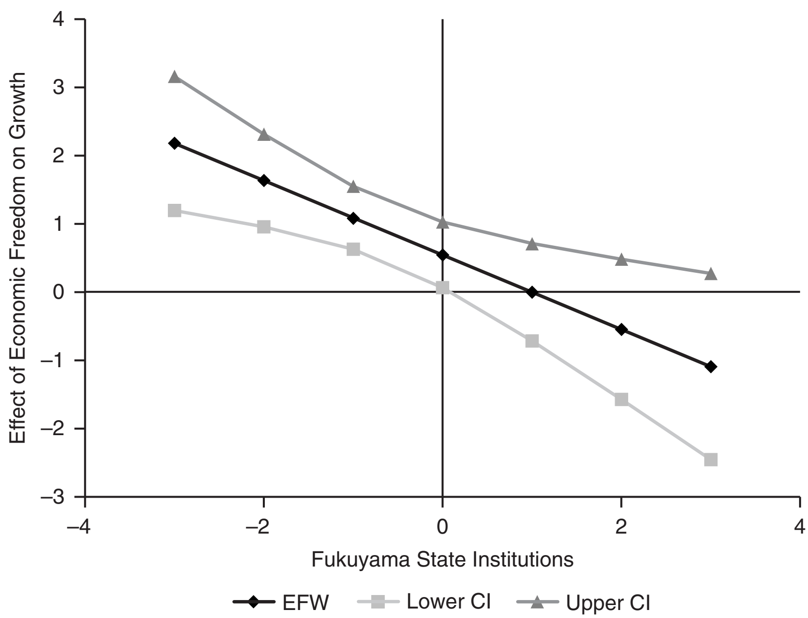
Note: Confidence interval reported is 95 percent.

Over this interval, the marginal effect of Government Effectiveness is statistically significant for no value except when economic freedom is ten, at which point it is actually *negative* and statistically significant. We should note, however, that were we to report marginal effects of Government Effectiveness on still lower levels of economic freedom, it would be positive and statistically significant.

Figure 3 and Figure 4 report the same results while swapping in the definition of strong state institutions from Fukuyama. At low levels of strong state institutions (the scale is an average of two z-scores, so the [−3,3] interval is kept), economic freedom is once again statistically significant and positive, while at high levels it is statistically insignificant. And while the same pattern emerges for the marginal effects of Fukuyama's strong state institutions as we observed for Government Effectiveness alone, the effect is not significant for any level of economic freedom within the distribution.

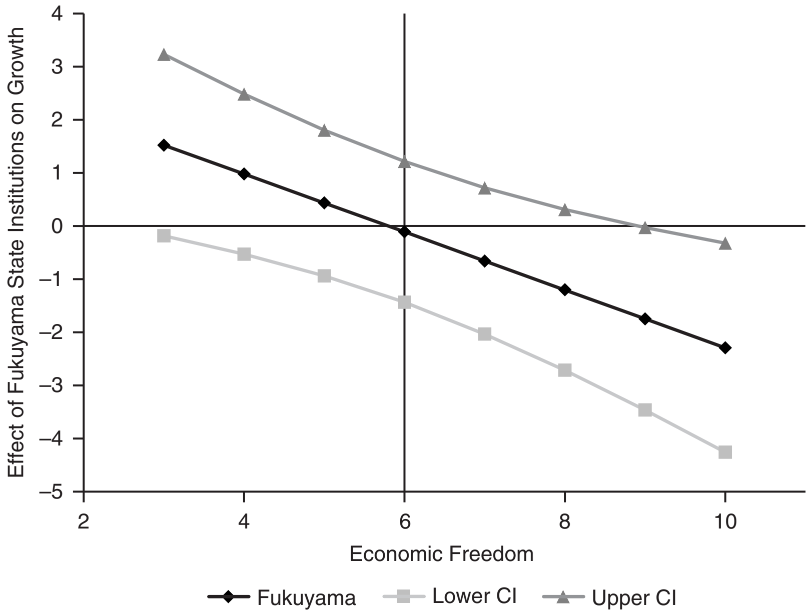
FIGURE 3

Marginal Effect of Economic Freedom on Growth, Conditional on Fukuyama State Institutions



Note: Confidence interval reported is 95 percent.

FIGURE 4
Marginal Effect of Fukuyama State Institutions on Growth, Conditional on Economic Freedom

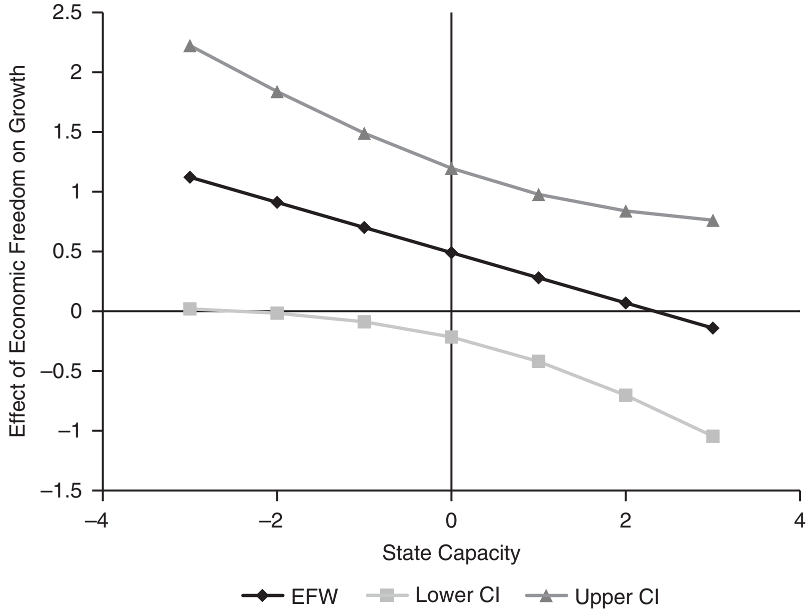


Note: Confidence interval reported is 95 percent.

These results indicate that the effect of economic freedom declines as state capacity increases. They also indicate that the effect of state capacity declines as economic freedom increases, though the effect is not significant for most levels of economic freedom. Rather than state capacity complementing economic freedom as a determinant of growth, the results indicate that at low levels of institutional quality, these sets of institutions may substitute for one another.

Figure 5 calculates the effect of economic freedom conditional on the measure of state capacity derived from *Varieties of Democracy*. (The [−3,3] scale used is again the same.) In this case, the marginal effect of economic freedom is only statistically significant at 5% at very low levels of state capacity. (With a weaker standard of significance, it remains significant.) Similarly, the marginal effect of State Capacity, as found in Figure 6, achieves statistical significance at very low levels of economic freedom. A one unit increase in state capacity corresponds to about a 1 percentage point increase in average annual

FIGURE 5
Marginal Effect of Economic Freedom on Growth, Conditional on State Capacity



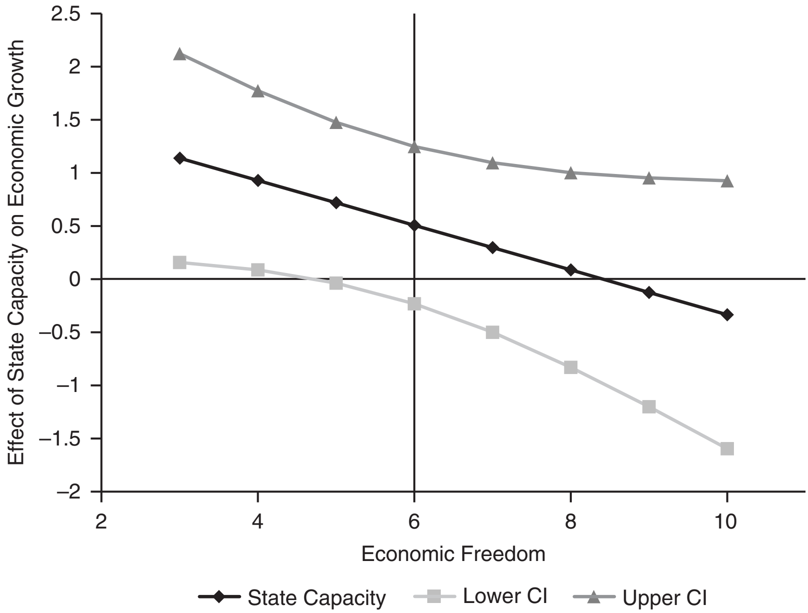
Note: Confidence interval reported is 95 percent.

economic growth; however, as economic freedom increases, the effect of state capacity declines and loses statistical significance.

Figures 1-6 are the main results of the paper: the effect of each kind of institutions is strongest when the other is very weak. But the results should not be taken too literally. We doubt that a methodology geared more towards identifying the effects of the institutions themselves (as opposed to investigating their interrelationship) would find negative point estimates. What this investigation has yielded isn't so much that state capacity or economic freedom is superior to one another, but that their effects are, in fact, intertwined.

In some sense, this is consistent with the message of "State Capacity Libertarianism." In another, it is a rejection of it. Rather than yielding especially strong growth rates when one gets both sets of institutions "right," or even merely an additive effect between the two, state capacity and economic freedom substitute for one another.

FIGURE 6.
Marginal Effect of State Capacity on Growth, Conditional on Economic Freedom



Note: Confidence interval reported is 95 percent.

Countries that have had *either* economic freedom or state capacity in the recent past have seen higher rates of economic growth, but getting more state capacity when you already have lots of economic freedom does not lead to faster economic growth.

It is worth noting, however, that it appears to be far easier to obtain more economic freedom than it is to obtain more state capacity. Getting more economic freedom is as easy as turning the dial on a tariff rate; the only constraint to doing so is the political process. Meanwhile, a facetious way of describing how to achieve more state capacity is that no one has any idea how. A more serious way of describing it is that development economists have a certain set of strategies that they believe will work for building state capacity (Andrews et al. 2017), but it's a serious issue that developing countries will actually devise strategies to fake state capacity in order to please intergovernmental organizations (Pritchett et al. 2013), because that is actually easier than building state capacity.

Secondly, while the marginal effects we ultimately conclude with are hardly ringing endorsements for the essential importance of state capacity in the story of economic development, they do not comport well with the arguments of some of the critics of State Capacity Libertarianism. For example, at least when considering how state capacity varies across countries and time since 1970, its relationship with economic performance is not driven entirely by reverse causality, which contradicts some of the framing of Geloso and Salter (2020). And to the extent that cultural variables over the relevant time interval are captured by country fixed effects, culture is not driving the relationship either. This contradicts part of the argument from Caplan (2018). Whatever the limits of our panel analysis, we find that state capacity can increase economic growth under certain conditions are robust to concerns about backwards causality (GDP per capita is controlled for) or culture or culture-adjacent variables (which are *largely*, though not *unfailingly*, addressed with country fixed effects). To recapitulate, our results are at odds with claims that state capacity is an unambiguous cause of growth, but it seems to have some role to play, if an auxiliary one, that remains after controlling for both the initial wealth and culture of a country.

Conclusion

Cowen (2020) proposes that free institutions are an insufficient condition for achieving maximal growth, and contends that the missing ingredient is a stronger, more capable state. A long-standing literature has shown that free economic institutions have a positive effect on growth, while the literature on state capacity has similarly shown robust relationships in the recent literature that has tested it. While Cowen's position has drawn rapid criticism, we test his hypothesis using an interaction between the two sets of institutions.

Using four measures of state capacity, one of which is wholly novel to this article, we find that each set of institutions has a role to play in causing economic growth, and that they are interrelated. However, when taking into account the interaction term, we find that each set of institutions has its strongest effect when the other is weakest. The effect of more state capacity when economic freedom is already high is not one of complementarity, nor is it even additive. Rather, state capacity and economic freedom appear to be substitutes for one another.

The Government Effectiveness data from *Worldwide Governance Indicators* is easily accessible, is of high quality, and is a reasonable means of assessing state capacity. Our own new method of measuring state capacity is not as extensively vetted, but it is a large panel of data that would allow one to measure the effect of state capacity in many other ways. Our results hold for three of the four measures of state capacity, but they do not hold for "State Economic Modernity." Ultimately, we suggest that, if the debate on State Capacity Libertarianism continues, it should follow the other literature on the topic of institutions and growth and focus on quantitative comparisons, as we have done here.

Appendix: Principal Component Analysis

The four components of our state capacity index are combined using principal component analysis. By accounting for the covariance between variables, principal component analysis reduces the dimensionality of a set of variables while maintaining the maximum variance. Alternatively, the first principal component condenses the four component variables into one score that preserves as much information as possible. The next principal component is orthogonal to the first and contains the maximum amount of variation not explained by the first component. Eigenvalues from our analysis indicate that the first principal component explains close to 60 percent of the total variation of the four variables, whereas none of the remaining three components explain more than 17 percent of the variation.

