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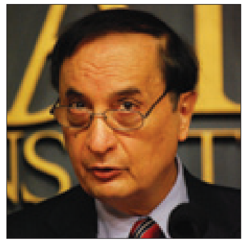

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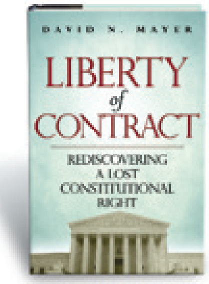

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Law schools teach a folktale
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Cato Policy Report

January/February 2011 Vol. XXXIII No. 1

Easy Money and the Decapitalization of America

BY KEVIN DOWD AND MARTIN HUTCHINSON

In the Gospel of Matthew, Jesus recounts the Parable of the Talents: the story of how the master goes away and leaves each of three servants with sums of money to look after in his absence. He then returns and holds them to account: the first two have invested wisely and give the master a good return, and he rewards them. The third, however, is a wicked servant who couldn't be bothered even to put the money in the bank where it could earn interest; instead, he simply buried the money and gave his master a zero return; he is thrown into the darkness, where there is weeping and wailing and gnashing of teeth.

In the modern American version of the parable, the eternal truth of the original remains—good stewardship is as important as it has always been—and there is still one master (the American public), albeit a master in name only, who entrusts his capital to the stewardship of his supposed servants. Instead of three, however, there are now only two (the Federal Reserve and the federal government); they are not especially wicked, but they certainly are incompetent: they run amok and manage to squander so much of their master's capital that he is ultimately ruined, and it is he rather than they who goes on to suffer an eternity of wailing and teeth-gnashing, not to mention impoverishment. For their part, the two incompetent servants deny all responsibility, as good politicians always do, and—since there is no accountability (let alone biblical justice) in the modern version—ride off into the sunset insisting that none of this was their fault.

FUTURE ASSET BUBBLES?

The Federal Reserve is supposed to be a monetary servant, but its masters in the general public don't seem to be able to control it. Its actions keep distorting returns in the economy and creating bubble after bubble.

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KEVIN DOWD is a visiting professor at the Pensions Institute at Cass Business School in London and an adjunct scholar at the Cato Institute. **MARTIN HUTCHINSON** is a former banker, correspondent for Reuters BreakingViews, and author of the weekly column "The Bear's Lair." They are coauthors of *Alchemists of Loss: How Modern Finance and Government Intervention Crashed the Financial System* (Wiley, 2010). This article is based on their paper for the Cato Institute's 28th Annual Monetary Conference, "Asset Bubbles and Monetary Policy."

H. L. Mencken Research Fellow P. J. O'ROURKE speaks at the Cato Institute on November 3. The event concluded a five-city tour for his new book, *Don't Vote: It Just Encourages the Bastards*, with stops in Dallas, Houston, Los Angeles, San Francisco, and Washington.

BY DAVID BOAZ

"When libertarians defend limited government, we are defending freedom and the progress it brings."

Editorial

The Joys of Freedom

A colleague tells me that we're too negative here at the Cato Institute; we spend too much time talking about the depredations of government rather than the benefits of freedom, even *The Joy of Freedom*, as David Henderson put it.

That's probably true of my own book *The Politics of Freedom*. So to start the new year, I want to talk about freedom, not politics.

Sometimes libertarians and our critics, arguing over what kind of rules are needed to ensure social harmony, forget just how much of our life is in fact free. We make thousands of choices every day, engage in thousands of interactions with others, without any coercion. That's a powerful demonstration of the central place of freedom in our lives, and the ability of people to create peace and order without central direction.

It's not easy to define freedom. Leonard Read said, "Freedom is the absence of man-concocted restraints against the release of creative energy." Hayek referred to "a state in which each can use his knowledge for his purposes." Tom G. Palmer is partial to this description from John Locke:

> [T]he end of Law is not to abolish or restrain, but to preserve and enlarge Freedom: For in all the states of created beings capable of Laws, where there is no Law, there is no Freedom. For Liberty is to be free from restraint and violence from others which cannot be, where there is no Law: But Freedom is not, as we are told, A Liberty for every Man to do what he lists: (For who could be free, when every other Man's Humour might domineer over him?) But a Liberty to dispose, and order, as he lists, his Persons, Actions, Possessions, and his whole Property, within the Allowance of those Laws under which he is; and therein not to be subject to the arbitrary Will of another, but freely follow his own. (*Second Treatise on Government*, sec. 57; discussed in Palmer, *Realizing Freedom*.)

That is, a free person is not "subject to the arbitrary will of another" and is free to do as he chooses with his own person and property. But you can only have those freedoms when the law protects your freedom and everyone else's.

However we define freedom, we can certainly recognize aspects of it. Freedom means respecting the moral autonomy of each person, seeing each person as the owner of his or her own life, and each free to make the important decisions about his life.

Freedom gives meaning to our lives; indeed, it allows us to define our own meaning, to define what's important to us. Justice Antonin Scalia mocked his colleague Anthony Kennedy for writing, "At the heart of liberty is the right to define one's own concept of existence, of meaning, of the universe and the mystery of human life." But surely (whatever its relevance to constitutional jurisprudence) that is a part of freedom.

And thus each of us should be free to think, to speak, to write, to create, to marry, to eat and drink and smoke, to start and run a business, to associate with others as we choose. Freedom is the foundation of our ability to construct our lives as we see fit.

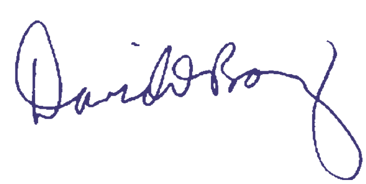
The social consequences of freedom are equally desirable. Freedom leads to social harmony. We have less conflict when we have fewer specific rules about how we should live—in terms of class or caste, religion, dress, lifestyle, or schools.

Economic freedom means that people are free to produce and to exchange with others. Freely negotiated and agreed-upon prices carry information throughout the economy about what people want and what can be done more efficiently. As Henry Hazlitt put it, for an economic order to function, prices must be free to tell the truth. A free economy gives people incentives to invent, innovate, and produce more goods and services for the whole society. That means more satisfaction of more wants, a higher standard of living for everyone, and more economic growth.

And that process has taken us in barely 250 years of economic freedom from the back-breaking labor and short life expectancy that were the natural lot of mankind since time immemorial to the abundance we see around us today in more and more parts of the world (though not yet enough of the world).

The country singer Brad Paisley's video, "Welcome to the Future," captures a lot of this. It's an ode to commerce, technology, achievement, social change, and cultural diversity. (The video makes that clearer than the song itself. And also check out his "American Saturday Night," a celebration of trade and immigration.)

Ancient man was just as smart as we are. So what's changed? Freedom. A political system of liberty gives us the opportunity to use our talents and to cooperate with others to create and produce, with the help of a few simple institutions that protect our rights. And those simple institutions—property rights, the rule of law, a prohibition on the initiation of force—make possible invention, innovation, and progress in commerce, technology, and styles of living. When libertarians defend limited government, we are defending freedom and the progress it brings.



The Constitution and the right to contract

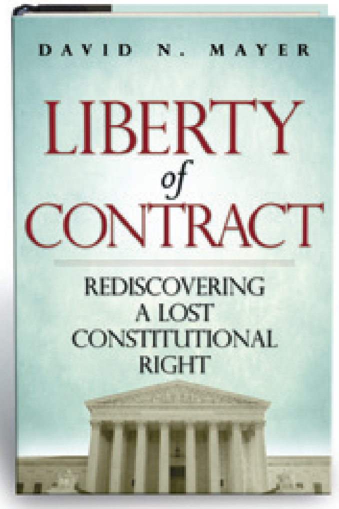
Correcting the Narrative of Liberty

Every young lawyer studies the reviled *Lochner v. New York* decision in his first class in constitutional law. In 1905, the professor teaches, the Supreme Court overturned a maximum-hours law intended to protect poor bakers from employer predation and, in so doing, forced hated laissez faire economics upon a market-broken people. Justice Oliver Wendell Holmes, Jr., offered perhaps the most famous dissent in constitutional jurisprudence, fulminating that "a constitution is not intended to embody a particular economic theory." It wasn't until 1937 and the New Deal that the Court righted its course.

All of which is hogwash, argues David N. Mayer in *Liberty of Contract: Rediscovering a Lost Constitutional Right*. Mayer, a professor of law and history at Capital University, places *Lochner*, which he notes is "commonly regarded by legal scholars as the archetypical activist decision of the Supreme Court," within the extended history of the broader liberty of contract.

