Threats to Prosperity in North and South America

The Cato Institute is committed to holding seminars throughout the country each year, on the basic premise that important questions of policy and governance should not be confined to Washington. At the Policy Perspectives 2012 event in New York City in March, Steve Forbes, chairman and editor-in-chief of Forbes Media, focused on the economic headwinds holding the country back. The true source of prosperity, he said, is the free market—and these barriers are standing in the way. Mary Anastasia O'Grady, an editorial board member of the *Wall Street Journal*, detailed the intellectual roots of underdevelopment in Latin America—and, more importantly, the lessons they hold for economic growth in the United States.

STEVE FORBES: We all know, even though the economy is doing better this year, that we are still witnessing a punk performance. It's like being on a superhighway and getting the automobile to go from 20 miles an hour to 40. It should be going 70 or 75—and, when no one is looking, 125. But something is inhibiting us. I'd like to take a few moments to touch upon the major headwinds that are pushing us back, at a time when we should be moving forward rapidly.

The first, of course, is monetary policy—possibly the most boring subject in the world. The best way to think about monetary policy is to continue the above metaphor. Let's say you have an automobile, a magnificent vehicle in its own right. If you don't have sufficient fuel for that car, you'll stall. With too much fuel, you'll flood the engine. Only with the right amount do you have the chance to move forward.

The same is true of an economy, even one that has all of the basic strengths. If you don't supply enough money to meet the organic needs of the marketplace, you'll stall. If you print too much money, you get the economic equivalent of a flooded engine. The Federal Reserve has been on a bender recently, printing excess money ever since the early part of the last decade. We never would have had a housing bubble if the Fed had not provided the juice for it.

Money, of course, is not created by government. It is generated by individuals who make transactions in the marketplace. Money is simply a facilitator of those transactions. Before money, we had to barter—which means that if I wanted to sell an ad in *Forbes*, I might have to accept a herd of goats as payment. If I then wanted to turn around and purchase iPads for our writers, I'd have to be prepared for the Apple storeowner to demand sheep rather than goats, which would then take me to a sheep herder, who may prefer red wine to my white wine . . . . and so on. Simply put, commerce becomes cumbersome. With money, however, it's much easier to create capital, invest in the future, and bring that future into the present.

The key, however, is that money has to be stable in value, like ounces in a pound or inches in a foot. Can you imagine what would happen if Washington did to the hour what it does to the dollar? Sixty minutes in an hour one day, 42 minutes the next, 77 the following . . . you would soon need hedges, derivatives, and futures to figure out how many hours you're working. If you hire someone for $15 an hour, you'd have to specify if that's a New York hour, an Illinois hour, or a Bangladesh hour. The key is simplicity.

The way to do this is to re-link the dollar to gold. For all its imperfections, the question is: What works better, gold or politicians? Without a stable currency measure, people invest in existing hard assets—which results in capital flight from this country because people are not willing to take risks. Equity prices are supposed to reflect the present value of discounted future income flows. But if you don't know what the income flows are denominated in, that depresses values today. Stability works. Make money a fixed measure of value. Period.

Another headwind that has been holding us back, which Cato has been at the forefront of, is taxes. What the mandarins in Washington don't understand is that taxes are a price and a burden. A tax on income is the price you pay for working. A tax on capital gains is the price you pay for taking risks. A tax on profits is the price you pay for success. And the idea is a simple one: when you lower the price of good things like productive work, risk taking, and success, you get more of them. When you raise the price, you get less. Yet the political class keeps trying to raise taxes to solve their own spending problem.

The current tax code, though, goes way beyond raising revenue. It is ultimately a source of power and manipulation, and the biggest source of lobbying in Washington. Last year, we spent 6.5 billion hours filling out tax forms—the equivalent of three million full-time jobs. The code has been changed more than 14,000 times since 1986 and, no matter what your faith, it is beyond redemption. The only thing to do with this monster is drive a stake through its heart, bury it, and hope it never rises. We need to start all over.

