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On Power and the Use of Coercion

"Middle-Out" Economics

by Richard A. Epstein

This past week I appeared on the PBS News Hour on a segment hosted by Paul Solman. The segment was titled "Top-down or middle-out? Debating the key to economic growth." The show focused on the work of Nick Hanauer, an American entrepreneur and venture capitalist with a net worth of $1 billion, who appeared opposite me on television. Hanauer gave a talk on TED that went viral, receiving over a million views on YouTube, in which he advanced a middle-out thesis for economic growth: "The fundamental law of capitalism is, if workers don't have any money, businesses . . . don't have any customers."

I was asked to comment on his thesis. The exchange was hard to get off the ground. His remarks were made without reference to anything that I said. I directed sharp criticism to his populist creed and argued that the middle class creates wealth through its demand — not the capitalist through his innovation.

Top, Middle, or Bottom?

When you appear on television, it's hard to control how the central issues are framed. In this instance, the title chosen by PBS bought into Hanauer's conception of the world with its middle-out perspective. But the phrase "top-down" does not reflect my views, as the segment's title suggests. I take the classical liberal position on wealth creation.

The first source of difficulty is that a top-down approach frequently implies that wealth is created through central planning. That is, the government coordinates all forms of social investment. Following Friedrich Hayek, I cannot think of a worse way to plan the operation of any economy. The classical liberal view on this subject is that of bottom-up wealth creation, which operates as follows.

The initial assumption is that the state is not regarded as the creator of rights, but as their protector. Individual rights in labor and intelligence belong to an individual as a matter of birth, not via a grant from the state. Claims to particular property are initially created by occupying land, capturing animals, or grabbing things that are otherwise unowned. Once individuals own property, the key office of the legal system

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"Middle-Out" Economics by Richard A. Epstein (continued from page 1)

is two-fold: First, to stop aggression, and second, to allow for coordinated activities, which include the use of public funds to create the needed infrastructure over which private transactions take place.

At this point, the relationships between consumption, production, and growth are not determined by some magical law that favors a top-down, middle-out, or bottom-up position. What happens is that individual decisions to collaborate on various ventures drive all aspects of the wealth cycle from innovation to implementation. There is no privileged position for either middle class consumption or capitalist innovation. Hanauer is, of course, correct to say that unless consumers have income they cannot buy the services, both new and old, that capitalists produce. But the relationships are reciprocal, so that entrepreneurs must be there to provide goods and services that consumers want, and to pay wages to workers which they then spend in their roles as consumers. All sides of the relationship constantly feed each other.

At this point, any claim of priority no longer makes any sense. Indeed, a claim to focus on aggregate consumption for the middle class makes no sense either. Let each individual decide how much of his income or wealth to consume or invest. Let each person also decide whether to direct his or her investments into new or old technologies. Each person makes his or her choices with some knowledge of the plans of others. Their decentralized choices will yield a more informed set of outcomes on both production and consumption than either a state-imposed top-down or middle-out version of the world.

The Problem With Middle-Out Economics

The decision by Hanauer to stress his so-called middle-out position carries with it dangerous policy implications, which are evident in how he treats both labor and taxation policy.

One supposed implication of Hanauer's consumer-driven account is that efforts to pump out aggregate demand depend on boosting up income for the middle class by devices targeted to that end. This policy goes back as far as the 1930s when one of the rationales for mandatory collective bargaining under the National Labor Relations Act stemmed from the supposed belief, as its statutory findings announced, that "the inequality of bargaining power" between employers and employees "depresses the purchasing power of wage earners," for which the higher wages wrought by concerted union action was the appropriate policy response.

Yet the NLRB miscarried for multiple reasons. First, its pro-union policies only address the union members, not overall consumer demand. If unions get more through industrial action, other workers could easily get less, so that no confident claim can be made about the aggregate effects of unionization. In addition, the shift in market arrangements increases bargaining costs and results in monopoly dislocations, including strikes, lockouts, and other interruptions in production, that offset any supposed gains from more aggregate consumption. Rather than rig markets, the better approach is to secure open competition in all markets, so that wages are bid up as productivity increases, wholly without government intervention.