"For a period of exactly 40 years, from 1897 to 1937, the Supreme Court protected liberty of contract as a fundamental right, one aspect of the basic right to liberty safeguarded under the Constitution's due process clauses," Mayer writes. He shows how this protection, far from being about promoting a given take on economics, was only part of a larger judicial mandate to maintain general liberty. Thus decisions like *Lochner*, which halted government meddling in the labor market, were not about protecting the market at all. Rather, Mayer argues, they saw the courts upholding the right of every individual to freely make choices about how to lead his or her own life.

Mayer finds this liberty of contract embedded deep in the common-law tradition inherited from England. And this tradition places the *Lochner* Court squarely at odds with the epithet commonly hurled at it by progressive scholars. "Contrary to the orthodox, Holmesian view," Mayer writes, "the Court was not engaged in judicial activism when it protected liberty of contract as a fundamental right during the 40-year period prior to 1937. Rather, the Court was simply enforcing the law of the Constitution, specifically the right to liberty as protected substantively under the Fifth Amendment's or the Fourteenth Amendment's due process clause."



The other half of the story told in law schools is wrong, too, Mayer argues. Progressive legal scholars who see the *Lochner* decision as the high-water mark of judicial activism subsequently point to *Lochner*'s overturning as a return to neutral principles of constitutional adjudication. But the judges who overturned *Lochner*-era jurisprudence, far from being principled, were ignoring principles. "They were judicial activists who abdicated their twin duties of enforcing constitutional limits on government power and protecting the fundamental rights of individuals—all in order to advance the New Deal policy agenda."

Mayer traces the fall of *Lochner* and, with it, the liberty of contract, to three factors: the Court's changing membership, the standard of review, and shifts in popular theories of jurisprudence. Regarding this last, Mayer argues that "the rise of legal realism and sociological jurisprudence" crowded out "the old jurisprudence of natural law and natural rights, which had informed America's founding generation and the original principles of liberty."

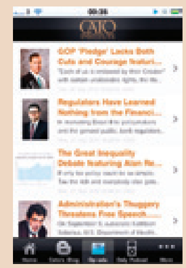
Mayer concludes by exposing the underlying ideology of *Lochner's* critics. The view of that case and its era taught to every law student is a "folktale," one "invented by early 20th-century Progressive movement scholars"—a folktale "perpetuated by modern-day apologists for the 20th-century welfare/regulatory state."

Liberty of Contract sets the record straight. ■

Visit www.cato.org/store or call 800-767-1241 to get your copy of *Liberty of Contract* today; $21.95 hardback.

Cato News Notes

THERE'S AN APP FOR THAT



The Cato Institute's new iPhone app, available for free, is a great way to stay up to date, from wherever you are, with everything that's happening at Cato. From being able to access the Cato@Liberty blog, or op-eds penned in major publications by Cato scholars, to gaining instant access to the latest Cato Daily Podcast or cable TV news clips, you can now have Cato Institute information resources in the palm of your hand—or on your iPad. To download the app, just search "Cato" in the iTunes App Store.

CATO AND MEXICO'S DRUG WAR

Former Mexican president Vicente Fox had kind words for "the prestigious Cato Institute" in a recent post on his blog. Fox, discussing the disastrous War on Drugs that continues to cause horrific violence within his country, quoted at length from Cato scholar Juan Carlos Hidalgo's writing about the parallels between drug prohibition and alcohol prohibition 80 years earlier. Fox then turned to Glenn Greenwald's *Salon* column about California's Proposition 19 and Greenwald's Cato study on drug decriminalization in Portugal. Cato president Edward H. Crane had raised the topic of drug legalization with Fox and his top advisers when the then-president hosted Crane and other Cato scholars at Los Pinos, the presidential residence, during a 2002 Cato conference in Mexico City.

JOHN MCWHORTER of Columbia University, a contributing editor to the *New Republic* and *City Journal*, discusses the devastating impact the war on drugs has had on black families. He spoke at a Cato Institute seminar in New York in October.

Cato Institute founder and president EDWARD H. CRANE (left) greets KEVIN KANE, president of the Louisiana-based Pelican Institute for Public Policy, at a dinner in Cato's Wintergarden. The event was part of the State Policy Network's Federalism in Action Summit in November.

CHRISTOPHER J. CONOVER (left), research scholar with the Center for Health Policy and Inequalities Research at Duke University, discusses his new Cato Institute study, "Congress Should Account for the Excess Burden of Taxation," at a Forum on October 13. He and DOUGLAS HOLTZ-EAKIN (right), former director of the Congressional Budget Office, emphasized the enormous deadweight loss taxes impose on the U.S. economy.

At a private lunch at the Cato Institute on November 4, ELAINE STERNBERG (left), author of *Corporate Governance: Accountability in the Marketplace* and *Just Business: Business Ethics in Action*, said the conventional view of business ethics taught in schools around the world and exemplified in "stakeholder theory" runs counter to fundamental human rights. Her argument generated a lively discussion among the philosophers and legal scholars at the lunch. DAVID BOAZ, Cato's executive vice president, listens.

Regulation magazine editor Peter Van Doren was one of several Cato scholars who spoke to students at the Fund for American Studies' Capital Semester program and the Swedish think tank Timbro's Sture Academy on November 8.

William H. Patterson, Jr., editor and publisher of *The Heinlein Journal*, discussed his new biography, *Robert A. Heinlein: In Dialogue with His Century*, at a Cato Book Forum on October 21. Heinlein, often called "the dean of science fiction writers," has been very popular with libertarians since the 1960s, especially for his novel *The Moon Is a Harsh Mistress*. Heinlein, who was a Cato Sponsor before his death in 1988, said that his favorite books were all "on one subject: Freedom and Self-Responsibility." In his biography, Patterson writes that Heinlein's writings "galvanized not one, but four social movements of his century: science fiction and its stepchild, the policy think tank; the counterculture; the libertarian movement; and the commercial space movement."

Continued from page 1

Since past expansionary monetary policies led to bubbles, we should expect the even more expansionary policies pursued since the onset of the current financial crisis to produce new bubbles, and this is exactly what we find. Within the United States there are at least three very obvious bubbles currently in full swing, each fuelled by the flood of cheap money: Treasury bonds, financial stocks, and junk bonds. We can be confident that these bubbles will come to unpleasant ends like their predecessors, but on a potentially much grander scale. The bubbles will then burst in quick succession.

We have to consider also the nontrivial knock-on effects: the Treasuries collapse will trigger an immediate financing crisis for governments at all levels, and especially for the federal government, one that will likely involve the downgrading of its AAA credit rating, and so further intensify the government's by-then already chronic financing problems. Nor should we forget that these financial tsunamis are likely to overwhelm the Federal Reserve itself: the Fed has a highly leveraged balance sheet that would do any aggressive hedge fund proud; it too will therefore suffer horrendous losses and is likely to become insolvent. The events of the last three years will then look like a picnic.

There is also the problem of resurgent inflation. For a long time, the United States has been protected from much of the inflationary impact of Federal Reserve policies: developments in IT and the cost reductions attendant on the outsourcing of production to East Asia had the impact of suppressing prices and masking the domestic impact of Fed policies. Instead, these policies have produced a massive buildup in global currency reserves: these have increased at 16% per annum since 1997–1998 and caused soaring commodity prices and rampant inflation in countries such as India (current inflation 16%) and China (maybe 20%, judging by wage inflation, and definitely much higher than official figures acknowledge), whose currencies have been (more or less) aligned to the dollar. U.S. inflation was already rising by 2008 (annual rate 3.85%), but this rise was put into reverse when bank lending and consumer spending then fell sharply. However, the huge additional monetary overhang created over the last couple of years (or, to put it more pointedly, the vast recent monetizations of government debt) must eventually flood forth—and, when it does, inflation is likely to rise sharply.

> "Federal Reserve monetary policy over the past 15 years or so has produced bubble after bubble, and each bubble is bigger and more damaging."

Once inflation makes a comeback, a point will eventually come when the Fed policy has to go into sharp reverse—as in the late 1970s, interest rates will be hiked upwards to slow down monetary growth. The consequences would be most unpleasant: the U.S. would experience the renewed miseries of stagflation—and a severe one at that, given the carnage of a renewed financial crisis and the large increases in money supply working through the system. Moreover, as in the early 1980s, higher interest rates would lead to major falls in asset prices and inflict further losses on financial institutions, wiping out their capital bases in the process. Thus, renewed inflation and higher interest rates would deliver yet another blow to an already gravely weakened financial system.