How well does the State Capacity index constructed from first principal component capture information contained in all four of the underlying variables? Appendix Table 1 presents correlation coefficients and factor loadings, which measure the variance of each variable explained by the new index. Factor loadings range between 0.55 for the equality of education variable to 0.46 for the state control over territory variable. Therefore, our state capacity index has a positive association with each of the underlying variables, and the amount of variation explained in the analysis is similar for all variables (an indication that state capacity index is not disproportionately derived from just one of the underlying variables). Similarly, the correlation coefficients in Appendix Table 1 between individual components and our state capacity index are all positive and at least 0.70. The State

APPENDIX TABLE 1
Correlations and Factor Loadings: Principal Component Analysis

	State Capacity Index	State Fiscal Source of Revenue	Particularistic or Public Goods	State Authority Over Territory	Educational Quality	Factor Loadings
State Capacity	1					
Index	721					
State Fiscal Source	0.7464	1				0.4873
of Revenue	721	773				
Particularistic or	0.7761	0.4206	1			0.5067
Public Goods	721	773	828			
State Authority	0.6997	0.3701	0.3947	1		0.4568
Over Territory	721	721	770	770		
Educational	0.8347	0.4791	0.5746	0.4573	1	0.5450
Quality	721	773	828	770	828	

Capacity index constructed from the first principal component is a convenient summary of the underlying variables that correspond to various aspects of state capacity.

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On the Origins of Entrepreneurial Alertness: Did Bauer and Yamey Precede Kirzner?

J. Robert Subrick

After the Second World War, the entrepreneur virtually disappeared from economic analysis (Baumol 1968). This neglect followed from the emerging models of general equilibrium that formed one aspect of the core of economic theory.[1] By assumption, the Walrasian auctioneer knew the appropriate prices necessary to equate quantity supplied with quantity demanded in each market. In addition, the auctioneer knew when and by how much to adjust prices when an exogenous factor changed such as income or production technology. Trade only occurred at equilibrium prices so that markets cleared. No market participant chose or changed prices; it occurred exogenously.

Kenneth Arrow recognized the lack of real world mechanisms to determine and adjust prices in competitive markets. He identified a logical gap in the perfectly competitive model. He wrote that "there is no place for a rational decision with respect to prices as there is with respect to quantities" (Arrow 1959: 42). Prices exist independent of

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Cato Journal, Vol. 40, No. 3 (Fall 2020). DOI:10.36009/CJ.40.3.10.

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[1]Keynesian macroeconomics formed another prominent aspect of economic theory. It too lacked any use for an entrepreneur as it focused on the movement of statistical aggregates with little concern about the underlying microeconomic processes.

consumer and firm behavior. A complete model would have to provide a solution to the conundrum.[2]

Israel Kirzner (1967, 1971, 1973) responded to Arrow's challenge. He argued for the reintroduction of the entrepreneur into economic analysis in order to explain how markets work. He offered a novel interpretation of the role of the entrepreneur in explaining how markets adjust to changes in conditions. Entrepreneurs recognized profit opportunities that no one else had. What appeared as an equilibrium price was not; it was a disequilibrium price that once recognized would yield profits. The fundamental aspect of entrepreneurship is alertness. Entrepreneurs, wrote Kirzner (1997: 72), notice "hitherto unnoticed profit opportunities" that arise from disequilibrium prices.

Kirzner did not devote many pages in his writings to discussing economic development. He focused on microeconomic processes, especially those pertaining to the mechanisms necessary to attain or approach equilibrium states. He devoted less time to understanding the role of entrepreneurship in explaining the differences in income per capita around the world. However, early in the development of his theory of entrepreneurship, he did critically examine the role of the entrepreneur in explaining comparative economic development.

In "Entrepreneurship and the Market Approach to Development," Kirzner (1971) offered a definition of the entrepreneur that predated his more well-known 1997 definition. He argued that development economics in the 1960s, outside of the Schumpeterian variety, did not include the entrepreneur and, as a result, explanations regarding the differences in income around the world were not adequate. Like general equilibrium models, models of economic development lacked an endogenous source of innovation, invention, and resource reallocation.

Kirzner's critique of development economics included a citation to P.T. Bauer and Basil Yamey's 1957 book, *The Economics of Under-Developed Countries*. He argued that their contribution missed the central feature of entrepreneurship—namely, alertness to new opportunities to make a profit. I disagree. Indeed, Bauer and Yamey (1957: 106) identified the same aspect of entrepreneurship that Kirzner would later stress—"hitherto unsuspected opportunities for profitable economic activity." Even though Kirzner (2005: 465)

[2]Few have followed up on Arrow's concerns. See Fisher (1983), Yates (2000), and Gintis (2007) for exceptions.

referred to the Bauer-Yamey book as a "classic" in development economics, he failed to fully recognize the pioneering contributions they made to understanding the true nature of entrepreneurship.

Kirzner's Critique of Development Economics in the 1960s

Neoclassical economics, as characterized by Arrow-Debreu general equilibrium, does not explain how prices emerged from the trading process. Prices existed prior to exchanges. The Walrasian auctioneer knew the necessary information regarding consumers' preferences and information as well as the cost curves facing the firms. After collecting all the information, the auctioneer identified the vector of prices necessary to clear markets. Trade only occurred after prices were announced. Arrow identified this puzzling aspect of neoclassical theory; it lacked a theory of how prices change in a competitive market: "Each individual participant in the economy is supposed to take prices as given and determine his choices as to purchases and sales accordingly; there is no one left over whose job its is to make a decision on the price" (Arrow 1959: 43). Prices existed independent of the decisions of individuals. No one within the model set or changed prices.

Interest in the entrepreneur increased in development economics in the early 1960s as alternatives to general equilibrium theorizing appeared. Irma Adelman (2001) argued that entrepreneurship became the central variable in development policy from 1958 to 1965, while McClelland (1961), Hagen (1963), Baumol (1968), and Leibenstein (1968) each offered their own attempt to include the entrepreneur. Peter Kilby (1971) identified no less than 13 aspects of entrepreneurship related to economic development. Entrepreneurship appeared on the intellectual agenda but its essential component—alertness—did not.

Kirzner (1971) developed the arguments that would later appear in *Competition and Entrepreneurship* (1973). He criticized development and growth economics for misunderstanding the role of the entrepreneur:

> The literature dealing with development proper gives some attention to entrepreneurship, although little effort has been devoted to formulating a clear theoretical understanding of

> the entrepreneurial role. Discussion has revolved primarily around the possibilities of an "entrepreneurial climate" emerging in hitherto primitive economies; as weak in underdeveloped countries as frequently assumed; around the feasibility of relying upon foreign entrepreneurs, and similar issues [Kirzner 1971: 194].

In a footnote following the above quote, Kirzner cites Bauer and Yamey (1957). He includes them in the group of economists who have discussed entrepreneurship but failed to address its central feature of alertness—perceiving hitherto unnoticed profit opportunities. He should not have, because Bauer and Yamey identified the central aspect of entrepreneurship that Kirzner stressed. They, too, recognized and discussed entrepreneurial alertness.

Kirzner goes on to argue that:

> However valuable, these discussions appear either to lack an explicit theoretical framework within which to examine the relevant issues, or, at best, to be founded rather shakily on the theory of entrepreneurship as expounded by Schumpeter in his justly famous work. . . . Consequently, the real function of the entrepreneur in a developing market economy seems often to have been poorly understood, and the plausibility of rapid development under alternative economic systems to have been accepted uncritically [Kirzner 1971: 195].

Kirzner recognized the importance of the entrepreneur in explaining economic growth and development as did many others in the 1960s. Unlike the others, Kirzner identified an aspect of entrepreneurship they did not. In order for economies to grow, someone had to grasp "the knowledge which might otherwise remain unexploited" (Kirzner 1971: 197). But Kirzner was not the first to recognize the importance of alertness.

P.T. Bauer and Basil Yamey on Entrepreneurship

Although much of development economics in the 1950s and 1960s neglected the entrepreneur, the contributions of P. T. Bauer and Basil Yamey did not. Rather, they emphasized the importance of the entrepreneur in their earliest writings. Bauer clearly identified entrepreneurship as a vital but neglected aspect of orthodox development economics. His early studies on trade in West Africa (Bauer 1954) provided ample evidence that entrepreneurship was omnipresent and was vital in understanding how economies evolve from low to high levels of income per capita. For example, Bauer (1954: 30) wrote that the trader-entrepreneur (as he referred to entrepreneurs) in Nigeria and the Gold Coast exhibited the following characteristics: "exceptional effort, foresight, resourcefulness, thrift and the ability to perceive economic opportunity." Trader-entrepreneurs, at least those in Nigeria and the Gold Coast, perceived profit opportunities. They were alert. Entrepreneurs recognized the gains that emerged from changes in relative scarcities, new information, new ideas, or serendipity.

In other writings, Bauer continued to argue that the trader-entrepreneurs existed throughout the developing world. His field-work in sub-Saharan Africa provided plenty of evidence. According to Bauer ([1963] 1972: 347), "The prominence of foreigners in African commerce reflects technical and administrative skills, thrift, [and] the ability to perceive and take advantage of economic opportunity." Once again, entrepreneurs perceive economic opportunity when it arises. They do not simply respond to a given set of prices, production techniques, or information. Entrepreneurs engage in more than arbitrage. They recognize profit opportunities no one else had and develop new means to attain their goals.

Bauer and Yamey (1957) offered a comprehensive discussion of the source of economic development that extended beyond conventional models at the time that stressed capital formation or the rate of savings. They stressed a number of factors including the quality of public institutions and policies, the importance of international and intranational trade, values, and attitudes. More importantly, central to their argument, they stressed entrepreneurial alertness and its perception of "hitherto unsuspected opportunities."

Bauer and Yamey began their discussion of the entrepreneur by noting that entrepreneurship occurs quietly through small changes that raise productivity. Better knowledge of prices and costs allow the entrepreneur to make profits. Knowledge of productivity increasing techniques also represents an aspect of entrepreneurship. But they extended entrepreneurship beyond greater knowledge of existing conditions. In some cases, it leads to significant changes. In particular, "Innovation and the exercise of entrepreneurship in the sense of creating or taking advantage of *hitherto unsuspected opportunities for profitable economic activity* are often dramatic in their impact," wrote Bauer and Yamey (1957: 102, emphasis added). They went on to argue that "the ability of individuals to perceive new opportunities for profit and the ability and willingness to exploit them are indeed crucial in economic development" (ibid.). From these passages, it is clear that Bauer and Yamey held views similar to those of Kirzner regarding the central features of entrepreneurship.

Bauer and Yamey (1957: 102) pointed to how entrepreneurs help generate new ideas and new techniques that foster economic development:

> The activities of the innovators or entrepreneurs who introduce new crops or techniques of production or open to new trading routes or areas of cultivation, and of those who appreciate the potentialities of new ideas and novel methods and adopt or adapt them for local use, raise the level of economy.

Kirzner's contribution to the theory of entrepreneurship clearly has its antecedents in the works of Bauer and Yamey. Yet, their contribution appears to have been forgotten. There is no mention of their pioneering work on entrepreneurship in Kirzner's seminal book, *Competition and Entrepreneurship* (1973); nor in Kirzner's 1997 *Journal of Economic Literature* article, which is a survey of his theory of entrepreneurship. Neverthelss, in Kirzner's (2005) contribution to a conference volume in honor of Bauer after his death, he called Bauer and Yamey's 1957 book a "classic."

Conclusion

Bauer and Yamey's (1957) identification of entrepreneurship with "hitherto unsuspected opportunities for profitable economic activity" prior to Kirzner does not imply that he did not make a scientific contribution to the theory of entrepreneurship. Originality is only one aspect of scientific progress. As George Stigler (1955: 294) noted, "Scientific originality in its important role should be measured against the knowledge of a man's contemporaries. If he opens their eyes to new ideas or to new perspectives on old ideas, he is important in the scientifically important sense."

Even though Bauer and Yamey identified an aspect of entrepreneurship that had eluded development economists and the profession more broadly, Kirzner's discussion opened the eyes of others. For example, Schultz (1975, 1990) developed an alternative theory of entrepreneurship that emphasized the role of human capital partially in response to Kirzner in order to better understand the process of economic development. Moreover, Baumol (1990) differentiated between productive and unproductive entrepreneurship, and differentiated his approach from Kirzner's. Although, Bauer and Yamey emphasized the role of entrepreneurship in explaining the process of economic development, Kirzner brought a new perspective to an old idea.