I am personally in favor of a flat tax: a single rate, with generous exemptions for adults and children, and no federal income tax on the first $46,000 for a family of four. Beyond that, the rate should be 17 percent with no taxes on savings or death. We should be able to leave this world unmolested by the IRS—or, as the Founders would say, no taxation without respiration. The same rules should apply on the corporate side. If you do that,

the dollar is as good as gold.

The next barrier to growth, not surprisingly, is spending. Of course, it's not just that public spending is wasteful. It's ultimately a source of power. What the government does is, it takes resources from you, puts it through the sausage factory, takes a cut, and then spits it out to politically anointed recipients. That's not stimulus; it's stagnation. One reason the current president doesn't like achieving real reductions in spending is because he knows, given his background, that it is a source of power. The more resources you control, the more power you have at the center. John Maynard Keynes, after all, said it doesn't matter whether you dig a hole and fill it up again—it doesn't matter where the money goes— as long as you have that power. It's about power, which is why they love it when the government goes from 20 percent of GDP to 25 percent. The more the better.

Regulations are another form of taxation, a burden on the economy. The cost of complying with regulations each year in this country is $1.75 trillion. The regulatory state, in other words, is bigger than every economy in the world except for the top three or four. We do that to ourselves with regulations.

James Madison, the father of the Constitution, wrote in *Federalist* 51: "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary." We need sensible rules for the road. We need speed limits in school zones, for instance—but this is very different from the government telling you what, where, and when to drive.

C. Northcote Parkinson was a British naval historian and author of the bestseller *Parkinson's Law*. Back in the 1920s, he noticed that the British Navy was sharply downsized after World War I, when they thought they weren't going to have any more wars to fight. They had far fewer ships, far fewer crews, and far fewer dock workers. But what Parkinson noticed in particular was that the Admiralty, which ran the navy, was bigger than it was when the war ended! And he concluded that organizations grow—like weeds—until somebody stops them, no matter what may be the work at hand.

The same is true of all organizations. They all, if you leave them alone, lose sight of why they were originally created. But private markets serve as a check on this tendency. If you expand to fill the allotted time, without meeting the needs and wants of the market, you fail. Why, then, is the FDA still testing based on a model from 60 years ago—a period during which there have been countless major advances in medicine? Why are they letting countless cancer patients lead shortened lives by refusing to approve medications? It's a power play, in a sea of cumbersome rules, with no incentive to streamline the process.


Steve Forbes

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Ronald Reagan was right. He said that if you want to change minds in Washington, the best way to do it is through the heat of public opinion. It is not enough to have a change at the top and get a few new faces on Capitol Hill. Ideas matter—and we need to make the case that free enterprise works. Markets create social trust. Government destroys it. In the real world, even if you lust for money, you don't get it unless you provide for others—and, without you knowing it, that creates circles of cooperation. Markets force you to look toward the future. That's what the Cato Institute understands, and that's the mentality that we must encourage to get others to understand as well.

MARY ANASTASIA O'GRADY: Many of you are no doubt wondering what Latin America could possibly teach the United States—what with our muscular Constitution, open markets, limits on federal power, and independent central bank. (No snickering, please.) I was once like you. But, in the last few years, I have seen a number of frightening parallels between this country and our neighbors to the south. To be clear, those parallels did not begin with this president, but they have certainly become more pronounced under the current administration.

The fashionable explanation for Latin American underdevelopment blames corruption, lack of education, poor infrastructure, and—my personal favorite—a shortage of money. But these things are symptoms of bad policies, which I sum up as the Three Ps of poverty: populism, protectionism, and prohibition. Our challenges are, how do we keep politicians from turning us into government dependents? How do we keep markets open? How do we change drug laws in a way that prevents organized crime from replacing democratic institutions?

Yet, I'm increasingly convinced that, just as corruption and poor infrastructure are byproducts of the Three Ps, so are the Three Ps byproducts of something else. The source of our economic troubles—in both Latin America and here—is, I believe, much more fundamental.

Consider two simple observations. First, to borrow a fundamental principle of the Cato Institute, ideas matter. To be more specific, those ideas that prevail in society as legitimate are what matter. And second, without entrepreneurship, it is impossible for a society to achieve prosperity.