THE DECAPITALIZING EFFECTS OF REPEATED BUBBLES

Federal Reserve monetary policy over the past 15 years or so has produced bubble after bubble, and each bubble (or each group of contemporaneous bubbles) is bigger in aggregate and more damaging than the one that preceded it. Each bubble destroys part of the capital stock by diverting capital into economically unjustified uses—artificially low interest rates make investments appear more profitable than they really are, and this is especially so for investments with long-term horizons: that is, in Austrian terms, there is an artificial lengthening of the investment horizon. These distortions and resulting losses are magnified further once a bubble takes hold and inflicts its damage, too: the end result is a lot of ruined investors and "bubble blight"—massive overcapacity in the sectors affected. This has happened again and again, in one sector after another: tech, real estate, Treasuries, and now financial stocks, junk bonds, and commodities—and the same policy also helps to spawn bubbles overseas, mostly notably in emerging markets right now.

We also have to consider how periods of prolonged low (and often sub-zero) real interest rates have led to sharply reduced saving and, hence, to lower capital accumulation over time. U.S. savings rates have fallen progressively since the early 1980s, falling from nearly 12% to a little over 6% by the end of the decade, bottoming out at 1.4% in 2005. It then recovered somewhat, but even after the shock of 2008, the savings rate rose in 2009 to only 5.9%—well below its long-term average of about 8%—and the most recent data suggests that it is now declining again.

Even without federal budget deficits, it is manifestly obvious that such savings rates are inadequate to provide for the maintenance, let alone growth, of the U.S. capital stock (or, for that matter, its citizens' desires for a secure retirement): the U.S. economy is effectively eating its own seed-corn. Now add in the impact of federal budget deficits of around 10% of GDP and we see that the deficits alone take up more than the economy's entire savings, without a penny left over for investment. It then becomes necessary to supply U.S. capital needs by foreign borrowing—hence the persistent and worrying balance of payments deficits—but even this borrowing is not enough. Hence over the long term, low interest rates are decapitalizing the U.S. economy, with damaging long-term implications for its residents' living standards: in the long run, low interest leads to low saving and capital decline, and they in turn lead to stagnation and eventually to the prospect of declining living standards as America ceases to be a capital-rich economy.

Not to put too fine a point on it, savings have been suppressed for close to two decades, preventing the natural accumulation of capital as baby boomers have drawn closer to retirement, while much of the country's magnificent and once unmatched capital stock is being poured down a succession of rat holes.

> "Savings have been suppressed for close to two decades, preventing the natural accumulation of capital as baby boomers have drawn closer to retirement."

THE FEDERAL GOVERNMENT DESTROYS CAPITAL

We should also see these problems in the context of a vast number of other government policies that are decapitalizing the U.S. economy. The wastefulness of government infrastructure projects is an obvious case in point. One instance is the Amtrak proposal for a Boston-Washington high-speed railroad, costed at $118 billion, compared to $20 billion equivalent for similar lines in France and under $10 billion for a line recently opened in China. Even more striking is the ARC tunnel project between Manhattan and New Jersey, recently killed by Gov. Chris Christie because of its excessive cost of $8.7 billion plus likely overruns. Yet the Holland Tunnel, performing an identical function and opened in 1927, came in at $48 million, equivalent to $606 million in 2010 dollars. Even allowing for the higher real wages of today's construction labor, and a certain amount of fiddling of the consumer price statistics by the Bureau of Labor Statistics, it should have been possible to bring the ARC project in at under $2 billion, less than a quarter of the actual projected cost. The high costs of infrastructure problems boil down to the onerous regulations under which such projects are carried out, such as the Davis-Bacon mandate to use union labor on federally funded projects and a whole welter of health, safety, and environmental regulations.

We also have to consider the impact of government fiscal policy. Large government deficits reduce capital accumulation insofar as they crowd out private investments; large levels of government debt also reduce capital accumulation in that they imply large future burdens on taxpayers, and these burdens reduce their ability (not to mention their willingness) to save. The government's deficits have risen from 1.14% of GDP in 2007 to a projected 10.64% of GDP in 2010. In the process, U.S. government official gross debt has grown from almost 64% of GDP in 2007 to a little over 94% of GDP in 2010. The rate at which it is rising would suggest that the U.S. government's credit rating will soon be threatened, even without the prospect of an imminent Treasuries collapse; indeed, this figure alone portends a rapidly approaching solvency crisis.

Yet even these grim figures are merely the tip of a much bigger iceberg. The official debt of the United States, large as it is, is dwarfed by its "unofficial" debt: the prospective expenditures on entitlement programs—Social Security, Medicare, Medicaid, food stamps, and more—to which the federal government has committed itself, but not provided for—that is, additional debts that future taxpayers are expected to pay for. Recent estimates of the size of this debt are hair-raising. Using CBO figures, Laurence Kotlikoff recently estimated that this debt was now $202 trillion. That is 15 times the "official" debt and nearly 14 times annual U.S. GDP—implying that the average U.S. citizen would need to work almost 14 years simply to pay off this debt: no wonder Kotlikoff concluded that the United States is in fact bankrupt. This burden implies punitive tax rates on future employment income (and hence major disincentives to work or at least to declare income), but will also greatly discourage future capital accumulation as investors will (rightly) fear that there is little point building up investments that will eventually be expropriated by the government.

LONG-TERM OUTLOOK FOR THE U.S. ECONOMY

The long-term effect of U.S. economic decapitalization will not necessarily be apparent in day-to-day headlines; instead, the process will be almost glacial: mostly slow but utterly devastating in its longer-term impact.

Americans might also take heed from the experiences of other once-wealthy countries whose economies were crippled by progressive decapitalization:

- Britain was a wealthy country at the very frontier of technological advance in the late 1930s. However, when World War II broke out, the government took complete control of the economy and seized its entire capital stock, foreign investments and all. Over the next decades a bloated state sector and onerous controls deprived British industry of the capital it needed to refit, and the country went into long-term economic decline. By the late 1970s Britain was being referred to as the new "sick man of Europe," and British living standards were 30% lower than Britain's European competitors' and half those in the United States.
- Argentina, one of the world's wealthiest economies in 1930, with enormous foreign exchange reserves from wartime trading as late as 1945, embarked on wildly extravagant schemes of corruption, nationalization, and income redistribution under its 1946–1955 dictator

Juan Perón. Once Perón was removed, successive governments tried to restore Argentina's position—it was after all superbly endowed with resources and in the 1940s had a highly competitive education system—but without adequate access to capital were unable to do so. The result was progressive impoverishment, repeated debt defaults, and the country's descent into its continuing socialist squalor.

> "Monetary reform on its own will not be enough to reverse the destruction of U.S. capital: the federal government also needs to reform its own vast range of capital-destroying policies."

WHAT CAN BE DONE?

Thankfully, such a dire future is not inevitable, but radical reforms will be needed if it is to be avoided. Any reforms need to be based on a diagnosis of the underlying problems, and one of the most important of these is, quite simply, that U.S. policymakers place too much emphasis on the short term and fail to take adequate account of longer-term consequences. Nor should this be any surprise: the political environment in which they operate—including the fact that they are accountable over limited terms of office—encourages them to focus on the short term, so it is only to be expected that they would respond to such incentives: what happens after their watch is not their problem.

As far as monetary policy is concerned, these short-termist incentives create an inbuilt expansionary bias that has manifested itself in repeated asset price bubbles and now the prospect of renewed inflation, and the solution is to build in barriers to contain this bias. The key here is to reduce or—better still—eliminate the Fed's discretionary powers; this would put a stop to those who would meddle with the short-term interest rate and would thus head off the asset bubble cycle at its root. Interest rates would then be higher (and more stable) than they have been over recent years and so provide a stronger incentive for saving.

One possible reform would be to end the Fed's "dual mandate" and give it a single overriding objective—namely the maintenance of price stability—and reform its institutional structure to protect its independence from the federal government. Reformers could take their lead from the late lamented Bundesbank: instead of a federated central bank accountable to the federal government and headquartered in the federal capital, the American central bank could be reconstituted as a unitary central bank accountable to the states and relocated in the heartland of the nation: our recommended choice would be St. Louis, which also has the attractions of a strong monetarist tradition and of being less susceptible to the influences of Washington or Wall Street. The ideal Fed chairman would then be more concerned with the *St. Louis Post-Dispatch* than the *Washington Post* or the *Wall Street Journal*, and even the feeblest appointee would be strong enough to stand up to the badgering of east coast politicians and financiers.

A far better reform—and a far more appropriate one, given the Fed's dismal record since its founding—would be to abolish the Federal Reserve altogether and re-anchor the dollar to a sound commodity standard. A natural choice would be a gold standard, with the currency issued by commercial banks but pegged to and redeemable in gold. Interest rates and money supply would no longer be determined by central bankers but by market forces subject to the discipline of the gold standard. An alternative anchor might be some broader commodity basket, which has the additional attraction of promising greater price-level stability than a gold standard.