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How the Classical Gold Standard Can Inform Monetary Policy

James A. Dorn

Watching the frenzy surrounding Judy Shelton's confirmation hearing before the Senate Banking Committee on February 13, one is led to believe that the gold standard is a "nutty" idea, for which no serious economist or monetary policymaker could possibly have a kind word (see U.S. Senate 2020). This article critiques that wholesale refutation of the gold standard. In recent years (as well as in the past), both serious economists and reputable monetary policymakers have recognized the benefits of a gold standard in reducing regime uncertainty and promoting monetary and social order. Whatever one may think of President Trump's recent Fed picks, the gold standard itself deserves more respect than it's been getting.

Misguided Criticisms

All serious persons agree that stable money of some sort is crucially important to social order. But journalists and others commenting on Judy Shelton's views took for granted that a gold standard could not be consistent with such stability. Catherine Rampell (2020),

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Cato Journal, Vol. 40, No. 3 (Fall 2020). DOI:10.36009/CJ.40.3.11.

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a respected journalist with *The Washington Post*, wrote that "pegging the dollar to gold could restrict liquidity just when the economy needs it most, as happened during the Great Depression," while Robert Kuttner (2020), another widely read journalist, opined:

> As we painfully learned from economic history, a gold standard is profoundly deflationary, because it prevents necessary expansion of the money supply in line with economic growth. No serious person advocates it. . . . [I]f you want lower interest rates, the last thing you want is a gold standard.

Many economists have also argued against the gold standard. Lawrence H. White (2008, 2013, 2019b) has summarized their main arguments and concluded that they often set up straw men, misrepresent historical facts, and fail to understand that a genuine gold standard—as opposed to a pseudo gold standard—defines the unit of account as a given weight of gold, and gold serves as "the ultimate medium of redemption" (White 2013: 20). This is where a misunderstanding of the fundamentals occurs. According to White:

> To describe a gold standard as fixing gold's price in terms of a distinct good, domestic currency, is to begin with a confusion. A gold standard means that a standard mass of gold (so many troy ounces of 24-karat gold) defines the domestic currency unit. The currency unit (dollar) is nothing other than a unit of gold, not a separate good with a potentially fluctuating market price against gold. That $1, defined as so many ounces of gold, continues to be worth the specified amount of gold—or, in other words, that x units of gold continue to be worth x units of gold—does not involve the pegging of any relative price. Domestic currency notes (and checking-account balances) are denominated in and *redeemable for gold, not priced in gold*. They don't have a price in gold any more than checking account balances in our current system, denominated in fiat dollars, have a price in fiat dollars [White 2013: 4; emphasis added; also see White 1999: 27].

The pre-1914 classical gold standard should not be confused with the interwar gold exchange standard, which was a pseudo gold standard. Treating them as a single system—called "the gold standard"—is highly misleading. The prewar regime (1879 to 1914) was a market-driven monetary system, in which the money supply responded to the demand for money and the dollar was convertible into gold. There was no U.S. central bank overseeing the system; the Federal Reserve System did not begin operation until 1914. In contrast, the interwar gold exchange standard was a managed regime under the direction of discretionary central bankers.

In comparing real versus pseudo gold standards, Milton Friedman (1961: 78) emphasized that a "pseudo gold standard violates fundamental liberal principles in two major respects. First, it involves price fixing by government. . . . Second, and no less important, it involves granting discretionary authority . . . to the central bankers or Treasury officials who must manage the pseudo gold standard. This means the rule of men instead of law" (Friedman 1961: 78). Although Friedman himself was not an advocate of the gold standard, he recognized its benefits in limiting the size of government and producing long-run price stability.

Unlike Friedman, David Wilcox, a former director of the Division of Research and Statistics at the Federal Reserve Board, does not distinguish between real and pseudo gold standards. He argues that the "gold standard" was "a disastrous experiment in monetary policymaking," and that during the roughly 50 years since President Richard Nixon closed the gold window in August 1971, "central banks have learned how to control inflation with spectacular success." Perhaps, but as White (2019b) has noted: "the inflation rate was only 0.1 percent over Britain's 93 years on the classical gold standard, and "only 0.01 percent in the United States between gold resumption in 1879 and 1913." He shows that, although the Fed has made progress since the Great Inflation of the 1970s and early 1980s, the longer-run record cannot match that of the real gold standard. The U.S. annualized inflation rate, under a pure fiat money regime, was 4.0 percent for the 50-year period from April 1969 to April 2019 (as measured by the urban consumer price index). Moreover, Wilcox fails to recognize that during the classical gold standard, there was no U.S. monetary policy as the term is commonly understood; there was no central bank!

While some highly respected authorities have good things to say about the classical gold standard, the interwar gold exchange standard has been universally condemned. Indeed, it was the breakdown of that standard—which depended much more heavily on cooperation among various central banks than its pre-1914 counterpart—that contributed to the Great Depression (see Bordo 1981; Eichengreen 1987; Friedman 1961; Irwin 2010; and Selgin 2013).[1]

Furthermore, not even the generally defective gold exchange standard can be blamed for having restricted liquidity in the United States' case. So far as the U.S. was concerned, as Friedman states:

> It was certainly not adherence to any kind of gold standard that caused the [Great Depression]. If anything, it was the lack of adherence that did. Had either we or France adhered to the gold standard, the money supply in the United States, France, and other countries on the gold standard would have increased substantially.[2]

Even a constitutional political economist like James Buchanan can point to the gold standard and see both its benefits and flaws. He writes: "I am not necessarily anti-gold standard. I think gold would be far better than what we have. But I think there might be better regimes" (Buchanan 1988: 45).

The gold standard is not a panacea. It is only one of many monetary arrangements that might succeed in checking arbitrary government. There are others. And all of them are imperfect. Because no arrangement is ideal, we must choose among realizable, imperfect alternatives—there are always tradeoffs. But it is also important to take a principled approach to thinking about monetary reform and not to simply accept the status quo.

Most economic historians accept that the "gold standard"—or, more accurately, the interwar "gold exchange standard"—contributed to the Great Depression. Yet the belief that the *pre-1914 gold standard* was responsible for the U.S. economic collapse of the early 1930s is a myth. It was the Federal Reserve's policy mistakes, rather than its commitment to the gold standard, that was the major cause of the Great Depression. That, at least, is what Milton Friedman and Anna J. Schwartz claim in their landmark book, *A Monetary History of the United States*.

[1]The gold exchange standard operated from 1925 to 1931. Under that system, central banks could sterilize gold flows to insulate their domestic money supplies. Moreover, countries (other than the United States and United Kingdom) were allowed to hold their reserves in the form of dollars or pounds, in addition to gold. This system collapsed in 1931, after the UK ended convertibility to stem large outflows of gold and capital (see Bordo 1981).

[2]Quoted in Humphrey and Timberlake (2019: i).

The United States entered the 1930s with massive excess gold reserves. The Fed was not constrained in using those reserves to expand base money, and thus the broader money supply. As Richard Timberlake wrote in 2008:

> By August 1931, Fed gold had reached $3.5 billion (from $3.1 billion in 1929), an amount that was 81 percent of outstanding Fed monetary obligations and more than double the reserves required by the Federal Reserve Act. Even in March 1933 at the nadir of the monetary contraction, Federal Reserve Banks had more than $1 billion of excess gold reserves. . . . Whether Fed Banks had excess gold reserves or not, all of the Fed Banks' gold holdings were expendable in a crisis. The Federal Reserve Board had statutory authority to suspend all gold reserve requirements for Fed Banks for an indefinite period [Timberlake 2008: 309].[3]

More recently, both Timberlake and Thomas Humphrey, in their path-breaking book—*Gold, The Real Bills Doctrine, and the Fed: Sources of Monetary Disorder, 1922–1938*—identified the real culprit responsible for the Fed's misconduct. Instead of adhering to the rules of the gold standard, Fed officials managed the Fed's policies according to a fallacious theory known as the "Real Bills Doctrine." That doctrine holds that the money supply can be regulated by making only short-term loans based on the output of goods and services. The problem is that adhering to that doctrine would link the nominal value of the money stock to the nominal expected value of real bills, and there would be no anchor for the price level.

Lloyd Mints had it right when he argued:

> Whereas convertibility into a given *physical amount* of specie (or any other economic good) will limit the quantity of notes that can be issued, although not to any precise and foreseeable extent (and therefore not acceptably), the basing of notes on a given *money's worth* of any form of wealth . . . presents the possibility of unlimited expansion of loans, provided only that the eligible goods are not unduly limited in aggregate value [Mints 1945: 30, emphasis in original].

[3]Also see Selgin (2015a).

Setting up straw men, misreading economic history, and using ad hominem arguments are no way to conduct a hearing or improve monetary policy. Richard Timberlake is correct in noting that unless policymakers understand the real causes of the Great Depression—namely, the failure of Fed policy to maintain a steady path for nominal GDP and the failure of the Real Bills Doctrine to guide monetary policy in an era that did not have a real gold standard—then they "are forever in danger of repeating past mistakes or inventing new ones" (Timberlake 2007: 326).

It is true that, during the classical gold standard, mild deflation did occur, but it was generated by robust economic growth and was beneficial, in contrast to the severe deflation that occurred during the Great Depression due to Fed mismanagement of the money supply.[4]

In their study of the link between deflation and depression for 17 countries over more than a century, Andrew Atkenson and Patrick J. Kehoe find:

> The only episode in which there is evidence of a link between deflation and depression is the Great Depression (1929–1934). We find virtually no evidence of such a link in any other period. . . . [M]ost of the episodes in the data set that have deflation and no depression occurred under a gold standard [Atkenson and Kehoe 2004: 99, 101].

Moreover, under a commodity standard, long-run price stability allowed the British government to issue bonds without a maturity date, called "consols." Interest rates on those securities were relatively low and actually fell, going from 3 percent in 1757 to 2.75 percent in 1888, and 2.5 percent in 1903. The United States issued consols during the classical gold standard, in the 1870s.[5]

What Policymakers Should Know About the Gold Standard

George Selgin (2015a) has provided a list of 10 things every economist and policymaker should know about the gold standard (Table 1). It is a response to various criticisms and fallacies that

[4]On the two types of deflation, "good" and "bad," see Selgin (2015b) and Bordo, Lane, and Redish (2004).

[5]See https://en.wikipedia.org/wiki/Consol_(bond).

TABLE 1
Selgin's 10 Essential Points About the Classical Gold Standard

1. The Gold Standard wasn't an instance of government price fixing. Not traditionally, anyway.
2. A gold standard isn't particularly expensive. In fact, fiat money tends to cost more.
3. Gold supply "shocks" weren't particularly shocking.
4. The deflation that the gold standard permitted wasn't such a bad thing.
5. It wasn't to blame for 19th-century American financial crises.
6. On the whole, the classical gold standard worked remarkably well (while it lasted).
7. It didn't have to be "managed" by central bankers.
8. In fact, central banking tends to throw a wrench in the works.
9. "The "Gold Standard" wasn't to blame for the Great Depression.
10. It didn't manage money according to any economists' theoretical ideal. But neither has any fiat-money-issuing central bank.

Source: Selgin (2019a).

have persisted for some time, some of which have already been mentioned in the previous section. Without a keen understanding of each of the 10 points, which Selgin addresses in detail, confusion over the essence of a genuine gold standard (versus a pseudo gold standard) will lead to a dismissal of the key lesson of the classical gold standard—namely, its importance as a self-adjusting, spontaneous order and its consistency with limited government and freedom.

A rational discussion of the gold standard, as an alternative to a fiat money system, requires that journalists, economists, and policymakers become familiar with these 10 points and learn the details.[6] A better understanding of the classical gold standard and the flaws of a pseudo gold standard would help inform monetary policy—even if there is little chance we could ever return to a true gold standard.

[6]White (2008, 2013) has prepared similar lists.

Importance of Thinking About Monetary Alternatives

There are many alternative monetary regimes, ranging from a pure commodity standard to a pure fiat money system. Serious debate over those alternatives is a worthwhile project, which Cato has been involved with for decades.[7]

The importance of studying the properties of alternative monetary regimes and their consequences for safeguarding an essential property right—namely, the promise of a monetary unit that maintains a stable purchasing power in both the short- and long-run—cannot be understated. Indeed, we should not forget that Article 1, Section 8, of the U.S. Constitution grants Congress "the power . . . to coin money, regulate the value thereof, and of foreign coin, and fix the standard of weights and measures." That power was given to Congress, not to inflate the money supply, but to safeguard its value under a rule of law. Consequently, sympathy for gold can begin with a strict reading of that constitutional clause, the language of which clearly presupposes a commodity (gold or silver) standard. As Milton Friedman himself told members of Congress, "As I read the original Constitution, it intended to limit Congress to a commodity standard" (Friedman 2014: 652).