Looking beyond the immediate policy challenges in Latin America, it becomes clear

that it is the ideas of academia—and of intellectuals more broadly—that have played the most important role in undermining the entrepreneurial spirit in Latin American over the past century. Ideas that are hostile to entrepreneurship are not only part of the popular culture, they are embedded in the basic institutions of these countries.

At their core, these ideas hold that profits are morally suspect and private property is not justified, and it is these ideas that strike directly at the heart of prosperity for hundreds of millions of Latin Americans.

How did this happen? As John Maynard Keynes wrote, "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men who believe themselves to be quite exempt from any intellectual influence are usually the slaves of some defunct economist. Madmen in authority"—we won't mention names—"who hear voices in the air are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas." This is a truism that Latin Americans did not understand until it was too late—and it is how we too will lose if we don't emphasize the moral case for the market. Latin Americans, of course, have no problem being entrepreneurial. Immigrants to the United States have a long history of starting their own businesses once they've landed. So why don't they display these same skills at home? I submit to you that it is because the dominant ideas in the region over the last century have been hostile to entrepreneurship.

In a new book entitled *Redeemers: Ideas and Power in Latin America*, the Mexican historian Enrique Krauze profiles 12 individuals who he believes represent the major political ideas in the region from the middle of the 19th century through the 20th. He starts with José Martí and ends with Hugo Chávez—and along the way he includes profiles on Eva Perón, Che Guevara, Octavio Paz, Gabriel Garcia Márquez, and Bishop Samuel Ruiz, among others. These individuals, Krauze argues, were the ones who sowed the dominant political ideas over that time period. And those ideas focused on hostility toward individualism. Collectivism, economic equality, and the socialization of risk were the chosen themes of political philosophy—


Mary Anastasia O'Grady

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and it was the dissemination of these ideas that molded the norms and values of their respective countries. Not one name listed here, by the way, is an entrepreneur. I should add that Krauze also includes Mario Vargas Llosa in the group. He is not a collectivist but he is the exception to the rule.

The power of ideas was well understood among intellectuals on the left throughout the 20th century. They made it their business to get control of academia, and they succeeded. Take for example Venezuela, where the left got total control of the universities, and in the classroom a new narrative emerged. It gave the moral high ground to the state and denounced the market as immoral. Venezuela is reaping the fruits of that indoctrination today. Millions of Latin American students around the region have been marinated in that same stew. This view—that government redistribution is the source of justice and the market is greedy and wrought with failure—has had a profound effect on the political and economic climate in the region.

Today, the ideas of Che Guevara and Eva Perón have been discredited. Modern socialists—those who reject communism and fascism but favor some other form of collectivism—do not attack private enterprise head on. That would be suicidal because the market has created so much prosperity. They therefore emphasize not the wealth of nations, but the immorality of inequality. This, for socialists, is the soft underbelly of the market.

In societies where the morality of the market is understood, vigorously defended, and imparted to young minds, the ethics of collectivism doesn't do very well. But Latin America shows what can happen when the market is not defended. Even in a society that has made economic gains by adopting free-market policies, if the population is not convinced of the legitimacy of the market, it will attempt to destroy what it has achieved.

Take Chile, where since last year students have been running wild in the streets, making all kinds of demands from their government, and accusing those who don't give in of immorality. The tragedy is that the country's establishment—including the president—has not been able to put up a strong defense. This is in Chile, the one place in the region that actually reduced poverty significantly. We should be thankful for scholars like José Piñera for carrying the torch of liberty in Chile. But the fact remains that while Chileans are beneficiaries of the market system, they don't seem convinced of the morality of private property—and of differing outcomes.

Outside of Chile, things are even worse. In most of the region, the idea that equality is the highest goal was handed down from the ivory towers and enshrined in the constitu-

Continued on page 19

benefits are taken into account. While he finds that total state and local liabilities would be much larger, only some states would continue to struggle to improve their poor funding conditions, while others would likely improve over time. In the end Gokhale concludes that a significant portion of the deterioration happened in states with initially well-funded plans. "Much of the blame for this must be placed on the illogical accounting standards set by the Governmental Accounting Standards Board," he writes.