Yet monetary reform on its own will not be enough to reverse the destruction of U.S. capital: the federal government also needs to reform its own vast range of capital-destroying policies. Such reforms would include, among others, the following: (1) Government should stop meddling in the financial system; it should stop such programs as mortgage guarantees and deposit insurance, implement measures to prevent future bailouts, and abolish government-supported enterprises such as Fannie Mae and Freddie Mac, whose machinations have devastated the U.S. housing market. (2) Reformers should acknowledge the tendency of government to grow and to be excessively focused on the short term, and should push for a systematic program that will sharply reduce the size and scope of government and limit any future growth. (3) A range of tax reforms is needed to abolish tax-based incentives to borrow and remove tax penalties from saving, investing, and the transfer of capital between generations. (4) Government should tackle major budget imbalances. This requires a reversal of current expansionary fiscal policies and, for once, the United Kingdom provides a positive role model: the U.K. faces similar problems, but the new U.K. coalition government acknowledges these problems and is in the process of implementing major cutbacks to take Britain back from the brink. The United States needs to do the same.

The longer-term fiscal prospects for both countries are of course dire, but the good news is that most actuarial deficits are not so much hard-and-fast debt obligations as projections of what will happen if current policies persist. There are obvious economies that can be made once the U.S. government finds the courage to tackle these problems. Were we given to flippant remarks, we would be tempted to suggest that the situation is "desperate but not serious"—and more tea parties would be a good start. But then, being British ourselves, we would approve of tea parties, wouldn't we? ■

James Madison and the Origins of Partisanship

Critics argue that Congress has become the "broken branch" of government, marked by extreme partisanship and few achievements. They prescribe nostrums ranging from campaign finance regulation to redistricting reform to foster compromise rather than conflict on Capitol Hill. Yet the American founders, especially James Madison, believed "ambition must be made to counteract ambition" as a way to limit the power of government. The Constitution itself favors broad consent to laws over an efficient implementation of the will of a majority. William F. Connelly, Jr., the John K. Boardman Professor of Politics at Washington and Lee University and author of *James Madison Rules America: The Constitutional Origins of Congressional Partisanship*, and W. Lee Rawls, a longtime Senate chief of staff and author of *In Praise of Deadlock: How Partisan Struggle Makes Better Laws*, discussed Connelly's book, as well as the benefits and burdens of partisanship, at a Cato Book Forum in October.

WILLIAM F. CONNELLY, JR.: James Madison's Constitution incorporates both the mischief of faction and the spirit of party. American politics encompasses both intense minorities and aspiring majorities—both minority factions and special interest groups, and majority sentiment, often given voice by majoritarian parties. The Constitution checks and balances special interests and political parties, but the Constitution also embraces and empowers special interests and political parties. Arguably, the struggle among contending interest groups both constitutes and, if you will, corrupts our politics. Similarly, partisan confrontation between the political parties both constitutes and potentially corrupts our politics.

People persist today in arguing that the Founders were anti-party. Yet Madison concluded, "Parties . . . seem to have a permanent foundation in the variance of political opinions in free states." Madison saw politics as essentially partisan: "No free country has ever been without parties, which are a natural offspring of freedom." Indeed, he observed, "The Constitution itself . . . must be an unfailing source of party distinctions." It is tempting to concur with Madison and conclude that partisanship to this day is rooted in the Constitution.

Some insist today that the Founders did not expect political parties to form, that parties only arose later in American history. But in a 1792 essay titled "A Candid State of Parties," Madison concluded that parties of distinction are "natural to most political societies," and will likely endure. Even to this day, perhaps?

Admittedly, "A Candid State of Parties" is a partisan tract, just as were *The Federalist Papers*. Madison the Founder was a statesman, a politician, a political theorist, and a partisan. And that is not a criticism. Madison clearly understood that "in every political society, parties are unavoidable." In fact, he concluded parties "must always be expected in a government as free as ours."

Madison recognized that American politics and partisanship are rooted in the Constitution. Mere partisanship is possible precisely because of limited constitutional government, or as I like to say, the Constitution governs parties more than the parties govern the Constitution. Our constitutional concrete is sufficient to withstand partisan warfare today just as it did in the 1790s.

Partisanship is rooted in the Constitution because of First Amendment freedoms. Clearly freedom of the press and freedom of association allow and even invite the abuse of licentiousness and excessive partisanship. But what is the alternative? Madison understood that in a free society, politics, including the spirit of party, is ubiquitous. Since the latent cause of faction and spirit of party are natural to man, Madison sought to control the effects of faction, rather than to remove the causes, since the cure would be worse than the disease. That is what the Anti-Federalists wanted; it would have required curbing liberty. The point was to expand, not limit, liberty.

Partisanship is also rooted in the Constitution in another fundamental way. Throughout our history beginning in the 1790s, partisanship has been premised on the fault lines of constitutional interpretation and debate over the central principles of the separation of powers and federalism, or in other words, role of government questions. Contentious partisanship has its roots in the Constitution.

In the 1790s we also see the Founders' practice of their principles; their actions, too, seem to refute the notion that the Founders were anti-party. While the 1950s was a period of relative partisan quiescence as was the era of good feeling in the early part of the 1800s, I think if you look historically those two periods are the exception more than the rule.

Now, partisanship is potentially good and bad. Friction creates light as well as heat. Our Constitution invites constructive partisanship, including often cantankerous, cacophonous, contentious partisanship. The principal differences between our two great parties, whether over the war on terrorism, health care reform, or global warming, matter, and they are often principled differences.

It is worth examining some of the causes of heightened partisanship today. First, party primaries, especially in congressional elections, invite appeals to the party base, and clearly contribute to greater partisan polarizations. Should we eliminate congressional primaries or nominating primaries either at the presidential or congressional level? Should we return to the smoke-filled rooms?

A second cause is gerrymandered redistricting, especially enhanced by computer modeling. Perhaps we should adopt the reform of eliminating computers—or maybe not?

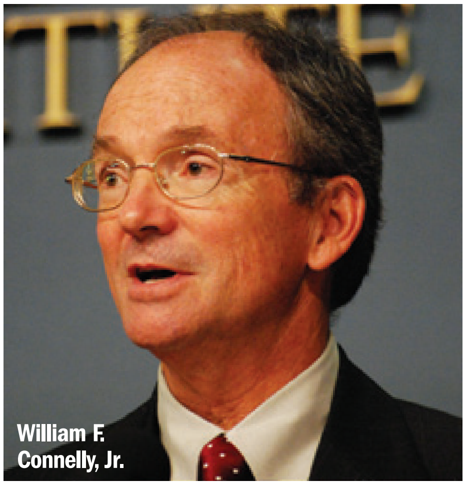
Third, the democratization and decentralization of Congress due to institutional reforms. Some of the above causes were consequences of the 1970s reforms, in Congress in particular, designed to make Congress more open and democratic. Should we reform the reforms?

Fourth: the growth of government and the concomitant increased stake in our politics contribute to increased partisan polarization. Big government gives you big politics. James Q. Wilson, one of the leading political scientists of recent generations, said that once politics was about a few things; today it is about nearly everything. Maybe what we need to do is limit government if we want to limit politics and make our politics less cantankerous.

Fifth, an important cause of partisan polarization has been the effort to advance comprehensive, nonincremental reforms. For example, the decision by Democrats to advance comprehensive health care reform may by its very nature have raised fundamental questions about the role of government. Perhaps we should refederalize some of the policy questions. Moreover, we blame political parties when we should also acknowledge the role of our two other key mediating institutions: interest groups and the media.

Sixth, greater partisan polarization is due to the explosion in the role of the number of interest groups, so-called hyperpluralism, including in the think-tank universe. Maybe we should blame or credit Cato for partisan polarization. The proliferation of think tanks over the last 30 to 40 to 50 years has contributed to a more ideological, or you could say more principled, politics.

Seventh, the dramatic increase in education among Americans augments polarization. If I may paraphrase Shakespeare, perhaps the first thing we should do is kill all the professors, though I personally hope we don't do that.


William F. Connelly, Jr.

"Throughout our history beginning in the 1790s, partisanship has been premised on debate over the role of government."

Eighth, decentralization, fragmentation, and greater competition of the new media as the hegemony of the old media establishment erodes have clearly contributed to the more cacophonous, contentious character of our politics. We're clearly not going to get rid of the Internet anytime soon. The media loves to report on the planes that crash, not the thousands of planes that fly successfully every day. Conflict is what gets covered as opposed to consensus, exaggerating the level of contentiousness in our politics. But do we want to get rid of the new media and return to the good old days, or was it the bad old days, of the media establishment? Do we really want to return to the 1960s' near monopoly of national news by NBC, ABC, CBS, the UPI, and AP wires?