The "chief architect" of the Constitution, James Madison, was clear that his preference was for a commodity standard, not for a fiat money standard:

> The only adequate guarantee for the uniform and stable value of a paper currency is its convertibility into specie—the least fluctuating and the only universal currency. I am sensible that a value equal to that of specie may be given to paper or any other medium, by making a limited amount necessary for necessary purposes; but what is to ensure the inflexible adherence of the Legislative Ensurers to their own principles and purposes? [Madison 1831; see Dorn 2018: 93].

Maybe such a concern is quaint, but it's hardly nutty. In fact, it's backed by a considerable base of knowledge on the history of money and monetary arrangements (see, e.g., White 2008).

[7]See, for example, *The Search for Stable Money* (Dorn and Schwartz 1987) and *Monetary Alternatives: Rethinking Government Fiat Money* (Dorn 2017).

Michael Bordo and Finn Kydland (1995: 424) highlight the gold standard's ability to solve the time-inconsistency problem:

> Our approach to gold-standard history posits that adherence to the fixed price of specie, which characterized all convertible metallic regimes including the gold standard, served as a credible commitment mechanism (or a rule) to monetary and fiscal policies that otherwise would be time inconsistent. On this basis, adherence to the specie standard rule enabled many countries to avoid the problems of high inflation and stagflation that troubled the late 20th century.
>
> Furthermore, we argue that the gold standard that prevailed before 1914 was a contingent rule. Under the rule, gold convertibility could be suspended in the event of a well-understood, exogenously produced emergency, such as a war, on the understanding that after the emergency had safely passed convertibility would be restored at the original parity. Market agents would regard successful adherence as evidence of a credible commitment and would allow the authorities access to seigniorage and bond finance at favorable terms.

In sum, "When an emergency occurred, the abandonment of the [gold] standard would be viewed by all to be a temporary event since, from their [the public's] experience, only gold or gold-backed claims truly served as money" (Bordo and Kydland 1995: 429).

Arthur J. Rolnick and Warren E. Weber, in their classic study "Money, Inflation, and Output under Fiat and Commodity Standards," find that, "under fiat standards, rates of money growth, inflation, and output growth are all higher than they are under commodity standards" (Rolnick and Weber 1997: 1320). And Nobel Laureate economist James Buchanan, who favored a rules-based approach to monetary policy, argues:

> The dollar has absolutely no basis in any commodity base, no convertibility. What we have now is a monetary authority [the Fed] that essentially has a monopoly on the issue of fiat money, with no guidelines that amount to anything; an authority that never would have been legislatively approved, that never would have been constitutionally approved, on any kind of rational calculus [Buchanan 1988: 33].

Like Buchanan, the constitutional political economist is interested in thinking about how to shape institutions to limit the power of government and allow free individuals to go about their own affairs. The pre-1914 gold standard provided "rules of the game," in which human creativity flourished—and people could count not only on long-run price stability, but also on stable exchange rates. Finally, most authorities agree that the period from 1880 to 1914, when the classical gold standard prevailed, was one of innovation, wealth creation, free trade, and sound money. Joseph Schumpeter (1954: 405–6) emphasized:

> An "automatic" gold currency is part and parcel of a laissez-faire and free trade economy. It links every nation's money rates and price levels with the money-rates and price levels of all the other nations that are "on gold." It is extremely sensitive to government expenditure and even to attitudes or policies that do not involve expenditure directly, for example, to foreign policy, to certain policies of taxation, and, in general, to precisely all those policies that violate the principles of [classical] liberalism. . . .It is both the badge and the guarantee of bourgeois freedom—of freedom not simply of the bourgeois *interest*, but of freedom in the bourgeois *sense*. From this standpoint a man may quite rationally fight for it.

Even John Maynard Keynes recognized the great benefits stemming from the pre-1914 gold standard:

> What an extraordinary episode in the economic progress of man that age was which came to an end in August 1914! . . . The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as we might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages [Keynes 1020: 11].

It is a legitimate and important role of scholars to think about monetary alternatives—even when they may not appear politically feasible. This is one reason the Cato Institute established a Center for Monetary and Financial Alternatives. It's also why each year, our

Annual Monetary Conference brings together the best minds to discuss, in a civil manner, how to improve current policies in order to increase trust in the future value of money and promote financial stability.[8] From constitutional political economists to central bankers, we welcome contributions from across the spectrum in what we consider a crucial ongoing conversation.

What Would Gold Principles Bring to the Fed?

If one is unfit to serve on the Federal Reserve Board because he or she sees the beauty of the classical gold standard, then Alan Greenspan also should never have been allowed to serve on the Board. He too was a strong defender of the classical gold standard. In 1966, he wrote:

> An almost hysterical antagonism toward the gold standard is one issue which unites statists of all persuasions. They seem to sense—perhaps more clearly and subtly than many consistent defenders of laissez-faire —that gold and economic freedom are inseparable, that the gold standard is an instrument of laissez-faire and that each implies and requires the other. In order to understand the source of their antagonism, it is necessary first to understand the specific role of gold in a free society [Greenspan 1966].

Although Greenspan lauded the classical gold standard, he realized that, once appointed, he would have to work within the existing legal framework—not advocate a return to the pre-1914 gold standard. Yet, his knowledge of how that system worked to maintain the value of money—and to allow interest rates, not central bankers, to allocate scarce capital—helped inform his approach to monetary policy at the Fed. Even many years after he began his long tenure as Fed chairman, Greenspan stated, in response to a question during his hearing before the House Committee on Financial Services on July 18, 2001: "Mr. Chairman, so long as you have fiat currency, which is a statutory issue, a central bank properly functioning will endeavor to, in many cases, replicate what a gold standard would itself generate" (Greenspan 2001: 34).

[8]See Dorn (2019) for a history of Cato's Annual Monetary Conference.

Conclusion

The operation of the classical gold standard offers many lessons for policymakers, including the importance of a credible commitment to a rules-based monetary regime and to enforceable private contracts under a just rule of law. This does not mean we should necessarily return to a gold standard, but simply that we should not dismiss that system as a "nutty idea." The gold standard should be understood as one approach for attaining monetary stability. It is a rules-based system that brings about long-run price stability via market forces and the free flow of gold. It is also a monetary regime that is consistent with individual freedom and the rule of law. To be operational, common money (i.e., currency and checkable bank deposits) must be fully convertible into gold at the par value (i.e., as defined by the dollar as a given weight of gold). A central bank is unnecessary for the operation of a genuine gold standard.

Without a sound understanding of the 10 essential points about the classical gold standard, as expounded by Selgin (Table 1), journalists and others will continue to perceive the gold standard as a "nutty" idea .They will see central banking, under a discretionary fiat money regime, as the only viable alternative. That would be a huge mistake.

Learning from the past means recognizing the benefits—as well as the costs—of alternative monetary systems. Those who wish to improve the current system must offer new ideas that draw from the past, but also offer imaginative ideas for achieving monetary stability. Moving toward a rules-based monetary regime would, itself, be to honor lessons learned during the classical gold standard.

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Book Reviews

Markets Against Modernity: Ecological Irrationality, Public and Private
Ryan H. Murphy
Lanham, Md.: Lexington Books, 2020, 212 pp.

There is a war happening, but it is not one between nations. It's a war between millions of years of human evolution and a few hundred years of rapid economic growth. In *Markets Against Modernity*, Ryan Murphy, Senior Research Fellow at the O'Neil Center for Global Markets and Freedom at Southern Methodist University, describes this war as "Ecological Irrationality." It is a clash between modern institutions (e.g., the rule of law, science, capitalism, globalism, and pluralistic democracy) and the influence of prehistoric habits on our minds. It is a clash that has spawned systemic errors across economic, social, and political relationships. It is a clash that can finally be analyzed and understood, now that Murphy has thrust it into the light.

He begins Chapter 1 with the relatively innocuous title "Trade is Good" and a discussion of the rise of DIY ("Do It Yourself") culture. Whether one seeks to make a simple pencil, a chicken sandwich, or an electric toaster, there is an important distinction—as famously noted by *Jurassic Park's* fictional chaos theorist Ian Malcom—between what one could do and what one should do. It is true, writes Murphy, that offshoring, outsourcing, and layoffs are less than aesthetically pleasing, but they "are a crucial part of the story of how we went from using monks as scribes . . . to giving away free pens and

Cato Journal, Vol. 40, No. 3 (Fall 2020).

pads of paper to whoever shows up." DIY "evangelists" may believe their cause benefits society, but the truth is quite the opposite.

Murphy goes on to discuss why trade is such a controversial topic for the general public. He cites an inability to interact with all 8 billion of our neighbors. In fact, he warns that we can barely keep track of more than a 100 of them—a limitation that traces back to humanity's tribal origins. Murphy warns that "[w]e are militantly skeptical of the idea that economic growth is a thing for us: we assume that what others call 'economic growth' will always be at the expense of us and those whom we identify with."

Moving beyond trade, Chapter 2 delivers a crash course in public choice as Murphy seeks to explain why "[t]here's no shortage of bad policies, even in countries with the world's most effective governance." After an introduction to the Virginia, Bloomington, Rochester, and Chicago schools of Political Economy, Murphy turns to George Mason University economist Bryan Caplan's theory of rational irrationality—a theory which diverges from the theory of rational ignorance in order to explain why people hold systematically biased beliefs with a high degree of certainty, despite little supporting evidence.

To draw on the example Murphy uses, consider the case of a policy choice. It would be difficult, if not impossible, for the average citizen to fully decode the potential ramifications of a new financial regulation, but that citizen will still vote for or against it. Per the theory of rational ignorance, we should observe random results as citizens effectively flip a coin for their decision. Yet, this is not what we see. Rational ignorance gets it right that understanding legislation has an extremely high cost with a small expected benefit for the average citizen. Thus, we can assume voters will rationally choose not to collect the necessary information to understand it perfectly. However, rational ignorance fails to explain why we observe systematic trends where it otherwise predicts randomness. Bryan Caplan explains this phenomenon in his 2007 book, *The Myth of the Rational Voter*, as "rational irrationality." Caplan explains that we can graph the "demand for irrationality" to show that people are more likely to behave irrationally as the cost of doing so decreases. Where the cost of irrationality is zero, one reaches a "bliss point" in which beliefs can be held without fear of consequence. Despite little confirming evidence, or even evidence to the contrary, these beliefs are held and acted on with certainty. This is why one can observe systematic voting in favor of ethnocentric policies (anti-foreign bias) despite the evidence that trade is good. However, when the cost of irrationality is high (e.g., waving one's arms in an attempt to fly), these same individuals behave rationally.

It is against this background that Murphy introduces his theory of ecological irrationality in Chapters 3 and 4. Although the name might be intimidating, the logic is quite intuitive. First, let's consider what it means to be ecologically rational. The majority of human history has been challenging for individuals, and Murphy argues that the echoes of these past challenges still linger in our minds. Becoming startled by a stick resembling a snake or a sound on a dark night might result in some teasing from friends, but this reaction is rational, or efficient, given the constraints of the environment. These are cases where an abundance of caution has long preserved humanity's survival. Because, as Murphy notes, this "way of thinking is suited for efficiently dealing with the constraints of the environment . . . , it is defined as ecologically rational."

However, when "we apply the mental tools we developed in the social environment of prehistory to modern day societies, politics, and economics," it becomes clear that something is amiss. People reject trades with strangers as if they were from a waring tribe. Others resist vaccines in pursuit of a more natural state of life. It's here that Murphy points out that these behaviors are no longer efficient, given the constraints of the modern environment. These behaviors are ecologically irrational.

Murphy warns that the impulses that drive us away from modern institutions (e.g., the rule of law, science, capitalism, globalism, and pluralistic democracy) are deeply embedded in us. These impulses have been honed over the entire course of human evolution. Modern institutions have only existed for a small portion of that history. Although, that is not to say we are without control. To avoid falling victim to persuasive efforts appealing to our inner ancestors, Murphy identifies four signals of ecological irrationality: authenticity, naturalness, folk economics, and conspicuous consumption status signaling. Each signal offers a unique insight into the human mind's perception of the surrounding world.

In Chapter 6, Murphy follows up with four possible solutions to mitigate ecological irrationality from a social perspective. Unfortunately, although each offers a unique incentive structure that can help inform our understanding of the world, all suffer from the need for radical change in order to be implemented. Regardless if one prefers one solution over another, the required overhaul of the existing government structure makes these solutions less than feasible if one was hoping for practical applications.

