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*Classical liberalism in the 21st Century**

Abstract

Current economic crisis 2007-2010 emerged as a result of very unfortunate state policies and regulations, like the Community Reinvestment Act, the FED's policy of easy money, overregulation of commercial banks, the Basle II Accord, and the monopoly on the credit rating market. For this reason, this crisis is a result of state rather than market failure. Moreover, this crisis is a result of very unfortunate development in nearly last hundred years that consisted in nearly permanent rise in state regulation and expenditures. More state intrusion into economy means more troubles. In order to recover in economic and political sense modern societies need to rediscover classical liberal values – individual freedom, the rule of law and constitutionally limited government. Those who trade off freedom for security, as pointed out by Benjamin Franklin, do deserve neither, and will lose both.

Key words: state failure, free market, state interventions in economy, economic crisis, individual liberty.

When George Washington formed the U. S. government at the end of XVIII century, it has four ministries only, and total federal costs corresponded to some 1,3% of the U. S. GDP at that time. All legal production of that time consisted in the Constitution, Penal code and a handful of other federal, state and local legislation. European states of the late XVIII century have had more extensive legislation, but it was modest in size compared with how it looks like today. Until late 1920 s the total state expenditures rarely exceeded 10% of the

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GDP, regulation of business was tinny, and the state owned firms were next to nonexistent. Consequently, economic freedom was huge, entrepreneurship flourished and this led to an unprecedented rise in prosperity during 19^{th} century and before WWI. There were no welfare programs and no international state aid. Private charity helped people in trouble.

Farewell to free market

Things started to be different at the end of XIX century. It took some decades to obtain a new institutional design. European states have introduced national banks to oversee commercial banks and commercial traffic. Germany pioneered by nationalizing the pension system, and this move was followed by other states after the WWI. Chile was first in Americas to introduce state pensions. Some states run some industries (oil, railway, and coal mines, steel). The state intervention into business was at the beginning but the trend of progressive colonization of business by bureaucrats was already established.

Next larger intrusion of state into economy happened during the Great depression from 1930 s and during WWII. Common wisdom says that markets failed in 1930 s and that the state came to undo mistakes and to shift the economy toward prosperity. The true is however completely different.

As it is well known, markets sharply fell in October 1929 in the U. S. and some, but not all, developed countries of that time. The U. S., Britain and Germany were hit hardly, while Holland or Scandinavia was not. They all would recover without state intervention after some time, as it has always happened in the past. However, the American state turned to an active, interventionist policy and worsened the crisis turning it to the deepest depression on the West in the last hundred years.

The U. S. government did three particularly important mistakes. First, it sold newly issued bonds (via FED), and so withdraw money from the circulation. The M_1 was reduced in 1930 for 6,9%, in 1931 for 10,9%. In 1933 the M_1 was lower for 27% compared with the level in 1929.[1] The justification was that lower business activity requires less money. Otherwise, there would be a risk of inflation. This move restricted business access to money, and this led to a decrease in investment and to a lower level of economic activity. The FED

1 Cf. Higgs 2006.

neglected that credit activity at that time was low, so that larger amount of money in circulation would not be able to cause inflation.

Secondly, the U. S. government raised taxes on individual income and corporate profits more than ever in the U. S. history. Individual income tax rose from 1,5% to 4% in the lowest, and from[2]5% to 63% in the highest bracket. Higher taxes also kill economic activity. Income fell in 1932 for 13,3% and unemployment jumped to 23,6%, compared to 3,2% in 1929.

Finally, the government rose customs for 50% in an unprecedented move in the U. S. history. The justification for higher taxes and customs consisted in allegedly empty budget and protection of domestic producers. Despite that, budgetary revenues from customs fell from $ 602 million in 1929, to $ 328 million in 1932. Higher corporate taxes made more expensive economic activity and so reduced business and income. Higher income tax reduced readiness for work effort. Higher customs halved budgetary revenues instead to increase them.

All three moves have killed rather than revived the U. S. economy. They created depression out of recession that lasted to 1934. Some recovery came in 1934, but recession was back in 1937 and so the Western countries entered the WWII in economically weak condition.[2] The U. S. returned to the level of income from 1929 in 1951 only, i. e. 21 years thereafter. Anyway, the data for the U. S. and other Western economies from 1939 on are hardly comparable with the preceding period, because of the shift to a war economy, planning and rationing in all major economies of that time.