And yet, finally, the most fundamental cause of partisan polarization may be our 200-year-old constitutional system which, as I suggested earlier, invites the spirit of party in our politics—and I certainly don't recommend a new constitutional convention.

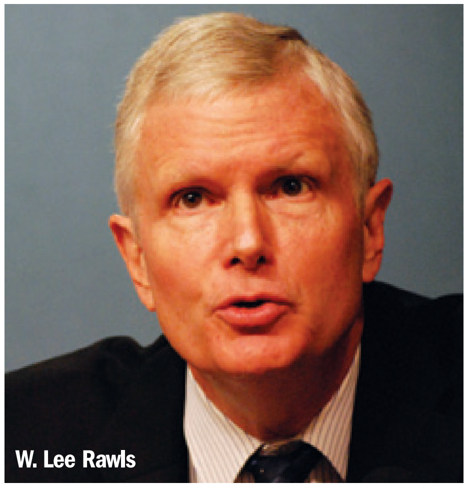
W. LEE RAWLS: For practitioners, this is a liberating book. For all of you who have cared deeply about America, participated in the American political system, and thought about America's future, this book is for you. If you're like me and over the past several decades have participated with gusto in our competitive two-party system, but you have found yourself recently pursued by a self-anointed core of political pundits crying foul at your every move, and demanding that you demonstrate more civility, comity, and a willingness to compromise, then this book is also for you.

Now, before I mistakenly portray this book as an ode to the rightwing rock star Ted Nugent, on the virtues of beef, beer, and hunting with a bow, let me emphasize that the liberation here is intellectual. At the core of Professor Connelly's thought, again to the practitioner, is what we would label "Madison's Conundrum." It is in fashioning this conundrum and embedding it in the Constitution that the full scope of Madison's genius becomes apparent. For Professor Connelly, the strategic challenge faced by every participant in the American legislative process in its simplest terms is, "Do you compromise or do you confront?" Do you seek bipartisanship or partisan advantage, are you after a policy solution or a political outcome? Do you want to achieve an agenda item of the party platform, or do you want to advance the party's desire to achieve power? For all of us who have participated in the process, this is an eternal dilemma. For some, it arises as an occasional issue. But I can say that for members of Congress, their staff, and the political elements of the executive branch, this is not just a daily, but an hourly issue, as to how you respond to the challenges before you.

The brilliance of Professor Connelly's analysis is that what I call conundrum is not only intentionally embedded in the Constitution, but that Madison has made it unavoidable. The combination of separation of powers, bicameralism, federalism, midterm elections, all work together to pin the decisionmaker eternally on the horns of this dilemma. In Federalist 10 and 51, Madison lays out the underlying rationale and mechanics of this dilemma. Now, whereas the Greek gods chained Prometheus to the rock for eternity in retribution for helping man, Madison is not after revenge. Instead, he pins the participants of the American political process on the eternal horns of this dilemma for a purpose, forcing future generations to walk a tightrope. The goal is limited, but effective, government. Madison is not just protecting it against the abuses of power by Congress and the executive, he's also aiming to provide a new nation, after the failure of the Articles of Confederation, an effective enough system to govern itself on a new continent.

Moreover, this conundrum not only provides for limited and effective government, it also provides for energetic, creative government. This is a point I had never thought about—40 years in the game and it never crossed my pea-brain, and I have to say as an aside, my wife stands prepared with a list of other points I've completely missed in my lifetime, but a little thought will quickly show you the value of this insight. Decentralized, horizontal systems with multiple participants are inherently more energetic and creative. This may offer an explanation of how a backwater country of several million in 1789 has managed to become the wealthiest, most powerful nation on the planet, utilizing a government designed 220 years ago. With his separation of power, Madison ensured that energy is not unchecked; with his cool, accurate assessment of human nature, Madison ensured that the combination of the strategic dilemma, the separation of powers served to keep energy within constitutional bounds. Madison gave us energy, deliberation, but not unchecked ambition.

After I left Senator Frist in 2005, I made the mistake of picking up and reading some of the "broken branch" literature. In particular, the broken branch school of thought criticized Senator Frist for passing the Medicare drug benefit and the bankruptcy legislation during his time as majority leader. Now, my understanding of broken means something that doesn't work, so I was mystified by a lot of the line of criticism that says when you pass something others disagree with, the system is broken. I fully understand policy or political disagreement; it says a piece of legislation is bad, poorly conceived, deserves defeat. But the fact that your opponent passes a bill you do not like does not strike me, at least, as evidence of a broken system; rather, it raises the fact that you, as an opponent, consider it to be bad law. The broken branch school also began to clamor for bipartisanship, compromise, and civility.


W. Lee Rawls

> "Madison would not be on the sidelines going tsk, tsk about the legislative process. He'd be in the middle of it."

I took some time and went over to the Woodrow Wilson International Center and wrote a little book that takes a hands-on look at the American legislative system. I'm going to do a little bit of a self-promotion and quote from the book that was written before the election in 2008: "Advocates of post-partisan politics invoke a new era where these tensions dissolve. Regrettably, as we have shown, the existing legislative machine will not grant them their wish. Moreover, as long as political parties remain the unit of cooperation within the American political system, and it is difficult to imagine American democracy without them, the desire of the post-partisans to cross the river Jordan into the political promised land will remain unfulfilled."

More important, the post-partisans fail to realize that the clash of contending forces they hear in the political arena is the sound of democracy at work.

Whereas the broken branch and other schools of thought attempt to solve Madison's dilemma, Madison rejects the very existence of a right answer. For Madison, as long as the dilemma stays intact and the basic constitutional machinery remains intact to provide limited and energetic government, the answer to the strategic dilemma at any given moment is up to the participants, based on a range of particular considerations that they face. Madison is not out to determine the outcomes as long as the decision takes place within a constitutional context. In fact, Madison would reject a silver bullet explanation or solution to his conundrum.

Madison would not be on the sidelines going tsk, tsk about purported fouls in the legislative process. He'd be in the middle of it, moving ahead rapidly, maximizing whatever he thought was the best policy. For Madison, you can choose bipartisanship, or you can go your merry partisan way. You can choose a policy outcome, or seek political advantage. You can even wholeheartedly engage in gridlock, which I have done on occasion. After all, gridlock is no more than a preference for existing law over some new untested scheme. All of these are valid responses. Think of Madison as offering a political form of the Atkins Diet: eat meat, be happy, lose weight.

In short, all Americans should feel that they can enter the political fray, love their country, and fight hard; and certainly don't let anybody tell you they have all the answers. ■

28th Annual Monetary Conference

Asset Bubbles and Monetary Policy

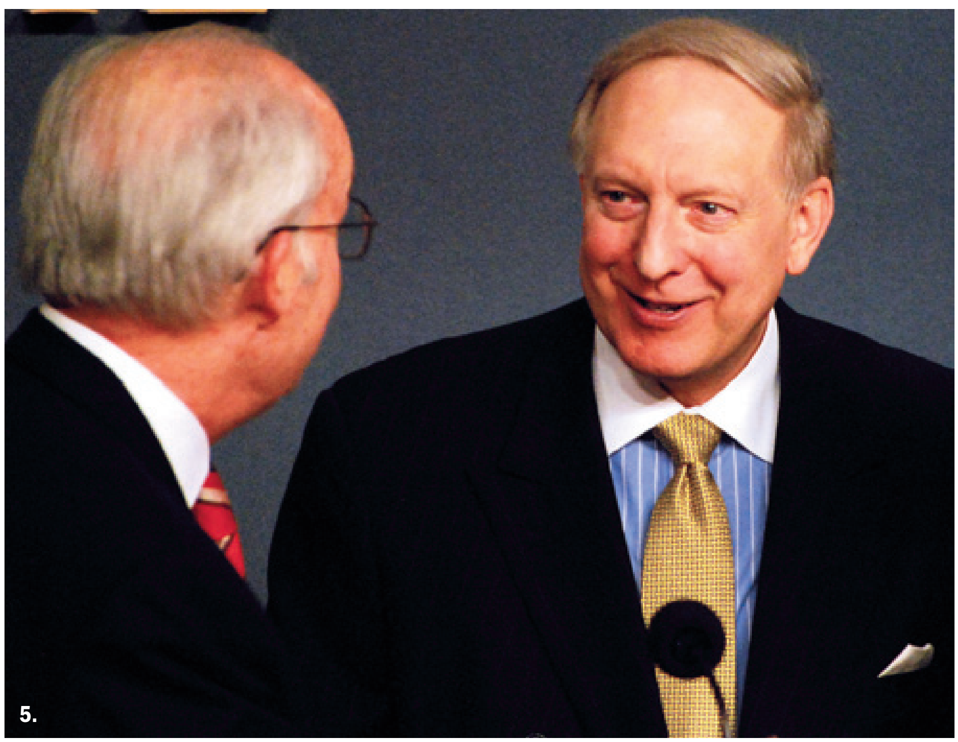
November marked the 28th year of Cato's Annual Monetary Conference directed by Cato vice president for academic affairs James A. Dorn. In a year marked by another round of quantitative easing, massive federal spending, and promises of much more, leading experts came together to consider the role of monetary policy in preventing financial instability and the function of asset prices in guiding policy.