Returning to the DIY movement, Chapter 8 hedges earlier claims—though only slightly. After more than 100 pages, Murphy acknowledges the existence of DIY enthusiasts who are simply enthusiasts. He is absolutely correct in his analysis of the "poverty of DIY"—namely, that it is difficult to consider the value of one's own leisure time, capital accumulation (such as a work bench and set of tools in the garage), and other hidden costs. However, his distinction between pleasurable and daunting work, as well as his noting of the IKEA effect (that consumers place a disproportionally high value on products they create themselves), serve as more of a passing acknowledgement than a robust review of DIY benefits. To this end, I would point Murphy in the direction of Caplan's lesson on both Kaldor-Hicks efficiency and Steven Landsburg's analysis of drug legalization. In the lesson, Caplan demonstrates how the art of economics consists in tracing extended consequences, not just extended costs.

Chapter 9 follows with a similar argument on "Social Luddism," a term Murphy uses to describe those who seek social status in a manner akin to rent-seeking. One example he presents is wine expertise. People use their time and energy to gain knowledge and status, but Murphy argues that this results in waste from a social standpoint. Disregarding the motte and bailey fashion of some of the arguments, this example suffers from a lack of consideration in regard to possible benefits. Yes, there is a cost associated with this activity, but is there truly no value in the refinement of one's individual enjoyment of wine? What of other hobbies or interests?

Although such portions of Chapters 8 and 9 raise an eyebrow, they do offer a fitting segue into the discussion of expert credibility in Chapter 10. Murphy uses Anneberg University professor Philip Tetlock's work on experts to highlight the importance of healthy skepticism in a world influenced by ecological irrationalities. The optimal case is to have society trust experts only where the marginal benefit equals the marginal cost. Below this, people die from preventable diseases because they ignored doctors. However, above this, blind faith leads one down the road to serfdom. It's a difficult line to walk, but the evidence for ecological irrationality highlighted across the book is proof that it's important to maintain such skepticism.

Markets are complicated. But markets are not abstract constructs; they are made up of millions of individuals, each of whom have their own unique preferences. If we wish to understand what influences the market, it is crucial that we understand what influences the individual. Murphy has both contributed to this understanding and shown there is much work to be done in the investigation of ecological irrationalities, or the clash between modern institutions and the influence of prehistoric habits on our minds. Students and economic professionals alike should take careful note of this book. While his political reform proposals may be out of reach, the tools and examples that Murphy presents are immensely useful in improving one's understanding of the hidden forces that guide popular thought in the modern world.

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The Deficit Myth: Modern Monetary Theory and the Birth of the People's Economy
Stephanie Kelton
New York: Public Affairs, 2020, 336 pp.

Stephanie Kelton's *The Deficit Myth* is quite the talk of the town. To quote Amazon's webpage:

> The leading thinker and most visible public advocate of modern monetary theory—the freshest and most important idea about economics in decades—delivers a radically different, bold, new understanding for how to build a just and prosperous society.
>
> Stephanie Kelton's brilliant exploration of modern monetary theory (MMT) dramatically changes our understanding of how we can best deal with crucial issues ranging from poverty and inequality to creating jobs, expanding health care coverage, climate change, and building resilient infrastructure. Any ambitious proposal, however, inevitably runs into the buzz saw of how to find the money to pay for it, rooted in myths about deficits that are hobbling us as a country.
>
> Kelton busts through the myths that prevent us from taking action: that the federal government should budget like a household, that deficits will harm the next generation,

> crowd out private investment, and undermine long-term growth, and that entitlements are propelling us toward a grave fiscal crisis.

It's an attractive vision, but it doesn't work.

I am reminded of Einstein's time at the Swiss Patent Office where he used to check applications to patent perpetual motion machines. They don't work, but the fun is working out why. The same applies to proposals to bring about prosperity that depend on loosening the monetary spigots. MMT is a perfect example.

MMT in a Nutshell

MMT is a macroeconomic school of thought in the post-Keynesian tradition. Its central tenets: fiscal deficits don't matter; monetary policy should be subordinate to fiscal policy; and the monetary authorities should be willing to issue base money to finance government spending. MMT is associated with large-scale government spending, a focus on ending involuntary unemployment, and programs to alleviate poverty and fight climate change.

Kelton's book builds on earlier work by Warren Mosler and Randall Wray but has its roots in Abba Lerner's system of "functional finance," which goes back to the 1960s. She builds on Lerner primarily by adding a federal job guarantee that would eliminate involuntary unemployment and provide an automatic economic stabilizer.

MMT makes *big* promises. It would "build a more just economy that works for the many and not just the few" and put "people and planet first." "MMT's lens enables us to see that another kind of society is possible, one in which we can afford to invest in health care, education, and resilient infrastructure. In contrast to narratives of scarcity, MMT promotes a narrative of opportunity."

But does MMT deliver? Let's see what she says.

Tax and the Government Budget Constraint

"The idea that taxes pay for what the government spends is pure fantasy," writes Kelton. Really? Let's go back to basics. The government must finance all its expenditures. In a world in which it does not issue debt and does not issue currency, and assuming away any gifts it might receive, all its expenditures must be financed by current taxation.

If the government can issue debt but not issue currency, then it can finance its expenditures by current taxation or by issuing debt. But to issue debt is to pass on the obligation to repay that debt to future taxpayers. If that debt is to be repaid, then it must be repaid out of future tax proceeds.

If the government can issue its own currency and monopolizes the issuance of currency, then it can also pay off its debt obligations as they come due by issuing additional base money ("printing money"). Does this mean that printing money allows the government to avoid the need to raise taxes? No, because printing money lowers its value against goods and services, and so operates as a tax on money holdings and other holdings of wealth that are fixed in nominal terms (such as level annuities). So, barring gifts, all government expenditures must be financed by taxation in one form or another.

Federal Job Guarantee and Minimum Wage

Kelton explains:

> The federal government announces a wage (and benefit) package for anyone who is looking for work but unable to find suitable employment in the economy. Several MMT economists have recommended that the jobs be oriented around building a care economy . . . the federal government would commit to funding jobs that are aimed at caring for our people, our communities, and our planet. . . . Since the market price of an unemployed worker is zero . . . the government can create a market for these workers by setting the price it is willing to pay to hire them. Once it does, involuntary unemployment disappears. Anyone seeking paid employment has guaranteed access to a job at a rate of remuneration established by the federal government.

This sounds great: involuntary unemployment eliminated and everyone willing to work gets a high federal minimum wage or more, to the extent that market wages are forced higher to compete. But hold on. If it is such a good idea, why not raise the minimum wage beyond the $15 an hour she suggests? Why not $30 an hour? Or $50? The problem is that there are a raft of jobs that are profitable to provide at existing wages but would disappear at higher wages.[1] It is not just the existing unemployed who would end up on federal payrolls but these newly unemployed too, and many of their employers. Think of the restaurant sector. That sector and others in the same position could only survive by hiking their prices: dining out would become a lot dearer. Ordering in, too. The federal government, the employer of last resort, would find itself with the problem of what to do with all these people also turning up for guaranteed jobs. The feds would have crowded out much of the labor market and wiped out the lower paid sectors of the economy.

Uncle Sam's Printing Press

"Why does the financing have to come from Uncle Sam?" asks Kelton. "Simple. He can't run out of money." Imagine that the government pays debts coming due by handing over dollar bills that it has in a chest in the basement. If it runs out of bills, then it will default the next time a payment comes due. But then imagine if it can also print money. If it runs out of bills, it can avoid default when the next payment comes due by printing more. It does not follow, however, that the government can *always* meet its payment obligations by printing more money.

Suppose the government prints money at an accelerating rate and we end up with an accelerating hyperinflation. The traditional tax-collection apparatus will break down because the tax revenue will be worth almost nothing by the time it comes in. Similarly, the government will effectively be unable to borrow in its own currency because the borrowed funds would also be worth next to nothing by the time they come in. As the hyperinflation accelerates further, the real value of the revenue from printing money also goes to zero. The government then faces the prospect of default despite being able to print any amount of its own money. To give an example, by the end of the Hungarian hyperinflation of 1946, the total value of all Hungarian notes in circulation was a thousandth of a U.S. cent (see Judt 2006: 87). The Hungarian government didn't have a cent, let alone a dime. The Hungarian government would have been

[1]"There's no reason every job—all the way down to retail clerk or fast food worker or janitor in a luxury Chicago hotel—can't be a good job, with dignified pay, hours, security, and benefits," she says. The question however is how many of these jobs would still exist.

unable to make repayments denominated in other currencies or make inflation-linked payments in its own.

The mistake is to presume that what is correct at the margin (i.e., that the government can avoid default by issuing a few extra dollar bills) is also correct under any circumstances, that is, at any scale. There is also the related point that issuing a small amount of money will have a negligible impact on prices but issuing a lot of money will not.

National Debt and Entitlements

It is a “myth,” writes Kelton, “that deficits will burden the next generation.” This claim is also wrong. Suppose Congress passes a Boomers Boomtime Act to provide for a humongous 75th birthday payout to each surviving member of the first Boomer cohort born in 1946. They will reach 75 in 2021. These payments are to be financed by a zero-coupon bond with a 40-year maturity. Since none of the beneficiaries will be around to pay taxes when the bond is due to be repaid, they get a free handout.

Who bears the burden of paying for it? When the Boomer bond comes due in 2061, the government faces the following choices: (a) pay it off by raising taxes, (b) pay it off by issuing money, (c) default, (d) pay it off by rolling over, that is, by issuing a new bond.

If (a), then the burden is borne by taxpayers in 2016.

If (b), the subsequent price level is higher, so the burden takes the form of a tax on money holdings and other instruments of fixed nominal value.

If (c), default, the burden is borne by those who suffer the adverse consequences of default.

If (d), then the rollover will mean that there will more debt after 2061 than there would otherwise have been and we have the same choices again when the new payments come due. If the decision is to roll over each time, then the debt/GDP ratio will hit a level at which the government defaults sooner than otherwise.[2] Thus, however the

[2]I implicitly assume, as seems reasonable in this (MMT) context, that the rate of growth of the national debt, including entitlement commitments (see below), exceeds the economic growth rate. In that case, the ratio of debt (including entitlements) to GDP will keep growing, and default is then inevitable unless the government resorts to (a) taxation or (b) printing money.

government responds when the Boomer bond matures, some group born after 1946 bears a burden from it.

More generally, any arrangement that involves one group issuing a debt that another group is expected to pay for *necessarily* burdens the second group. The injustice is all the worse because the second group has no say in the matter.

There are also the government's entitlement programs, Social Security, Medicaid, etc. This takes us to Kelton's "myth" that "entitlements are propelling us toward a long-term fiscal crisis. . . . There is absolutely no good reason for Social Security benefits, for example, to ever face cuts. Our government will always be able to meet future obligations because it can never run out of money."

These programs however are just another form of debt insofar as they create obligations on the government's part to make future payments. Consequently, my earlier argument, that programs that create future obligations burden future generations, applies here also.

Entitlements are large, so the corresponding burdens would be large as well. To illustrate, there are perhaps $210 trillion in entitlements, and possibly more.[3] If these entitlements are to be paid for by future taxation, then that is a lot of future taxation. If they are to be paid for by rolling over, then we would anticipate the ratio of debt (including entitlements) to GDP rising considerably, possibly to default levels.

Then there is the option of meeting those obligations by printing money. Given that the current stock of base money is just over $5 trillion, that response implies a possible 42-fold-plus expansion of the monetary base. That, in turn, implies a considerable increase in prices. Making entitlement payments is one thing, but the purchasing power of those payments is another.

We have here another instance of the margin vs. scale issue. The government can increase entitlements a little with next to no impact on their real value. But if the government creates huge entitlements to be financed by printing money, then those entitlements are going to be greatly devalued in purchasing power terms. And what the government must absolutely *not* do is create huge entitlements that are inflation-linked and then rely on printing money to

[3]This figure comes from Laurence Kotlikoff's testimony to Congress in 2014 (see Haskins 2015).

finance them. If it does that, it will produce both hyperinflation and default. The "myth," that the national debt is a problem, is not a myth.

Constitutional Political Economy of MMT

We can break down MMT into a set of policy *ends* (what the government spends *on*), and a set of policy *means* (how the government finances its spending), which in the case of MMT would involve large deficits and a lot of borrowing and money printing. The expenditure and the financing of that expenditure are two different issues. Bernie Sanders might use MMT to advance a more right-wing version of the Kelton agenda, but Donald Trump might seize upon the spending opportunities promised by MMT to advance his own, even more right-wing, agenda, for example, to promote policies that work for the few and not the many.

My point is that it is short-sighted and potentially counterproductive to promote a particular policy package such as MMT because *you* can use it to finance projects that *you* like, because someone else might use it to finance projects that you do *not* like. To the extent that MMTers persuade people that MMT-based government finance is a good idea, they can hardly restrict that message to people who share their own political views. If you think of MMT as a government-financing package, then that financing package can be used to finance any government spending program, whatever its political hue.