In addition to higher taxes and more restrictive monetary policy, government launched broad welfare programs and public works. Both were intended to foster demand, provide more jobs, and extend social protection. *Freddy Mac* was just one of these programs intended to make more affordable house ownership to American citizens. With exception of public works all programs conceived at that time still last and in the meantime they got an extended form. Many other state and federal programs are launched as well. The reactions of the governments to the crisis and state interventions in the economy were fostered by popularity of socialism and planning in intellectual and political circles from 1930 s on. It was widely believed that the state will provide

2 Cf. Higgs 2006.

a remedy there where markets failed. This created an atmosphere for a continued rise in the size of the state.

In the years following the WWII the state extended and deepened its influence on the economy via several mechanisms. First, planned economies were introduced in countries of the East Europe. Second, the state on the West has operated a number of firms of even the whole branches (industries like railways, infrastructure, civil aviation, mines, steel, banks, insurance, culture and education…). Third, governments on the West continued to issue regulation on nearly every field of economic activity. Yugoslav self-management and German workers codetermination were more popular abroad among the Western intellectuals than in their birthplaces. Regulation of these two types rose costs of doing business, reduced economic freedom, enlarged corruption opportunities and promoted rent seeking opportunities in a number of fields. Contrary to planning that deprives individuals of freedom of choice in a drastic way, regulation stifles economic activity step by step. Planning deprives economic freedom steeply, regulation via slippery slope.

These developments were accompanied with the permanent rise in state expenditures, especially in the OECD countries, from 1950 s to early 1980 s, what again means higher taxes.

Retreat from the state interventions in 1980s

Eighties brought two temporary setbacks to the continued trend of expanding economic role of the state that lasted for decades. These two moves have broken the trend of a continuous rise of state, but they were not able to annul previous developments and to reduce state expenditures to 10% of the GDP.

First, some developed countries started pro market reforms that consisted in privatization of state owned enterprises, tax cuts, decrease of subsidies and welfare programs, reduction of state expenditures, deregulation, stabilization of prices, etc. The pioneers[3] of this new trend were Margaret Thatcher in the UK and Ronald Reagan in the U. S. Some other countries followed the case,

3 Actually Chile pioneered the trend in the late 1970, with reforms designed by José Piñera, minister for labor and social affairs in Augusto Pinochet's government. The reform consisted in wholesale privatization, price and trade liberalization, tax cuts and – for the first time in history – in a complete privatization of the state owned pension funds. Cf. Piñera 2002. Cf. also Larroulet 1993.

like Australia and New Zealand in 1984, Ireland from 1986, Finland and Iceland in the mid 1990 s, etc.

Second, in the late 1980 s communist regimes collapsed throughout the East Europe. Ex communist countries entered transition that consisted in a move from communist dictatorship, planned economy and the rule of the communist party to democracy, market economy and the rule of law.[4] During transition the state abandoned its role of governing economy via privatization on the large scale. In early 1990 s pro-market reforms were popular and it seemed for a moment that the transition countries will establish more free economies than they were in developed countries. Estonia with Mart Laar and the Czech Republic with Vaclav Klaus were first to conduct enthusiastic pro-market reforms and became the reform champions in the East Europe. Some other governments followed the case. However, this development faded away in the second part of 1990 s and 2000 s. Several factors contributed to this, and at least two of them are to be mentioned.

First, all successful transition countries wanted to join the European Union. As a consequence, they needed to adopt extensive regulation of the *Acquis* that was especially heavy in areas such as the protection of environment, energy, transportation, labor law, consumers' protection, etc. This regulation was worked out in developed and overregulated West European countries and its enforcement in the East Europe predictably reduced economic freedom and growth rates.

Second, with the breakdown of communism many interest groups ceased to exist for some time. However, along the path of reforms of the state and economy, interest groups started to reemerge, and with the lapse of time they became more and more powerful. In interaction with the EU regulatory state they slowed down pro-market reforms and extended rent seeking opportunities. Steve Pejovich (2009) calls this a transition from socialism to socialism – from the hard „real socialism" to a soft socialism of the European Union.

For these and probably also some other reasons the majority of the East European countries abandoned free market philosophy and adopted statism. This made them similar to the West European welfare states. Basically they traded off economic freedom for more regulation and redistribution in order to enhance social security. The period of 1993-2007 was a period of prosperity in

[4] Cf. Prokopijevic 2001.

the U. S. and Europe. Despite that, after the year 2000 there was no a larger economic reform in the developed world.