The conference, which "drew a standing-room-only crowd," as the *New York Times* noted, addressed a key issue underlying the 2008 financial crisis: Did the Federal Reserve contribute to the crisis by keeping interest rates too low for too long? Would a more restrictive monetary policy have prevented the asset-price bubble in housing?

Jerry L. Jordan, former president of the Federal Reserve Bank of Cleveland, launched the conference with his keynote address on the need to limit Fed discretion and adopt a monetary constitution. Criticizing the Fed's handling of the financial crisis, he noted that, "once you damage the underlying rule of law in the economic political system, it's very hard to restore." He went on to argue that "fiscal policies have become part of the problem. They are not part of the solution, and monetary policies cannot correct the mistakes made by the rest of government."

On the first panel, Carmen M. Reinhart, coauthor (with Kenneth Rogoff) of *This Time Is Different: Eight Centuries of Financial Folly*, argued that the primary problem facing U.S. policymakers is the large debt overhang. While asset prices should be watched, debt crises must be resolved; tough choices must be made. Adam Posen, an external member of the monetary policy committee at the Bank of England, cautioned that central bankers don't have sufficient information to target asset prices and thus should not do so.

Lawrence H. White, Mercatus Professor of Economics at George Mason University, reminded everyone that the fundamental problem with the present global monetary



1. JERRY L. JORDAN, former president of the Cleveland Federal Reserve Bank, discusses the Fed's unwarranted discretion. **2. GEORGE TAVLAS**, director general of the Bank of Greece, offered the experience of his own country as a warning to the United States, and stressed the need for a sound monetary anchor. **3. ADAM S. POSEN**, external member of the Monetary Policy Committee at the Bank of England, discussed monetary policy's impact on bubbles. **4. MICKEY LEVY** (left), chief economist of the Bank of America, talks with **JOHN B. TAYLOR**, author of the "Taylor rule" for monetary policy. **5.** Cato Institute vice president **JAMES A. DORN** (right), who has organized all 28 Annual Monetary Conferences, talks with Cato senior fellow **GERALD P. O'DRISCOLL, JR.**

regime is that it is a pure fiat money regime with no automatic adjustment mechanism. If there were a real gold standard and free (competitive) banking, sound money would have precluded the 2008–2009 financial crisis and would help prevent future crises.

George S. Tavlas, director general of the Bank of Greece, said he "felt right at home in the United States." He reiterated the point that there is no external constraint on the U.S. dollar as the world's key reserve currency. Any link to gold ended by the early 1970s. Without a sound monetary anchor, and therefore monetary discipline, the global monetary system is adrift. In the meantime, "floating exchange rates among all the major currencies would provide a mechanism for some adjustment to global imbalances and a safeguard against asset price bubbles and a future crisis."

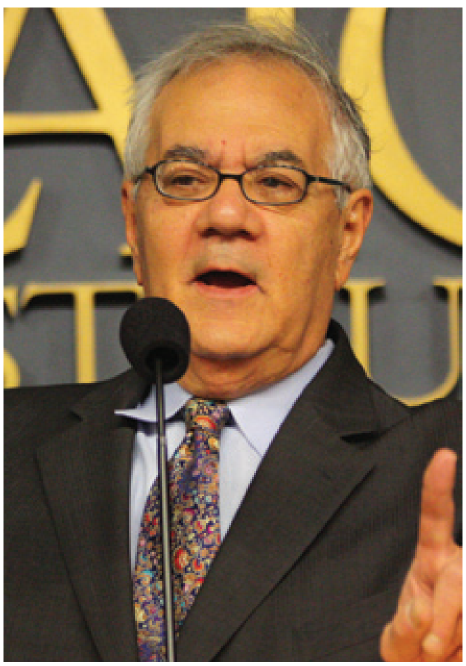
Gerald P. O'Driscoll Jr., senior fellow at Cato and a former vice president at the Federal Reserve Bank of Dallas, placed most of the blame for the housing/financial crisis on loose monetary policy, but also pointed to other policy errors and nonmonetary real factors. Kevin Dowd, an economist at the Cass School of Business, London, agreed that monetary policy was the main culprit and warned that continued ultra-low interest rates and quantitative easing are fueling new asset bubbles in "Treasuries, financials, and junk." He favors getting rid of the Federal Reserve's "dual mandate" and having only one target: price stability. But, "a far better reform—and a far more appropriate one, given the Fed's dismal record since its founding—would be to abolish the Federal Reserve altogether and re-anchor the dollar to a sound commodity standard."

Other notable speakers included Charles Plosser, president of the Federal Reserve Bank of Philadelphia; John B. Taylor, professor of economics at Stanford University and author of the "Taylor rule" for monetary policy; and Manuel Sánchez, deputy governor of the Bank of Mexico.

The papers presented at the conference will be included in an upcoming issue of the *Cato Journal*. Video and audio of the conference is available at www.cato.org.

6. MANUEL SANCHEZ (left), deputy governor of the Bank of Mexico, talks with MARY ANASTASIA O'GRADY, editor of the *Wall Street Journal*'s "Americas" column, and IAN VÁSQUEZ, director of Cato's Center on Global Liberty and Prosperity. 7. In the front row at Cato's 28th Annual Monetary Conference: former Federal Reserve Bank presidents WILLIAM POOLE and JERRY L. JORDAN, MICKEY D. LEVY of Bank of America, and Cato senior fellow GERALD P. O'DRISCOLL, JR. 8. CARMEN REINHART, coauthor of *This Time Is Different: Eight Centuries of Financial Folly*, warns attendees that tough choices can't be avoided in resolving the debt crisis.

Former governor Gary Johnson (R-NM) poses with fans after his speech to students at a Cato on Campus forum on November 1. Johnson discussed his time in office, how he eliminated New Mexico's budget deficit, and his new mission to end drug prohibition.



At a Cato Policy Forum in November, Rep. Barney Frank (D-MA) said that the only way to effectively limit military spending is to "stop doing what we are trying to do" and narrow the "national security." Frank has said he formed the Sustainable Defense Task Force in response to an op-ed by Cato's Christopher Preble, who also spoke at the event.

Cato Senior Fellow Randal O'Toole (right) calls for privatizing public transit at a briefing on Capitol Hill in November. Debating William Millar (left), president of the American Public Transportation Association, O'Toole said that government subsidies are the cause of many of transit's problems, including huge declines in productivity and significant increases in the average cost per trip.

Senior fellow Andrei Illarionov (far left) was among the scholars who spoke to free-market think tank leaders from around the world as part of an event at Cato on November 11 organized by the Atlas Economic Research Foundation.

OCTOBER 6: *Why Africa Is Poor and What Africans Can Do about It*

OCTOBER 7: Cato Institute Book Forum and Luncheon featuring P. J. O'Rourke (Beverly Hills, California)

OCTOBER 7: *You Know I'm Right: More Prosperity, Less Government*

OCTOBER 8: *Power Grab: European Integration in the Post-Democratic Age*

OCTOBER 13: Congress Should Account for Excess Burden of Taxation

OCTOBER 13: Cato Institute Policy Perspectives 2010 featuring P. J. O'Rourke (Dallas, Texas)

OCTOBER 14: Cato Institute Policy Perspectives 2010 featuring P. J. O'Rourke (Houston, Texas)

OCTOBER 14: *James Madison Rules America: The Constitutional Origins of Congressional Partisanship*

OCTOBER 21: *Robert A. Heinlein: In Dialogue with His Century*

OCTOBER 25: Birthright Citizenship and the Battle over Illegal Immigration

OCTOBER 29: Cato Institute Policy Perspectives 2010 (New York, New York)

NOVEMBER 3: *Don't Vote: It Just Encourages the Bastards*

NOVEMBER 10: The Future of Public Transit: What Are the Roles of the Federal Government and the Private Sector?

NOVEMBER 10: The Future of Public Transit: What Is the Role of the Federal Government?

NOVEMBER 16: *Alchemists of Loss: How Modern Finance and Government Intervention Crashed the Financial System*

NOVEMBER 17: Is Taxpayer Financing of Campaigns Constitutional?