A deeper issue is that any policy that gives policymakers the appearance of being able to spend a lot without having to bear the unpopularity of the high taxes needed to finance that spending is a dangerous one and invites abuse. Any such policy entails a major shift in power away from the legislative branch to the executive branch, because it gives the latter additional means of finance that bypass constitutional constraints against government overspending. To elaborate, the Constitution says that fiscal policy, the power to tax and spend, is constrained by the need to obtain congressional approval. If there were no Fed, or if the Fed were genuinely independent, then Congress could deny appropriations for spending projects of which it does not approve. But if the executive branch has the power to print money, then it has a potential means to circumvent Congress. If Trump wants his wall and Congress denies the appropriations, he can then order the Treasury secretary to print the necessary money instead. From this perspective, MMT is something of a constitutional abomination.[4]

It is a fundamental principle of constitutional political economy that economic policymakers operate under rules that constrain the decisions they make, and that these rules should be designed in ways that prevent undesirable behavior on their part. Under this way of thinking, the rules operate as bulwarks that constrain policy makers in order to protect everyone else from the misuse of the powers entrusted to those policymakers.

For proponents of MMT and for many other advocates of big government, however, those rules serve no real purpose and merely constrain policymakers from achieving the lofty ends that they seek to pursue. Yet they fail to appreciate that lofty ends do not justify giving those in power unrestrained discretionary powers. As Adam Smith observed:

> The statesman who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it [Smith (1776) 1994: 423].

Nationalize the Fed

Should MMT be adopted, then the Fed would become subservient to the Department of the Treasury, but in a more nakedly obvious way than it was during the years before the 1951 Treasury-Fed Accord, and without operating under the constraints of the Bretton Woods watered-down gold standard. Personally, I would suggest that, if MMT were adopted, then the government should make the new monetary policy arrangements transparently obvious. The Fed's independence, such as it was, would be history and there would be no point pretending otherwise. The government should

[4]Few presidents would have the self-restraint to refrain from taking advantage of such powers, but the point is that if the Constitution were properly followed, we wouldn't have to rely on his or her self-restraint in the first place.

nationalize the Fed and make it a division of the Treasury, whose responsibilities would then be to issue currency and manage the national debt. Nationalizing the Fed would highlight the underlying chartalism of MMT (i.e., the idea that money is a creature of the state),[5] and would also simplify analysis going forward because it would cut out the need to consider Fed/Treasury interactions that only mask the underlying reality. We could then talk openly about the *government printing money*. If the United States is going to embark on a monetary policy worthy of a banana republic, then it should look the part.

How Would MMT Work in Practice?

Suppose then that the government goes full throttle MMT à la Kelton. This spending must be financed, however, and the government would have to do so by some combination of levying taxes, borrowing, and printing money. In essence, she proposes high government spending and a big deficit financed by borrowing ("debt finance") and printing money ("monetary finance").

If such a policy were launched at a time when there is considerable unemployment, then one would suppose that unemployment would fall. But there must eventually come a time when the economy returns to more or less "full" employment, whether because of those policies or despite them being a separate question. What happens then? To examine this question, I built a model along "unpleasant monetarist arithmetic" (see Sargent and Wallace 1981) lines and got some interesting results.

Let's consider the following three possible MMT policies: (1) the government pursues pure debt finance; (2) the government pursues pure monetary finance; and (3) the government pursues debt finance for as long as possible, up to the point where it is about to default, and then switches to monetary finance.

Let d be the long-term growth rate of the deficit and g the long-term rate of economic growth. It is reasonable to suppose that

[5]One might even go as far as to say that MMT is the apotheosis of chartalism and I do not mean that as a compliment. Chartalism maintains that the state is entitled to monopoly privileges regarding the issue of currency. In response: a government monopoly is always a bad idea, period.

MMTers would want d considerably in excess of g, so let us assume that this is so. Under a policy of pure debt finance, the debt/GDP ratio would grow relentlessly and must at some point reach a level at which the government defaults. Hence, debt finance makes government default inevitable if pursued for long enough—that is, pure debt finance is unsustainable.

Under a policy of pure monetary finance, d becomes the key driver of the inflation rate. If d is steady in the long-term, then the inflation rate will converge to a long-term steady state. But if d itself grows, so the deficit grows at an *accelerating* rate, then long-term inflation will also accelerate.

Under the third policy, the debt/GDP ratio rackets up to the brink of default, then the government switches to monetary finance with similar long-term outcomes as pure monetary finance.

It is important to emphasize that under monetary finance there is no way in which the government can simultaneously pursue an inflation target. Instead, the inflation rate becomes a residual outcome from the government's fiscal policy and the government loses all control over the inflation rate. To make matters worse, the inflation rate also becomes the macroeconomy's main shock absorber, so any shocks that produce unexpected increases in the deficit will lead to unexpected increases in inflation, which makes inflation highly uncertain too. A policy of monetary finance is therefore dangerous, because it can easily lead to runaway inflation or even hyperinflation. Externally, these effects on prices and inflation will be reflected in a falling, volatile and uncertain exchange rate.

In sum, we have a variety of possible long-term consequences, ranging from merely bad (highish and uncertain inflation, loss of control over inflation, a volatile exchange rate) to positively catastrophic (huge levels of national debt, high future taxation, national default and all that might entail, runaway inflation, hyperinflation). I could go into a long discussion of why any other fiscal-monetary policy mix would produce better long-term outcomes. On the fiscal side: a balanced budget or lower deficit financing. On the monetary side: a monetarist rule, a nominal GDP target, a Taylor Rule, a gold standard, whatever.

Suffice to say that the poor performance of MMT is not a coincidence. On the fiscal side, it encourages a much more rapid run-up of the debt/GDP ratio than any alternative, which has got to be the worst possible fiscal policy in the long term. On the monetary side, it throws away any attempt at controlling inflation or maintaining monetary stability by making monetary policy subservient to runaway government spending. MMT performs so badly *precisely because* it represents the extremes of fiscal and monetary excess.

Rising Inflation: MMT's Achilles Heel

Indeed, MMT does not even work on its own terms. Kelton herself indicates that an MMT policy package is constrained by the requirement that inflation should not rise. Unfortunately, she hasn't thought it through.

Current U.S. inflation is 2.3 percent. Is she suggesting that the government should pursue MMT subject to the constraint that the inflation rate should not rise above 2.3 percent? If so, she should advertise the fact to help dispel the concerns of those who might have gotten the impression that MMT is some sort of funny money scheme. If she did so, much of the knee-jerk opposition from sound-money people would dissipate. The problem, however, is that a commitment to maintaining inflation at no more than its current rate would severely constrain the ability of MMT to deliver on its promises.

A looser interpretation of her "inflation shouldn't rise" constraint would apply to inflation in the long run. But then consider my unpleasant monetarist arithmetic results. Since pure debt finance is fiscally unsustainable, any MMT package must involve some element of monetary finance. But, *ex hypothesi*, the monetary finance must be constrained by the need to avoid rising inflation in the long run. A necessary condition to prevent rising inflation is that the rate of growth of the deficit should not itself increase. This constraint is not as severe as requiring that current inflation should never rise, but it is a severe constraint nonetheless. The problem is that it is not at all clear how much of what she promises can be delivered while satisfying this constraint. That she does not address this issue is the central failing of her book.

In effect, she offers us the prospect of a bunch of goodies but doesn't explain why those goodies fall within the economy's production possibility frontier, that is, are actually attainable—an intriguing oversight for an economist.[6]

She offers a revealing anecdote when she recalls a discussion between James Tobin and President Kennedy:

> Tobin recalls JFK asking, "Is there any limit to the deficit? I know of course about the political limits. . . . But is there any economic limit?" When Tobin confessed that "the only limit is really inflation," the president replied, "That's right, isn't it? The deficit can be any size, the debt can be any size, provided they don't cause inflation. Everything else is just talk."

"Everything else is just talk" captures it perfectly. Indeed, it undermines the entire book.

We shouldn't forget what subsequently happened. Government spending on the Vietnam War and the Great Society overdid it, and the United States ended up with rising inflation and the monetary troubles of the 70s and early 80s. MMT's fiscal proposals are akin to the Great Society and its monetary proposals are akin to relying on the pre-NAIRU, or fixed, Philips Curve that was discredited by Milton Friedman. From this perspective, MMT has a distinct sixties feel to it.

In both cases, the root problem is the same: the absence of a coherent theory of inflation. The Keynesians of the sixties didn't have one and neither does Kelton. Now, as then, the solution to that problem is the same: their macro model needs some version of the quantity theory of money to connect the money supply to the price level, and thence to the inflation rate. If the central bank or the government pursue policies that lead to too much monetary growth, then the result will be a higher than desired inflation rate. The solution to that problem is also the same as it was then: to rein in the rate of monetary growth. In short, MMT is not particularly modern and the monetary theory has too much money and not enough theory.

[6]As she says, "The real challenge lies in managing your available resources—labor, equipment, technology, natural resources, and so on—so that inflation does not accelerate." This passage describes the problem nicely but does not give the solution to it.

Having Your Cake and Eating It Too

Kelton might object that these negative outcomes would not occur under MMT because counter measures would be taken once (or even before) inflation started to rise. So, what counter measures would she pull from her MMT toolbox? The answer is a rise in taxes.[7]

One can imagine the howls that would follow a proposal to raise taxes "merely" because inflation had gone over some "arbitrary" threshold. Why abandon The Project? Why stop policies that were on the verge of making the world a better place just as the going gets tough? MMTers attempting to stick to the "if inflation rises" script on which The Project was predicated would be cast into the role of fiscal conservatives. Don't they know that deficits don't matter, etc.? They then reap the downside of overpromising.

If and when taxes were increased, it is doubtful that doing so would get inflation back down again. We know from monetarism that the inflation rate will only come down once the underlying monetary growth rate has slowed. But since the MMTers lack a decent model of inflation the likely policy responses would be some muddle akin to what we experienced in the late 1960s and much of the 70s, and with similar results: rising inflation followed by stagflation, a new Keynesians vs. monetarists controversy, and inflation only being brought under control again when policymakers relearn the lessons learned then—namely, the importance of the quantity theory of money.

Anything but MMT

The poor long-term performance of MMT under my simulations is a perfect illustration of why policymakers need to be constrained by rules. To illustrate the benefits of such rules, consider the following. Recall that we can think of MMT as a set of policies that break down into two subsets:

(1) MMT = {MMT spending program; MMT financing program}.

[7]Wrong again. The only way to reduce inflation is to rein in the excessive monetary growth that is the proximate cause of rising inflation. So, Kelton's statement that "MMT . . . offers a more sophisticated array of techniques for managing inflationary pressures than what we have today," does not instill much confidence.

The former is about what goes out of the government's coffers and the latter is about what goes in.

It seems to me that for most people inclined toward MMT, the big attraction is the MMT spending program. For the sake of argument, let's hypothetically agree with that spending program and then ask if we can replace the MMT financing program with something better.

The MMT financing program consists of a combination of high deficits, tax, borrowing, and monetary finance. This financing program is a key reason why MMT performs so badly, so let's replace it with an alternative financing program that is a combination of, let's say, more restrained deficits, tax and borrowing, and no monetary finance. The monetary side of this program would be taken care of by some monetary policy or rule that focuses on a stable inflation rate or something similar. We then come to:

(2) Alternative to MMT = {MMT spending program; alternative financing program}.

My models indicate that this "Alternative to MMT" would produce considerably better outcomes, including a less rapid run-up of national debt and lower inflation.

Why then would you not prefer the "alternative" to MMT? The "alternative" still delivers the spending goodies you want, but in a less damaging way in the long-term. But the "alternative" is old-fashioned tax and spend!

My point is that even if you support MMT because of its spending program, there is no good reason to support MMT in preference to some tax and spend policy mix with the same spending program. Whatever your preferred government spending program, MMT is a poor way to finance it.

So, if you are a hard-left socialist who supports the Kelton government spending platform, you should support tax and spend, not MMT. And if you do not support her spending platform, say because you are not politically hard left or because you support sound money, then you would also not support MMT. Whatever your politics, MMT is not for you; MMT is just bad economics.

Don't Cry for Me Argentina

In the end, MMT comes down to this: the government spends a lot, issues a lot of debt, and prints a lot of money. It is not as if it hasn't been tried before.

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America's Revolutionary Mind: A Moral History of the American Revolution and the Declaration That Defined It
C. Bradley Thompson
New York: Encounter, 2019, 584 pp.