Crisis 2007: „You never want a serious crisis to go to waste"

Business environment has profoundly changed with the economic recession from[2]007-2010. Many called it the crisis. Economic difficulties during recession have killed nearly[5] all reform instincts that eventually existed in developed countries and even worse – they recall state interventions in various forms. The interpretation of causes for troubles was similar to 1930 s. The change of heart is particularly to be regretted in some large dailies, like *The Wall Street Journal*: „…we are facing a decisive turn in the evolution of American capitalism… gone is the faith…that the best road to prosperity is to unleashed financial markets to allocate capital, take risk, enjoy profits, absorb losses. Raised is the hope that markets correct themselves when they overshoot. Also scrapped is the notion that governments role is to get out of the way…"[6] Markets are not perfect, but they are still the best way to conduct business operations. Markets are the least inferior in allocating resources. Less markets means more power for bureaucracy, more bureaucracy means more inefficiency and corruption, i. e. more waste of resources and more power of bureaucracy over society.

The mainstream political approach says, markets failed and the state has to act in order to diminish harm and to speed up recovery. Later on we are going to see that this formal justification is wrong, as it was in 1930 s. One may be suspicious about formal justification simply because we have experienced in the past that there are hidden motives for the state intervention. Crisis situations are an excellent opportunity for state and bureaucrats to interfere into economy and to enlarge they stake. Rahm Emanuel, the *White House* chief of staff, was probably inconsiderate when he said that the crisis is an „opportunity for us", i. e. for Obama's administration: „You never want a serious crisis to go to waste. And this crisis provides the opportunity for us to do things that you could not do before".[7] Emanuel was sincere to confess that the main point is to enlarge state control over economy rather than to divert crisis to some positive outcome. For the latter task it is known that it is impossible.

5 Just some governments, like the UK that reduced VAT from 19% to 16%. This holds temporary – i. e. in 2009 only.

6 *In turmoil capitalism in U. S. sets new course*, The Wall Street Journal, September 20, 2008, pp. 1-2.

7 Cited according Boaz 2009, p. 3.

Nevertheless, the crisis is used as an alibi for bureaucratic and state action. Leviathan advances at best during natural disasters, wars and crisis, anyway at best during some extraordinary happenings.

Even worse, the share of the state responsibility in current crisis is much larger than ever before. There are altogether five larger mistakes of the state trough regulation that created landscape for collapse of the mortgage market and consequent economic recession.

First, the state forced banks to provide mortgages for the sub-prime market, via *Community Reinvestment Act*, that was legislated during President Carter in 1977, but strengthened in 1996 and 2005, during presidents Clinton and G. W. Bush. The *Act* led to misallocation of resources. If the state takes care how much apartments we need to buy, the story ends with people having neither apartments nor jobs – as we have seen during this crisis.

The U. S. central bank (FED) provided easy money, in order to prevent recession after the fall of the *dot. com* market in 2000, and the terrorist attack on the U. S. on September 11, 2001. Cheap money probably prevented recession in 2000 and 2001, but it also provided the impression of easy money on the U. S. and other relevant markets, and investors needed to find out a place for it. It turned out that a lot of that money ended in mortgages and mortgage based securities. The FED policy was a second regulatory mistake.

A third mistake – the American regulators allowed to only three credit rating agencies (*S & P*, *Fitch*, *Moody's*) to operate in the U. S. By creating a cartel of credit rating agencies the government made more difficult to find out the true about the business performance and real credit rating of firms, commercial and investment banks, different types of funds and insurance companies. The interest of credit rating agency is to provide fat salaries to their employees rather than to investigate the real state of affairs in some market giants and so eventually to upset the market with an eventual early warning. The true business performance and credit rating of investment and commercial banks and other firms was detected by some business partners of these banks and firms rather than by credit agencies, simply because business partners have stronger interest to obtain such information than credit rating agencies.

Basel accord II is another contribution of the state to the crisis via mistaken regulation. It demands 100% reserve of maximum 8% for classical credits, 50% of maximal 8% for mortgages and 20% of maximal 8% for mortgage based securities only. It means 8 out of $ 100 for the real sector investment, $ 4 for mortgages and $ 1,6 for mortgage based securities. Just by reallocating your investment from mortgage to mortgage base security you earn 2,4 percentage points. At the first sight mortgages are riskier than mortgage based securities because they require $ 4 reserve per $ 100 U. S. investment, while mortgage based securities require $ 1,6 per $ 100 investment. Mortgage based securities sound riskless, but they prize investors with higher profits. The regulation apparently motivated firms to neglect the rule that profits go hand in hand with risks.