NOVEMBER 18: 28th Annual Monetary Conference: Asset Bubbles and Monetary Policy

NOVEMBER 19: Deficits and Defense

NOVEMBER 30: Profiting from Ivory Towers?

Audio and video for all Cato events dating back to 1999, and many events before that, can be found on the Cato Institute website at www.cato.org/events. You can also find write-ups of Cato events in Ed Crane's bimonthly memo for Cato Sponsors.

Cato Calendar

CATO INSTITUTE POLICY PERSPECTIVES 2011
Naples, Fla. • Ritz-Carlton
February 9, 2011
Speakers include Gov. Rick Scott and Neal Boortz.

23RD ANNUAL BENEFACTOR SUMMIT
San Diego • The Grand Del Mar
February 24–27, 2011
Speakers include Sen. Rand Paul, Craig Venter, and Daniel Hannan.

CATO UNIVERSITY SUMMER SEMINAR
Annapolis, Md. • Loews Hotel
July 24–29, 2011
Speakers include Rob McDonald, Donald Boudreaux, Edward H. Crane, Robert Levy, David Boaz, and Tom G. Palmer.

CATO CLUB 200 RETREAT
Newberg, Ore. • Allison Inn and Spa
September 22–25, 2011

Cato scholar blazes path of cyber-sanity

The Underwhelming Threat of Cyberterrorism

In 1983, Americans watched as Matthew Broderick, armed with only a personal computer, brought the world to its knees. In the popular movie *WarGames*, Broderick played a young hacker who broke into the military's electronic network and nearly started World War III. In recent years, as fear of terrorism continues to overwhelm rational threat assessment, the *WarGames* scenario looks a lot like what so-called cybersecurity experts and their federal government allies tout.

The problem with "cybersecurity," says Jim Harper, director of information policy studies at the Cato Institute, is that we're convincing ourselves that cyberspace is an endless sea of vulnerabilities that leave us weak and exposed. It's not. Harper has emerged as the voice of reason among breathless news reports of "cyber attacks" and calls for Washington to take over security of the nation's computing infrastructure. In his papers, congressional testimonies, and numerous media appearances, Harper emphasizes the need to better understand the nature of cyberspace, to appreciate the improvements in cybersecurity civil society is constantly generating, and to recognize the near impossibility that terrorists might inflict significant harm using computers.

"It's helpful to imagine 'cyberspace' as organized like the physical world," Harper says. "Think of personal computers as people's homes. Their attachments to the network analogize to driveways, which connect to roads and then highways. E-mails, financial files, and pictures are the personal possessions that could be stolen out of houses and private vehicles, leading to privacy loss."

Cyberspace will be secured the way real space is. Computer owners, like homeowners and businesses, should be the first line of protection for their own property, Harper says. They should install the latest patches and place their systems behind firewalls. What the government wants—to come up with a national cybersecurity plan and force it upon network, data, and computer owners—is akin to cutting down crime in neighborhoods by stationing police officers in livingrooms and dictating what sorts of door locks and alarm systems must be in all new homes.

"The analogy between cyberspace and real space shows that 'cybersecurity' is not a small universe of problems, but thousands of different problems that will be handled in thousands of different ways by millions of people," Harper says.

This analogy is particularly important when the topic shifts from broad "cybersecurity" to the narrower threat of "cyberterrorism." The popular view of such attacks, like *WarGames*, is nonsense, according to Harper. "With communications networks, computing infrastructure, and data stores under regular attack from a variety of quarters—and regularly strengthening to meet them—it is highly unlikely that terrorists can pull off a cybersecurity event disruptive enough to instill widespread fear of further disruption," Harper says. If they could do it at all, taking down websites, interrupting financial networks, or knocking out power systems does not terrorize. In a 2009 speech about cybersecurity, President Obama spoke about "weapons of mass disruption," a poor relation of the instruments that truly threaten violence and chaos.

JIM HARPER, director of information policy studies at the Cato Institute, has been a consistent voice of reason in the debate over cyberterrorism and computer security.

The federal government plays a significant role in protecting Americans from genuine terrorism. And, even though the threat of cyberterrorism is dramatically overblown, the government can improve security in that area, too. But it should not do so through regulation, Harper says. Instead, it can take advantage of its position as a large purchaser of information technology and, through the market, guide technology producers to meet better security standards.

The politicians in Washington should realize that the easiest way to protect critical data and infrastructure is not to make it vulnerable in the first place. "Where security is truly at a premium," Harper says, "the lion's share of securing infrastructure against cyberattack can be achieved by the simple policy of fully decoupling it from the Internet."

Harper's level-headedness is getting attention. The Obama White House cited a paper he wrote in the executive summary of its *Cyberspace Policy Review*. In it, Harper argued that updating tort law to allow those harmed by insecure computer products to recover damages from providers and manufacturers is a better path to true security than government regulation of the market. And he was called before the House Subcommittee on Technology and Innovation to testify about how the federal government should respond to cyberterrorist threats and how it should approach securing the nation's information-technology infrastructure.

Harper is adamantly clear that cybersecurity is important. While arguing that the federal government should not directly regulate computer security, he is careful not to downplay the need to secure our computer networks. But such security, like in the brick-and-mortar world outside the Internet, is a matter of personal responsibility, business interest, and common sense.

That same common sense should lead us to recognize that cyberterrorism does not exist and that threat of cyberwarfare is minimal. Claims to the contrary result from technological illiteracy and the incentives of government officials and contractors that favor inflating threats.

Cyberterrorism is "cyber–snake oil," Harper says. ■

Cato University Comes East

July 24–29, 2011 • Annapolis, Maryland

After several years in San Diego, Cato University will unfold this summer within the rich historical culture and waterside ambiance of Annapolis, Maryland—one of our country's original colonial cities. With its deep roots in the debates and events that were instrumental in shaping our country, Annapolis is a perfect setting for experiencing Cato University's intense study of the history, philosophy, and economics of liberty.

PRICE SPECIALLY REDUCED FOR 2011 | We've lowered the cost of Cato University this year to $995. This price covers all meals, receptions, lectures, materials, books, and evening events, but not overnight room charges. However, we've arranged a low room rate for all Cato University participants. The price—along with the nearby low-cost Baltimore airport—makes this Cato University a unique and not-to-be-missed experience.

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For additional details and registration: www.cato-university.org.

Exposing the Hidden Costs of Legislation

"A well-established principle of public finance holds that taxes impose costs on society beyond the amount of revenue the government collects," writes Christopher J. Conover, research scholar with the Center for Health Policy and Inequalities Research at Duke University, in **"Congress Should Account for the Excess Burden of Taxation"** (Policy Analysis no. 669). But members of Congress are often unaware of how high these costs actually are—they average about 44 cents per dollar of tax revenue for all federal taxes. Conover looks at the marginal excess burdens of federal spending and uncovers some striking findings. "One recent analysis estimates that the net present value of current and future-year output losses amounts to $3.40 for every dollar of federal expenditures financed by borrowing," he writes. He argues that "accounting for the excess burden of taxation is essential to honest policymaking," but those burdens "will not receive the attention they deserve until Congress includes them in its official cost estimates." This ignorance of costs is perhaps nowhere better illustrated than with the enactment of the Patient Protection and Affordable Care Act of 2010 (PPACA). "The total excess burden associated with PPACA could amount to $550 billion, or more than half of the bill's official cost estimate and $3.85 per dollar of supposed deficit reduction," Conover writes. He concludes, "It is irresponsible for members of Congress and the president to spend taxpayers' earnings without understanding the full burden they are imposing on those taxpayers."

Toward Truly Free Trade

It's a tale as old as trade itself. Protective tariffs drive up costs to consumers and keep capital and labor from finding more efficient, productive uses. In July 2010, Congress advanced the cause of trade liberalization when it passed the U.S. Manufacturing Enhancement Act, which suspended duties on hundreds of imported goods of special interest to U.S. manufacturing companies. But Congress left in place tariffs that protect many domestic producers from competition. In **"The Miscellaneous Tariff Bill: A Blueprint for Future Trade Expansion"** (Trade Briefing Paper no. 30), Daniel Griswold, director of the Cato Institute's Center for Trade Policy Studies, praises the bill, calling it a "rare step forward in U.S. trade policy in recent years," one that "could provide a template for expanding the freedom of Americans to buy and sell in global markets." But it doesn't go far enough, Griswold argues. When the House begins work on the next miscellaneous tariff bill, he writes, "House Republican leaders should. . . work with their counterparts across the aisle to expand the reach of the next bill to cover even more categories of imports—for the benefit of consumers, the manufacturing sector, and a U.S. economy struggling to shake off a steep recession."