The Founding Fathers of America eloquently expressed the high-minded ideals "all men are created equal." At the same time, however, many of the Founders engaged in the brutally cruel practice of slavery. This disconnect between principles and practice has caused historians to investigate what the Founders truly believed as opposed to what they said. In 1980, Howard Zinn's *A People's History of the United States* argued that the Founders' buzzwords of equality and liberty were just that. Their lofty language of revolution was merely a cloak for the aristocratic elite's nefarious goals of increasing and securing their grip on power and wealth. Zinn's approach was to peel back the Founders' rhetoric and see what they were really after behind their slogans. In more recent times, authors of the *New York Times*'s "1619 Project" claim American elites declared independence as a means to protect the institution of slavery.

Thankfully, C. Bradley Thompson's newest book, *America's Revolutionary Mind: A Moral History of the American Revolution and the Declaration That Defined It*, takes an entirely different approach: viewing the Founders' expressions of their ideas, sentiments, and aspirations not as carefully crafted rhetoric, but instead as genuine expressions of their sense of morality. Thompson is offering more than just an antidote to the more cynical tone of authors such as Zinn. In *America's Revolutionary Mind*, Thompson aims and succeeds in applying a new methodology of history, one which focuses on the connection between principles and practice. Thompson dubs this methodology "the new moral history." This new moral history explains the development of ideas akin to intellectual history, but its primary goal is to investigate "the intersection between moral thought and moral action, between what people say and what they do." Using this methodology, Thompson aims to show that motives explain actions better than large-scale processes of change and that, by examining the motivation of individual actors, we can come to more fruitful and accurate conclusions on historical events.

Spokesmen of the revolution such as John Adams, Thomas Jefferson, Thomas Paine, and the lesser-known Joel Barlow all expressed a similar sentiment, that the major cause of the revolution was a new mode of moral thinking, which informed and guided the actions of American colonists and preceded the revolutionary struggle that was to come. According to this reading, the American Revolution was a consequence of a new way of thinking about morality, which took root before a single shot had been fired. Adams explains that the real revolution was not the War of Independence but, in fact, the "radical change in the principles, opinions, sentiments, and affections" of the American people. Thompson agrees with Adams's conclusion arguing that scholars have ignored the "generative mainstream of the Revolution, namely, its moral causes."

Following the assessments of Adams closely, *America's Revolutionary Mind* is a book that has two main goals: first, "to elucidate the logic, principles, and significance of the Declaration of Independence as the embodiment of the American mind," and second, to focus on the moral underpinnings of the revolution. Thompson uses the Declaration of Independence as the "ideological road map" of the American Revolution, seeing it as the culmination and expression of the real revolution that Adams articulated. In the first chapter, Thompson argues that the Declaration of Independence is an expression of Enlightenment principles of nature, reason, and ethics informed by thinkers such as Isaac Newton, Francis Bacon, and above all, John Locke. Thompson asserts that "America's revolutionary mind is virtually synonymous with John Locke's mind." If the Declaration of Independence is a culmination of America's moral revolution, then the Declaration and its contents must be Lockean in their nature.

America's Revolutionary Mind is not a linear historical narrative; instead, Thompson opts to deal with topics thematically. Eight of the twelve chapters in the book deal with the four self-evident truths of the Declaration of Independence, which can be boiled down to equality, rights, consent, and revolution. In each of these chapters, Thompson draws out how essential Locke's thought was for the colonists to express what would become their highest ideals in the Declaration of Independence. Thompson not only invokes the most esteemed authorities of the day but also scores of lesser-known figures. Letters, pamphlets, sermons, and newspapers are all liberally quoted to draw out an interpretation of the broad consensus of Lockean values that pervaded Colonial America. What emerges is not an ad hoc, inconsistently applied grouping of Lockean principles but instead a comprehensive, holistic, and pervasive philosophy. By delving so deeply into contemporary records and artifacts, *America's Revolutionary Mind* corrects previous scholars who underestimate the intricacy of the theory of natural laws and natural rights that the colonists held dearly.

Given recent political events, Chapters 4 and 5 stand out as they cover the Declaration of Independence and the self-evident truth of equality. Thompson covers the Declaration's most famous phrase: "that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness." Chapter 4 consists of an explanation of how the colonists perceived equality. Their idea of equality was deeply Lockean in that equality meant freedom from the dominion of others. No person naturally rules over others without consent. Equality does not mean equal abilities, status, or wealth; equality instead is the state of not being dominated by another, being allowed to make use of one's natural life to pursue happiness.

The obvious elephant in the room is slavery. Chapter 5 attempts to navigate how the Founders could believe in the inherent natural rights of all people but ignore the fact that they held slaves in often brutal bondage. Thompson explains that none of the Founders endorsed slavery; in fact, many were aware of their moral hypocrisy. While some such as John Adams never held slaves and others like Benjamin Franklin became abolitionists, men of the Founding generation such as Thomas Jefferson and George Washington held onto their plantations and slaves despite their high-minded ideals. Few defended the institution of slavery, so why did it last so long? Thompson argues that the post-emancipation problem was what held the Founders back from fully practicing what they preached. Fearing reprisals from former slaves, men such as Jefferson resigned to the comforts of self-preservation before the demands of justice. Thus, the ideals of the revolution were intended to apply to all, but ideals of the revolution were too demanding for many of the leading revolutionaries.

Does this mean that the moral revolution Thompson describes was merely a set of principles that could be selectively chosen to suit one's preferences? Thompson emphatically says no and describes the Declaration of Independence as "the moment of America's great moral awakening." Faced with the ideals of the Declaration and the reality of the peculiar institution of slavery, Americans began to question slavery more than they ever had previously. The Declaration of Independence failed to abolish slavery. It made the crucial step, however, of establishing a benchmark from which to evaluate and to criticize slavery, that benchmark being the idea that all men are created equal. Under this reading, the Declaration was not an end to slavery but instead an awakening to its inherent unjust nature.

Thompson, in his preface, shows his intentions in *America's Revolutionary Mind*. He aspires to contribute to scholarship in the same manner as Gordon Wood and Bernard Bailyn. Their contributions have not yet been matched in originality or influence despite being written in the sixties. While Thompson has not put forward a strikingly new analysis, he has aptly affirmed the vitality of Locke within the revolutionary mind of colonial America.

But, at times, Thompson overstresses the influence of Locke to the detriment of other important authors who had comparable reputations amongst the colonists. Jefferson himself stated that the Declaration of Independence was based upon the ideas contained within the elementary books of public right written by Aristotle, Cicero, Locke, and Algernon Sidney, but all of these authors only merit brief mentions from Thompson. Yes, the American Revolution was a product of Enlightenment thought, but that does not mean the past was abandoned. The Americans vested great authority in the wisdom of classical authors such as Tacitus, Plutarch, and Cicero, as well as more recent English Republicans such as Algernon Sidney, James Harrington, and the authors of Cato's Letters John Trenchard and Thomas Gordon. Thompson does not engage with the classical-republican scholarship of the American Revolution, possibly saving these arguments for his next book covering the philosophy of the American Constitution, expected to be titled *America's Constitutional Mind*. Nevertheless, for a book which is described as self-sufficient, the approach of valorizing Locke above all others can obscure the nuances and intricacies of the American mind, which was well versed in matters beyond Locke.

Thompson's vision of new moral history is exceptionally welcome at a time when the Founder's motives are constantly under cynically guided scrutiny. I commend this book highly for taking the Founders seriously. By doing so, Thompson interrogates the American temperament and character to a degree that is rarely achieved. The new moral history of Thompson is a breath of fresh air for its unique approach. *America's Revolutionary Mind* is an excellent guide to how America's most important generation thought about the foremost issues of their day and how Locke's thought was indispensable to the Declaration of Independence, one of the most important documents in American, if not world, history.

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Free to Move: Foot Voting, Migration, and Political Freedom
Ilya Somin
New York: Oxford University Press, 2020, 263 pp.

Immigration policy is the most debated and controversial issue of our time. Across the developed world, political parties have greatly diverged on this issue. In Europe, political parties with a nativist bent have won elections and governed in coalition with other mainstream parties. But even mainstream parties, such as the Danish

Social Democrats, have adopted anti-immigration platforms as they adapt to the opinions of voters skeptical of immigration—and have maintained power as a result. In the United States, the 2016 election of President Donald J. Trump on an anti-immigration platform and an increasingly pro-immigration Democratic Party reveal a greater difference of opinion than on any other policy issue. Related to these political and policy developments is the perceived partisan sorting of voters into different geographic regions, the rise of left-wing and right-wing identity politics, and a general sense of deepening political polarization.

Antonin Scalia Law School Professor and Cato Adjunct Scholar Ilya Somin deftly combines these issues into one forceful thesis in his new book, *Free to Move: Foot Voting, Migration, and Political Freedom*. There are many new books about immigration, but Somin's is the only one that argues that the ability to exit a political jurisdiction and enter another, whether inside of a federal system or internationally, is the cheapest and best way to improve individual political freedom. As Somin argues, individual voluntary sorting through migration to different jurisdictions with different policies is a positive development that improves human welfare more than other means of changing political circumstances such as ballot box voting. We should emphasize how foot-voting can improve public policy by sorting people into jurisdictions where they prefer to live.

Many people in the world today live under governments that they would like to change, but voting and democratic decisionmaking are fraught with problems. Not only do individual voters disagree with each other over optimal policies, but a single voter has an infinitesimal chance of altering government policy through the ballot box. And even if policies were to change, the lag in time from their enactment to when their effects are felt can be quite long. Voters are rationally ignorant and often vote based on biases since their individual votes don't affect the outcome anyway. Thus, the resulting policies are often irrational and don't work. The outcomes are a lot like the famous "tragedy of the commons," where individual choices on how to use a collectively owned resource, in this case public policy, results in poor management that degrades the value of that resource. Democracy produces better outcomes than other forms of government, to be sure, and the people trapped in authoritarian regimes around the world have it a lot worse, but ballot box voting isn't a panacea either.

In such a world, policy reform through the ballot box is unlikely, uncertain, and often irrational from the perspective of individual voters who want to change the policies under which they live. Fortunately, there is another way for individual voters to live under the policies that they desire. Migrating, or foot voting, to other political jurisdictions with more desirable policies is a shortcut that achieves the goal of living under better policies for the migrant.

For example, if a Californian wants more freedom to own firearms with less state interference, then he has several options. He could spend his time voting for pro-gun candidates, organizing pro-gun rallies, or writing eloquent persuasive pieces for news outlets in his home state of California in an effort to change the rules under which he lives. Or he could just move across the border to Arizona and get that freedom without engaging in the mercurial political process. The migrant must value the benefits of living in Arizona over the cost of moving from California, but at least incurring that cost will result in the actual change for himself while spending years trying to change policy in his home state is a high-cost investment with a low and distant potential return. Not only is migration guaranteed to increase his personal utility by choosing a jurisdiction with gun laws closer to his liking, it also doesn't involve shifting policies in California that most residents there are happy with. Migration is a win-win for all involved, especially the migrant.

The benefits from foot voting accrue even if jurisdictions don't make any special efforts to attract migrants. Charles Tiebout made this point in a classic 1956 article arguing that jurisdictions offer different mixes of taxes and government-provided services based on the demands of their residents. Because these demands are heterogenous across geography, different jurisdictions will offer differing mixes, and that differentiation will appeal to people who share those preferences who live elsewhere. As a result, a variety of options exist where there are multiple different jurisdictions even though each jurisdiction is not actively competing with others.

The Tiebout model also works with private planned communities, gated communities, and home-owner associations. They offer different levels of security and benefits such as recreational facilities as well as vastly different fees without the high cost of having to move across state lines. These private clubs don't offer different gun policies, sales tax rates, or other laws imposed by their states or counties, but they do offer a small measure of choice of governance inside of government jurisdictions. Private communities are private clubs inside of a much larger polity and they offer substantial choice at a relatively low cost to middle income and wealthy residents.

The differences between countries is even vaster than the differences between American states and the differences between private communities. A standard deviation difference in economic freedom among American states is the difference between the states of Minnesota and Georgia. But a standard deviation difference in economic freedom between countries is the difference between Germany and Cyprus—a gulf in income and standard of living that couldn't be bridged for years or decades even if Cyprus adopted Germany's pro-growth policies. What is a Cypriot to do in such a situation—spend years of his life organizing for policy change or move? The former is uncertain and unlikely to have any effect, but the latter is guaranteed to change his life for the better.