Finally, the fifth regulatory mistake is related to banks. Some forty years ago investment banks were next to nonexistent. What happened in the meantime that they have plagued the market? The answer is simple but for many it is surprising. Commercial banks were overregulated so that they have spontaneously looked upon a field where they are able to operate with fewer restrictions. And this turned out to be the investment banking. The point is in the fact that an investment bank is like a firm rather than a bank – it undergoes a higher risk. Customers are seduced by the title 'bank' in its name, so that they do not perceive the difference in risks related to classical, commercial vs. investment bank. They discover the difference between the two when it is too late – when mortgages and securities have lost their value and when the crisis emerges.

The state cannot be considered innocent after it has provided such huge preparatory work for the distortion of market. The crisis might happen without the interference of the state, but in that case it would not be of this size. The only contribution of the market to the crisis may be the greedy behavior of bankers. Bankers and investors had the incentives to operate as they did. Incentives directed investment in what looked as an excellent business, but what *post festum* turned out to be a miss-investment. So, greed is not a troublemaker in itself. Rather it was collateral in the situation. Greed was a driving force of modern capitalism that brought an unprecedented level of development from the end of XVII century on. Throughout history the greed has played a very constructive role. Under badly arranged constraints greed may be destructive. The main thing is not the failure of greed, but a bad regulation and policy of the state in several before mentioned fields. For that reason it is safe to conclude that the ongoing crisis is a matter of 'state failure' rather than 'market failure'. Free market faded away with the WWI at latest.

After the state with its misfortunate policies and regulations finally caused the economic crisis, it has *de facto* created its new job. In order to moderate the impact of crisis and eventually to induce a recovery, the state has had again to act and to provide the corresponding measures to relief the impact of recession or even to foster recovery. It is a huge mistake to believe that the main troublemaker may undo its previous misdeeds by redesigning its role only. If the state was not aware that its regulation is going to cause the trouble, how one may believe that it is now able to design a remedy? The state acted in a number of cases, but not in some others what raises the question of discretionary power and corruption. For example, *Lehman Brothers* and several other investment banks collapsed and were not helped, other were bailed out (*AIG*, *Citibank*, *Fannie Mae*, *Freddie Mac*), while third were helped although they never asked the state for help (*Wells Fargo*, *J. P. Morgan*).[8] In some cases government has nationalized companies or their parts (*GM*, *Chrysler*); in others it bought shares, in third it provided subsidies. All these measures were politically negotiated and presented to the public as a *fait accompli*, despite protests from media and nearly all economists with reputation. The state infused over a trillion inflated dollars described as „economic stimulus" into the economy and took a tighter grip over the economy both through regulation an intervention.

After reliance on the war economies during the WWII and a huge raise in state expenditures and responsibilities in the second half of 20th century it seemed that liberal capitalism and classical liberalism are over forever. Markets became progressively constrained, while regulation and welfare programs flourished. Proponents of the rise of the state were convinced that they succeeded in reducing uncertainties of free capitalism at no cost. It seemed that individuals enjoy more security without any significant loss. However, it turned out to be seductive, because it gave birth to a very dangerous development.

The expansion of the size of state resulted in high taxes, overregulation, inefficient state management, and huge waste of resources via misuse and corruption. Many leading economies became economically stagnant. Direct and indirect state actions led to a loss in economic freedom, what adversely affect-

8 Some financial institutions like *Wells Fargo* got state aid without having asked for it, because the WF did not need it. The state provided assistance for various banks in order to cover the difference between good and bad banks. By providing assistance just to some institutions everybody in the U. S and elsewhere would know which institutions are good and which are bad.

ed economic growth and prosperity, leading to low or stagnant growth rates, high inflation and unemployment during 1970 s. Since this expansion of the state, collectivist convictions and statist ideologies resulted in bad results and dangerous tendencies, it is necessary to revive classical liberal values – individual freedom, personal responsibility, freedom of choice, the rule of law and constitutionally limited government. More free social environment and better economic results cannot be achieved without a revival of classical liberal values in 21st century. However, current economic crisis may encourage both the powers of liberalization and the powers of further state interventions.

Freedom at risk

As this article demonstrates, freedom is under assault and this is not from yesterday. This paper deals merely with the economic freedom, but it is not the only under the threat. Civil liberties are also in danger especially after anti-terrorist legislation in the U. S. and many leading Western countries that allow surveillance without judicial permission, checking internet and regular mail without permission, arrest and investigation without access to a lawyer or judge. The anti-terrorist legislation is just a new twist along the dangerous development that lasts for decades in the leading Western countries. State interferes in spheres of education, health care, social security, culture, everyday life, media and privacy. It is literary everywhere restricting the free traffic among individuals and so reducing individual liberty.