CATO POLICY REPORT is a bimonthly review published by the Cato Institute and sent to all contributors. It is indexed in PAIS Bulletin. Single issues are $2.00 a copy. ISSN: 0743-605X. ©2010 by the Cato Institute. • Correspondence should be addressed to *Cato Policy Report,* 1000 Massachusetts Ave., N.W., Washington, D.C. 20001. • Website: www.cato.org, call 202-842-0200, or fax 202-842-3490.

Trade with Korea Is Good for Americans

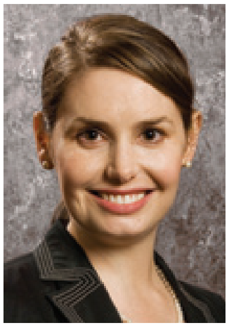
Americans sit on the unemployment line while China's economy grows—with China now displacing the United States as the number one trading partner of South Korea and other East Asian states. "How have the Obama administration and Democratic Congress responded to these challenges?" asks Cato Institute senior fellow Doug Bandow in **"A Free Trade Agreement with South Korea Would Promote Both Prosperity and Security"** (Trade Briefing Paper no. 31). "By retreating economically from the region." What's needed, Bandow argues, is for Congress to ratify the already-negotiated U.S.–South Korea free trade agreement (KORUS FTA). Enacting the FTA would increase American access to the South Korean market, adding, according to the U.S.–Korea Business Council, $35 billion worth of exports, $40 billion to the national GDP, and 345,000 jobs. The FTA would enrich South Koreans, too, resulting in a larger market for American goods and, thus, even greater benefits for U.S. workers and firms. Bandow examines the roadblocks in the agreement's path, including concerns over the sale of beef and automobiles. The FTA is not perfect, he admits. "Numerous compromises were made for political reasons—including retaining protectionist restrictions for American industries, such as ethanol and sugar." He argues that "the FTA should be viewed as a starting point from which Washington could continue to press for further liberalization" and that "Congress should ratify the already-negotiated accord with South Korea. The stakes, both economic and security, are high."

Can Socialism Get You Where You Want to Go?

"One industry has unquestionably been socialist for decades: urban transit, more than 99 percent of which is today owned and operated by state and local governments," writes Cato senior fellow Randal O'Toole in **"Fixing Transit: The Case for Privatization"** (Policy Analysis no. 670). And as we've come to expect from socialism, the results are terrible. In the past 40 years, transit worker productivity has fallen more than 50 percent, "urban transit is the most expensive way of moving people in the United States," and the "majority of transit systems use far more energy and pollute far more per passenger mile than the average car." O'Toole says the solution is not to expand transit through greater subsidies, but to privatize it. "Private operators would have incentives to serve customers, not politicians, with cost-effective transport systems." The paper traces the history of government transit involvement, beginning in 1964 when the "vast majority of the nation's transit systems were privately owned and profitable." It looks at the impact of the recession, looming transit debt, the crushing weight of employee pensions, crumbling infrastructure, and lack of innovation. O'Toole concludes with a privatization action plan, eight steps federal, state, and local governments can take to realize a truly efficient transit system.

Trade Preferences Are Still Protectionism

The Generalized System of Preferences, which benefits certain developing countries and aids their development through preferential access to the U.S. market and saves Americans hundreds of millions of dollars a year from duty-free imports, expires on December 31, 2010. In **"The U.S. Generalized System of Preferences: Helping the Poor, But at What Price?"** (Policy Analysis no. 43), Sallie James, policy analyst with the Cato Institute's Center for Trade Policy Studies, says that Congress should renew the GSP, but should also recognize that it doesn't go far enough. "To the extent that preference



recipients jealously guard their special access and resist global efforts to liberalize trade on a nondiscriminatory basis," James writes, "unilateral preference programs can be counterproductive to achieving a more liberal global trade regime and a more stable and permanent path to economic growth." James provides a thorough analysis of the impact of the GSP on the United States and its trading partners and outlines the program's benefits and costs. The expiration of the GSP offers the United States an opportunity to correct these faults by opening the U.S. market on a permanent and nondiscriminatory basis. "Those changes," James concludes, "would give American firms and consumers undistorted, permanent, and transparent access to the most efficient supplier, access that would not depend on the changing whims of Congress."

Introducing Cato Working Papers

In October, the Cato Institute launched a new publication series, the Cato Working Papers. Intended to share ideas and elicit feedback before being submitted to a peer-reviewed academic journal, the Working Papers offer cutting-edge policy research.

The series began with a paper by Andrew J. Coulson, director of the Center for Educational Freedom at the Cato Institute, examining whether **vouchers and tax credits** increase private-school regulation. In November, George A. Selgin, William D. Lastrapes, and Lawrence H. White assessed **whether the Federal Reserve has been a failure** and offer alternative arrangements that might do better. That same month, Michael F. Cannon, Cato's director of health policy studies, evaluated a contract-based solution to reforming **medical malpractice liability**.

Cato Working Papers are available at www.cato.org/workingpapers. ■

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"To Be Governed..."

JUST SHOOT ME

Every year, whether the Republican or the Democratic Party is in office, more and more power drains away from the individual to feed vast reservoirs in far-off places; and we have less and less say about the shape of events which shape our future.

—**William F. Buckley, Jr., 1961, quoted by George Will in the *Washington Post,*** November 21, 2010

ACTUALLY, IT'S A TRAGEDY BUT NOT A "PUBLIC HEALTH" ISSUE

"Too many lives are lost in motorcycle accidents," Christopher A. Hart, NTSB vice chairman, said in announcing that helmets had been added to the board's annual "most-wanted list" of safety improvements. "It's a public health issue."

—***Washington Post,*** November 17, 2010

OBAMA UNDERSTANDS: IT WAS A TAX INCREASE, NOT A TAX CUT, THAT WAS BEING DEBATED

I want to make sure that taxes don't go up for middle class families starting on January 1st.

—**President Obama, CNN.com,** November 12, 2010

WASHINGTON, CITY OF BOUNDLESS OPPORTUNITY

Seven of the nation's 10 richest counties are in the Washington region, according to a report from *Newsweek.*

—***Washington Post,*** November 12, 2010

The rise has been so dramatic that for the first time in five years, the average asking rent in D.C. is higher than in New York City, according to CoStar and a new report of third-quarter activity by commercial real estate firm Cassidy Turley. . . . "The federal government has created a smooth but slow rise in rents [in D.C.]," said Kevin Thorpe, Cassidy Turley's chief economist.

—***Washington Post,*** October 18, 2010

The best reflection of Washington's ever-expanding command and control over the economy can be found in the journalistic gold rush now being led by Bloomberg News, *Politico*, and the Atlantic Media Group, which have unloaded their pack mules and are dredging the Potomac, Congress, the White House, the agencies, and trade associations in search of news that moves financial markets. . . . By dint of its regulatory powers, its executive orders, its judicial decisions, its ability to conjure money out of thin air, and its budget-making authority, Washington dictates who can do business and how. . . . Although $5,700 for a subscription to *Bloomberg Government* might sound steep to you, it's chump change for businessmen who become the first in their cohort to read Line 125 in a pending bit of legislation and can place a bet on—or against—it in the market.

—**Jack Shafer, *Slate,*** November 18, 2010

THE BUDGET HEARING SCAM

The council is elected to make decisions, not to take polls. What's more, people know a set-up when they see it. [Mayor-elect Vincent] Gray's scenario, intentionally or not, is a prescription for raising taxes. Here is how it would work:

Council members, with the elections safely behind them, produce a deficit-closing term sheet that reads like a doomsday manifesto. It describes deep cuts in areas likely to produce the most screams: public safety, education, health care, workforce reductions, arts and culture, etc.

That is followed by council hearings at which long lines of witnesses representing nonprofit advocacy groups and employee unions produce gripping testimony that predicts untold pain and agony resulting from the projected program and payroll cuts.

Following the hearing, which stretches late into the night or the next morning, the lawmakers conclude, reluctantly of course, that there is strong "public" opposition to cuts in government and that they, as conscientious legislators, have no alternative but to keep the government at its current size and, instead, close the deficit with tax increases on middle- and high-income D.C. wage-earners.

—**Colbert King, *Washington Post,*** October 30, 2010

THE MYTH THAT JUST WON'T DIE

On the 787 billion dollar stimulus package, [Rep. Betsy] Markey voted yes. . . . Markey: . . . every economist from the far left to the far right was saying the government needs to step in because there was absolutely no private sector investment.

—***Capitol News Connection,*** October 15, 2010

Rep. Gerry Connolly (D)... replied that some federal spending was necessary to prevent the recession from becoming a depression.

"You're darn right I voted for the stimulus. Every economist, including [some] Republican economists... said, for God's sake, don't let it go off the cliff," Connolly said.

—***Washington Post,*** October 17, 2010