Somin mentions his personal experience with migration briefly in the introduction, but you can see how it informs his opinion. He was born in 1973 in the Soviet Union. He writes that "[t]he life of most residents of that totalitarian state was one of poverty and oppression. My family was materially better off than the average Soviet citizen, but still lived in awful circumstances by Western standards." At various times, several of his relatives were victims of the Soviet regime's oppressive policies, and as Jews they were held back by the state's institutionalized anti-Semitism. Somin and his family emigrated to the United States in 1979 and their lives improved across the board. He is materially wealthier, healthier, happier, and freer than he would have been had he stayed in the Soviet Union and, later, Russia. Maybe Russia would be freer today if Somin had stayed behind. He's a persuasive and eloquent writer, but even his abilities would run against the institutions and entrenched political opinions that govern his authoritarian homeland. In sum, Somin would have had virtually no chance of improving Russia but he would have suffered tremendously had he tried.

Put in those stark terms, emigration and foot voting is the preferred solution for people who want to improve their lot in the short term and long term. Indeed, the United States is one of the few countries in the world today where Somin's message should resonate. This land is overwhelmingly populated by those who left their homelands for more opportunity or whose ancestors did so. Most did so for economic reasons and the opportunity afforded by a relatively more free-market United States, but those fleeing political and social oppression often figure larger in our minds: Irish Catholics fleeing British domination of their home island; Germans leaving behind the failed revolutions of 1848; Mexicans escaping the civil war in the early 20th century; Jews escaping the brutal anti-Semitic policies of Imperial Russia; and multiple waves of refugees fleeing Communist and Islamist governments. These groups from across the world decided they'd rather save their families and start anew than take an enormous personal risk on the very small chance that they would change politics at home.

Foot voting isn't without risk to people living in the jurisdictions that accept the foot voters. Somin spends much of his book writing about the potential downsides of more foot voting, but two stand out as particularly important. The first is that migrants who vote with their feet could bring with them the poor institutions, violence, or poverty that induced them to move in the first place and "infect" their new homes. The United States is a free and rich country because of our institutions, but those institutions can change if enough people here vote for worse policies that upend or change them. Fortunately, there is little evidence of this occurring and much evidence that immigrants, in fact, improve policies from a libertarian perspective. Institutions tend to be sticky due to the doctrine of first effective settlement, which essentially means the founders of a polity have an enormous amount of influence on future policy and institutions due to the political framework and constitutions that they established. It's harder for successive generations to change them than it was for the founders to create them. Although voters have a huge impact, it is very difficult to overturn them. Furthermore, countries that faced large exogenous immigration shocks, like Israel and Jordan, liberalized their economies in response, while the United States did not begin to expand the welfare or fiscal state to where it is today until after the borders were closed in the 1920s.

Second, it is often argued that governments have an inherent power to keep out migrants for any reason, much like a property owner has the right to keep trespassers off his property. Somin spends many pages recounting philosophical debates over this point and rightly notes that the government does not own the country and cannot behave as a private property owner behaves toward his property. Arguing otherwise would grant the government an obscene degree of power over our personal freedoms that would be unbearable to most Americans and completely at odds with anything approaching a libertarian conception of individual rights. This is Somin's most controversial claim, but he's on sound historical-legal footing.

Although current governments claim an absolute power to limit entries, this was not always the case. Francisco de Vitoria (1480–1546), widely regarded as the founder of international law, argued that people have a right to move across borders peacefully. Hugo Grotius (1583–1645) refined Vitoria's theory further by arguing that individuals have a right to leave their own country and to enter and remain in another. The right to emigrate is respected by modern scholars, but the right to leave one country without the right to enter another is a very meager right and is as disjointed as saying that there is a right to buy property but not to sell it. Samuel von Pufendorf (1632–1694) was the first international law scholar to argue that state sovereignty grants it power to choose whom to admit that is more important than any natural right of movement. He was followed by Christian von Wolff (1679–1754) who argued that the sovereign owns the nation and exercises this power as an individual property holder does regarding entry of people onto his land. Emer de Vattel (1714–1767) had the most influence on modern international law regarding immigration when he argued that there is a qualified power of state sovereignty to control immigration with the two substantial caveats of innocent passage and asylum. De Vattel is extensively and selectively cited in U.S. Supreme Court decisions that created Congress's plenary power over immigration in the late-19th century. All of those scholars made exceptions for state security and the protection of individual rights as well as for those fleeing oppression, but the most extreme view of absolute state power without caveats is what dominates the modern view. Somin's view is much closer to that of de Vitoria and Grotius than it is to the other scholars.

Ilya Somin is a scholar with a wide body of work, from political science to philosophy and the law. *Free to Move* is a condensed and short primer on his political and philosophical writings. I've read many of Somin's other books and I recommend them all, but if you only have time to read one work by this prolific scholar to understand much of his thinking on current policy issues, *Free to Move* is the book for you.

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The Light that Failed: A Reckoning
Ivan Krastev and Stephen Holmes
New York: Penguin Books, 2020, 256 pp.

Some butterflies have evolved to resemble the face of an owl. This form of imitation can deter predators, but no one would expect a butterfly to do all the things owls do. In ecology, this is known as isomorphic mimicry. Development experts have used this phenomenon as a metaphor to explain the folly of installing copycat versions of Western institutions—the norms, laws, and governance structures of liberal democracy—in diverse countries. They may look right at certain angles, but on closer inspection they don't function as hoped.

If underwhelming performance were the only consequence of the West's attempt to spread liberal democracy abroad, we could take pride in the attempt. But in *The Light that Failed: A Reckoning*, political scientists Ivan Krastev and Stephen Holmes argue the consequences are much worse. In their words, "[a]fter the fall of the [Berlin] Wall, across-the-board imitation of the West was widely accepted as the most effective way to democratize previously non-democratic societies. Largely because of the moral asymmetry it implied, this conceit has now become a pre-eminent target of populist rage."

That moral asymmetry, they argue, is the untenable difference between the superiority of the imitated over the presumed inferiority of the imitators, in this case the West and those who spent the last 30 years trying to catch up. In short, democratic institutions, built in this way, are likely to fail and that failure then sparks feelings of humiliation and resentment among transitioning populations.

Eventually, the authors argue, this sense of defeat leaves the electorate vulnerable to alternative narratives proffered by authoritarian-leaning strongmen who promise to restore native pride by rejecting the West explicitly. Citing would-be autocrats such as Hungary's Viktor Orban and Russia's Vladimir Putin, Krastev and Holmes build their case for claiming that "[d]ispraising the West and declaring its institutions not worth imitating can be explained as imaginary revenge born of resentment."

For example, in Putin's victory speech following the 2012 presidential election, he told the crowds, "[w]e have demonstrated that nobody can impose anything on us. Nobody can impose anything." This resonates. One retired Russian military officer is quoted as saying, "I want a Russian idea for the Russian people; I don't want the Americans to teach us how to live. I want a strong country, one you can be proud of. I want life to have some meaning again."

The pursuit of liberal hegemony in the post-Soviet era, what Krastev and Holmes refer to as the Age of Imitation, has been, to be sure, a welcome and cooperative exercise in many of the countries that are now trending illiberal. Still, Krastev and Holmes say that "[e]ven without coercion or enforcement [by the West], being regularly evaluated by foreign judges bereft of serious knowledge of one's country" is enough to trigger an overwhelming sense of indignation. "What we have been trying to explain is why an adaptation to foreign standards that was initially desired ended up being experienced as non-consensual and imposed."

Through this lens, the illiberalism we are witnessing throughout the globe is less about a preference for an opposing ideology, per se—who can define "populism"?—and more about reclaiming independence from foreign superiority. They speculate that much of European illiberalism, for example, is "emotional and pre-ideological, rooted in rebellion against the 'humiliation by a thousand cuts' that accompanied a decades-long project requiring acknowledgement that foreign cultures were vastly superior to one's own."

The authors distinguish between the productive "learning by which states vicariously profit from each other's experiences," and the wholesale adoption of foreign models insensitive to local context. A recent study by World Bank economists, led by former Bulgarian finance minister Simeon Djankov, validates this distinction by showing a higher incidence of liberal reforms among geographical neighbors and commercial trading partners. There must be a lesson here in the emergent nature of idea diffusion.

Krastev and Holmes then devote the second half of their book to detailing what they see as the shared authoritarian stylings of Donald Trump and Vladimir Putin. Key to their argument is the idea that both political leaders represent a downstream consequence of the

Age of Imitation. The mechanics are psychological for both cases. Imitated nations, they claim, are also driven to demand a renewal of national pride and nativism in response to the global denigration of Western culture.

The book makes no attempt to provide a roadmap out of this mess. In a recent virtual interview for *Foreign Policy* magazine, Holmes clarified, "[t]his is not a policy book." They concede there are likely many other factors that either contribute to or have some independent claim for explaining the rise of illiberalism. For example, shrinking native populations and increased immigration have been tied to fears of losing national identity. In George Packer's biting critique of U.S. foreign policy in his 2019 book, *Our Man: Richard Holbrooke and the End of the American Century*, he concludes that nationalism, with its "irresistible taste of bitterness," is the "drink of political losers," and speculates, "[m]aybe that's true of nationalism everywhere."

In the end, we don't know how much to fault our ham-handed approach to spreading liberal democracy when explaining the illiberalism we see today, but we would do well to take this new analysis seriously since it affirms what we now about institutional change. The sociologist W. Richard Scott put it succinctly when he wrote that people are both the cause and effect of the institutions that govern them. We should not be surprised then to discover that outsider-led exercises in institution building are doomed to exacerbate, if not inspire, rebellion against foreign influence.

Of course, any post-mortem on our dashed hopes for the "end of history" in the post-Soviet era would be incomplete without accounting for China's somewhat quixotic rise. China has adopted many things from the West, but Krastev and Holmes here make a distinction between economic and institutional convergence. China wants to dominate the world stage, but they aren't looking to spread their doctrines nor adopt anyone else's. The authors write, "[t]he copious benefits of rejecting Western norms and institutions while selectively adopting Western technologies and even consumption patterns is what China teaches the world."

Xi Jinping's rhetoric dispraises the West, but it does not push an alternative ideology for others to follow. "Unlike America . . . China has no reason to think that a world populated by copies of itself would be a world congenial to Chinese interests." According to Krastev and Holmes, this matches the worldview Trump brings to the presidency.

His "nation as a business" approach to political economy interprets imitators as threats, not allies that can help support an "everybody wins" global order.

All of this leads Krastev and Holmes to predict that, instead of another Cold War over ideology, our future global contests will be "bitter struggles over trade, investment, currency and technology." They write, "the idea is not to replace a global liberal ideology with a global anti-liberal ideology, but to radically diminish the role of ideology in the arena of international competition." They believe Trump is primed for this kind of fight. Uninterested in perpetuating the 20th century idea of America as a "shining city on a hill," Trump seeks to normalize the U.S. as a "selfish state among selfish states."

Though not explicitly optimistic about its future, Krastev and Holmes make no bones about their own support for liberal democracy, describing the liberal nation-state as "the most effective human rights organization in the world." But they want to wake us up to the irony of pushing, from the top-down and from far away, a liberal model that denies local control.

How to go about supporting, but not leading, liberal reforms abroad is not obvious. Krastev and Holmes give us no recipes. That ambiguity is likely to favor the status quo among foreign policy and foreign aid circles. Still, we should have enough tragic evidence from the past to learn that excessive intervention turns out badly.

As a young assistant to Henry Cabot Lodge in Vietnam, Anthony Lake, who would later become Clinton's national security advisor during the Bosnian crisis, wrestled with this tension on the eve of the escalating war in Southeast Asia. After touring unspeakable horrors in Hue province along the Perfume River, Lake's view of America's purpose in Vietnam started to change. He was not alone. But like so many others at the time, Lake fought the nagging feeling that maybe America shouldn't be there at all. For many, such a thought was "unthinkable."

Nearly 60 years later, we face the same dilemma in many places. In her recent memoir, *The Education of an Idealist*, former UN Ambassador Samantha Power, widely characterized as an interventionist crusader (she would say mischaracterized), gives a painstaking account of the moral confusions she encountered at the heart of the foreign policy crises she had to navigate. She chooses to keep her faith in America's capacity to do good in the world, but hers is a story of a journalist cum activist cum diplomat who learns that her sincerity is not enough to overcome the complexities of other people's communities. In the end, she is chastened by the lessons learned in Bosnia, Libya, Syria and other challenging hot spots, concluding that we just cannot "predict . . . outcomes in places where the culture is not our own."

Krastev and Holmes's book challenges us to start thinking what has historically been unthinkable when it comes to our role in the world. They remind us that liberalism is about pluralism, not hegemony, and that "[h]uman beings need choices." If liberal democracy, the most choice-based ideology in the modern era, is to get a second chance, it must be by acts of choosing. Determining the proper role of outsiders, if any, in supporting opportunities to choose liberalism around the world is the foreign policy challenge of the 21st century. As we navigate that challenge, we should remember what the Age of Imitation has taught us. Butterflies pretending to be owls will eventually be exposed for what they really are.

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Cato Institute

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