Hanauer does not grasp these fundamentals. He repeats a common mistake when he writes: "But there is this upper limit on what we can spend. I drive a very nice car, but it's only one car. I don't own 1,000, even though I earn 1,000 times the median wage." True enough. But the point only shows that he has a diminishing marginal utility for one form of consumption, which means that his consumption expenditures will switch to fine wines and private jets, while his unspent wealth is used to fund investments in new businesses or charitable operations. Think of it this way: people who earn huge amounts, but take very little out by way of consumption, are doing a public service. Others gain from the increased supply of capital.

Unfortunately, Hanauer does not see matters this way, and thus makes counterproductive recommendations for both labor policy and taxation. On the former, he is an active backer of the $15 minimum wage law in Seattle on the ground that it will put money in workers' pockets so that they can buy more goods. But that assumes that the jobs will remain after the wages are increased — that the wage increase won't unleash collateral damage.

Indeed, his defense of major wealth transfers is condemned by his own example: "Wal-Mart earned $27 billion in profit last year. They could afford to pay their bottom million workers $10,000 more a year, raise all of those people out of poverty — save taxpayers billions of dollars, and still earn $17 billion in profit, right?" Not so fast. He speaks as if the huge transfer of wealth is fully captured by subtracting $10 billion from $27 billion. But huge hits generate counterstrategies as management has to find a way to stop the decline in share prices when net earnings drop by close to 40 percent. The cost of capital increases; capital to fund internal investments diminish. The firm looks at ways to cut workers to save labor costs, so that we see more outsourcing and greater automation. By the same token, it may have to raise prices to boost revenues, but only at the risk of lost business, given that its core customer base includes a large percentage of price-sensitive lower-middle-class people.

My approach was the opposite. Repeal the minimum wage and let people work for $.02 per hour. Let, not make, of course. This claim does not rest on some ludicrous assumption that anyone can "survive" on that nominal wage. Indeed, one reason that Solman was incredulous at my suggestion lay in his failure to understand why it sometimes makes sense for workers to take a low or nominal wage, namely, in order to improve their ability to earn more money a year later. Gary Becker called this investing in human capital, and clearly any individual who takes this strategy should have some other source of short-term income, whether from savings, a second job, family support, or in-kind payments of room and board. The constant talk of the living wage should not blind us to the importance of life-cycle earnings, which could be undercut by a high minimum wage that keeps people out of the labor market.

A similar criticism can be lodged against Hanauer's proposal to tax the rich to fund the middle class. It won't work. The tax increases under the Obama administration have not stopped the slide in median income in the United States, because they do nothing to ease the ever-rising burden of labor regulation, a topic that

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Hanauer never mentions. Today, the combination of taxation and regulation eliminates job opportunities, especially for workers at the bottom of the market.

The same logic applies to taxation targeted to the rich, which creates political uncertainty, drains investment income, and leads to wasteful albeit legal strategies of tax avoidance, including the now-popular tax inversions that drive companies overseas. Adam Smith was right to insist that low, flat taxes increase stability and spur growth.

The conventional wisdom holds that classical liberals like myself are ideologues untouched by human emotion and uneducated by practical experience. Many believe that to oppose the minimum wage is to tolerate pollution and abandon a public highway system. But that is a false caricature of laissez-faire, which has never once licensed nuisances against strangers or prevented the state construction and maintenance of infrastructure.

Laissez-faire economics is in retreat. Today, the progressive mindset drives much of public policy. So the populist skeptics of laissez-faire have to ask themselves a simple question: How can the decline in median income and the slow growth rate over the past six years be attributable to policies that have not been in place for a long time? The source of our current malaise is the populism of people like Hanauer who fail to understand the negative, but quite real, unintended consequences of their policy prescriptions.