Let me illustrate this dangerous trend in the field of the family relations. The state with its welfare programs transforms itself into a police state. „It is not called the welfare 'state' for nothing. Unnoticed by reformers and even more striking than the economic effects have been subtle but far reaching political developments. These developments involve the quiet metamorphosis of welfare from simply a system of public assistance into nothing less than a miniature penal apparatus, replete with its own tribunals, prosecutors, police, and punishments: juvenile and family courts, matrimonial lawyers, child protective services, domestic violence units, child-support enforcement agents, and other elements. Originally created to threat ills endemic to low income, single-parent homes, this machinery is increasingly intervening with police actions in the middle-class families. Kafkaesque is its logic…"[9] This is typical for an Orwellian rather than a free world.

This illustration was just to show that on the field of civic and political liberties things are not better than on the field I dealt with here – the economy. What happens is a continues loss of civic and economic freedom advancing in smaller rather than in larger steps, that merely passes unnoticed until you are not focused on some field. The justification is always similar, state actions are necessary to provide more security or to improve the welfare of some groups.

In the light of the previous, it is an irony that classical liberals and libertarians sometimes are blamed for economic crisis. It is said that their trump, free market, has caused the crisis. This is wrong for two reasons. First, classical liberals are away of the current economic and political mainstream. And if asked, they would not support any among the five regulations mentioned before. Second, this crisis is a failure of state rather than market as it is demonstrated above. Capitalism has abandoned free market approach for a century ago or so, and it took a regulatory approach with a permanent rise in regulation and state expenditures. So, it a crisis of the statist rather than liberal order.

It does not pay to look upon troublemaker among classical liberals and libertarians. Such efforts probably should divert attention from the real troublemakers, and these are both some intellectuals and those in power that share the ideas about a positive impact of the state interventions on the market. The main aim is to enlarge the power of state and bureaucracy over market and society rather than improve the situation. In normal times the programs tightening state control over market and society is not easy to sell. For that reason, shock, crisis, war is an excellent opportunity, as Rahm Emanuel explained, that should not be wasted. It is not important to be successful in state intervention. You may always find out an official who is going to admit, as Joe Biden, the U. S. Vice President did, that „we did mistakes" in understanding problems of the economy: „The true is, we and everyone else misread the economy. The figures we worked off in January /2009 – MP/ were the consen-

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[9] Baskerville 2008, 402-3. The author also cites attorney Jed Abraham who describes the apparatus of measures for collecting child support „as a veritable gulag, complete with sophisticated surveillance and compliance capabilities such as computer based tracing, license revocation, asset confiscation, and incarceration. The face of this regime is decidedly Orwellian." Ibid, p 417.

sus figures and most of the blue chip indexes out of there".[10] Despite the fact that pro-intervention bureaucrats failed to understand the economy, they will not give up with their financial interventions and new regulations. They just notice that interventions have not cured the economy because troubles are deeper than expected. It is also admitted that further interventions will be more costly. In such situations communists in the East Europe used to say, that positive effects of the communist project cannot be seen before the whole project is completed. It is well known how that story ended. But just a few remember the communist justification, so that politicians on the West may again ask for time and resources to complete their undertakings. As a matter of fact, this is just to spread fog around until larger waste and larger damage is done by policies.

Citizens on the West have not a direct experience with communism, so that it is easier to seduce them into this game where allegedly market fails and the state comes to rescue. The logic is, markets are volatile, the more state intervention, the less volatile markets will be, and there will be more stability and security. If more state intrusion into market forces is that efficient solution, why this intervention is limited. If it is so that the more state is better, let us turn to the state action completely. Let us hand over all commercial resources to the state, get rid of private worries how to employ them, and start enjoy in prosperity that is going to flourish. Naturally, the East Europeans lived under such a regime and they are aware that it is not sustainable and that it leads to a disaster, sooner or later. From Mises and Hayek on, this is also clear to many economists and intellectuals. Total state intervention leads to a total disaster, a partial intervention leads to a partial disaster only. It consists in further regulation, waste of state finances, rise of taxes, huge jump in state indebtedness, higher inflation. In the next round the economic freedom will be reduced, investment lower, work effort weakened, the rise of productivity lower, price stability shaken and the growth rate lower. More state interventions open a spiral to the bottom by reducing both income and freedom. Benjamin Franklin once said that those who trade off liberty for security, do not deserve any of them, and will lose both. It is a warning that holds still, and that requires from us to turn back to the values of classical liberalism in XXI century, i. e. to the individual freedom, limited government and the rule of law.

[10] ABC News, July 5, 2009, Transcript.

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