Social Security: Privatize It

The recent volatility of capital markets has reinforced the widespread argument that private investment in personal retirement accounts is unacceptably risky. "I'd have thought, after being reminded how quickly the stock market can tumble . . . that no one would want to place bets with Social Security on Wall Street," President Obama has said. But in **"Still a Better Deal: Private Investment vs. Social Security"** (Policy Analysis no. 692), senior fellow Michael Tanner provides substantial evidence that, in the long term, private capital investments are "a remarkably safe bet." After running through several different hypothetical investment scenarios, Tanner finds that—in each instance—a worker would have received higher monthly benefits from private investment.

"In fact, even in the worst-case scenario, a low-wage worker who invests entirely in bonds, the worker does no worse than under Social Security," he writes. Ultimately, the debate comes down to a question of risk. By its nature, Tanner notes, private capital investment will always contain a degree of uncertainty. Yet the current system is facing a $21 trillion shortfall in the future. As such, allowing workers to invest in a system of personal accounts involves "exchanging the political risks of an underfunded Social Security system for the market risks of private investment." Tanner concludes that the choice is clear. According to the numbers, "the vast majority of younger workers would be better off switching to such a system."

Mortgage Finance and the FHA

The government-sponsored enterprises Fannie Mae and Freddie Mac—along with many private subprime lenders—played the starring roles in the recent mortgage meltdown. But there were a number of supporting parts as well. In **"Fixing Mortgage Finance: What to Do with the Federal Housing Administration?"** (Briefing Paper no. 123), Mark Calabria, director of financial regulation studies at the Cato Institute, focuses on the most prominent. The Federal Housing Administration (FHA)—an agency tasked with insuring lenders against the risk of borrower default—was "one of the largest sources of credit for subprime borrowers." Calabria delves into the history of the FHA, "which has been one of an almost constant reduction in standards, usually as an excuse to 'restart' the housing market." The recent bust, he notes, has been similarly characterized by "governmental attempts to restart the bubble by transferring massive amounts of risk to the taxpayer"—and doing so at a great cost. The main problem with the FHA is that small changes in its portfolio can result in significant losses, potentially costing taxpayers more than the bank bailouts of the Troubled Asset Relief Program. Calabria therefore advocates a step toward sounder footing. The FHA should be scaled back immediately, he writes—with an emphasis on improving its credit quality—as a preliminary step toward terminating the agency in full. "Only then can we hope to avoid leaving the taxpayer holding the bag when the next bubble inevitably bursts," he concludes. ■

Continued from page 11

tions themselves. Latin American constitutions are hundreds of pages long. They have objectives like guaranteed national development, the eradication of poverty, and the protection of cultural heritage. The 1988 Brazilian constitution offers constitutional rights for everything from health to education. It guarantees minimum salaries, year-end bonuses, and vacation pay. The section dedicated to sports specifies that "the government shall encourage leisure as a form of social promotion."

Of course, who can object when the goal is to make the poor child more equal to the wealthy entrepreneur? The problem with a constitution that guarantees equality of outcome is that it cannot protect individual rights. It gives the government not only the power, but the *obligation* to use coercion toward that end. The fundamental problem with Latin development is this lack of liberty, which emanates from constitutional mandates that intrude on every aspect of human action.

What I'm describing originates with the intellectual class, of course, but many of these bad ideas in Latin America gained influence because the business class supported them. The 1961 Venezuelan constitution was, by most accounts, a fairly sound document. But factions, as James Madison would have called them, began to pick it apart. The business community played a key role.

Venezuelan journalist Carlos Ball described the process like this: "Many in the business community did not rebel against the growing state intrusion because they saw it was easier to convince one cabinet minister than a market of consumers. I'll never forget watching Venezuelan businessmen cheering the nationalization of foreign oil companies, not realizing that the politicians would soon come after them with more controls, regulations, and taxes."

The lesson is that when the state seizes the moral high ground in matters of personal decisions, there is no end to the steps that it will take to restrain liberty in the name of social justice. Our neighbors to the south have demonstrated it. You may think this can't happen in the United States of America. Unfortunately, I am nowhere near as convinced. ■