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Why Do So Many Know So Little About U.S. History?
by
Burton W. Folsom, Jr.

The problem starts in the schools, and with the content taught (or not taught). If, for example, most high school students today don't know when the Civil War occurred, or why it occurred, how will they understand what it accomplished?

The Advanced Placement (AP) classes in high school are important because they attract the best students and prepare them for college. The AP United States History Standards for teaching advanced history courses to millions of students across the nation were revised and expanded this year, "effective fall 2014," so I read them to see what all the fuss was about. I was appalled.

The central theme in U.S. history, according to these slanted standards, is group conflict and the perpetual tension with race, class, and gender. Thus, the section on immigration in the late 1800s will astonish many students: Why would almost a million immigrants each year want to come to a country so oppressive to so many groups? No answer to this key question is forthcoming.

The sheer silliness of the Standards may thwart their efforts to turn the students into incipient radicals. For example, the Standards never explain why the Puritans came to America, or why the Cold War started or why it ended. Why did the U.S. become the major economic power in the world? On this question also the Standards are silent, but they do tell the students, "The market revolution helped to widen a gap between rich and poor."

Few American presidents are even mentioned in the new Standards; entrepreneurs and even civil rights heroes are also mostly absent. Their stories of hard work, overcoming challenges, and seeing their vision change the nation have

rt of individuals like you who believe in individual liberty and free-market
e-paid envelope to make your tax-deductible contribution to this effort today.

inspired many students over the years, but those stories disappear from the new Standards.

The Standards regularly confuse good intentions with outcome. In discussing the Great Society reforms of the 1960s, for example, the Standards praise liberals for good intentions in wanting to help people: "Liberalism reached its zenith with Lyndon Johnson's Great Society efforts to use federal power to end racial discrimination, eliminate poverty, and address other social issues while attacking communism abroad."

What the Standards don't tell students is that the Great Society largely failed because its programs created perverse incentives. In the 1960s, under Aid to Families with Dependent Children (AFDC), unwed mothers were given incentives to have children out of wedlock. Payments for each child out of wedlock increased, Medicaid benefits were added, food stamps and rent subsidies were tossed in, and the *King vs. Smith* Supreme Court decision allowed these benefits to continue even if boyfriends lived with the unwed mother.

The intentions of the liberal reformers were good, but poverty often increased after the 1960s in part because millions of new babies – black, white, and Latino – were being born into fatherless homes. Research has strongly shown that children born into intact families have much higher rates of success and happiness in life than those children born into one-parent households. The Great Society, with its good intentions, weakened the family structure and often did more harm than good.

These points are, of course, omitted in the new Standards. Thus, we may be on the verge of failing to educate another generation of students. How can we preserve and defend the liberty this country was founded on if we don't teach students how we won our freedom and why our country, with all its faults, is worth defending? For the time being, we need to encourage parents to consider charter schools, private schools, and even home schooling in order to educate their children. Students in AP U.S. History classes should read Larry Schweikart's *Patriot's History of the United States* to give them insight into why America has been an exceptional nation in world history.

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Welfare State Grows as Self-Sufficiency Declines
by
Robert Rector

For the past 50 years, the government's annual poverty rate has hardly changed at all. According to the U.S. Census Bureau, 15 percent of Americans still live in poverty, roughly the same rate as the mid-1960s when the War on Poverty was just starting.

After adjusting for inflation, federal and state welfare spending today is 16 times greater than it was when President Lyndon B. Johnson launched the War on Poverty. If converted into cash, current means-tested spending is five times the amount needed to eliminate all official poverty in the U.S.

How can the government spend so much while poverty remains unchanged? The answer is simple: The Census Bureau's "poverty" figures are woefully incomplete.

The Census defines a family as poor if its annual "income" falls below specific poverty income thresholds. In counting "income," the Census includes wages and salaries but excludes nearly all welfare benefits.

The federal government runs over 80 means-tested welfare programs that provide cash, food, housing, medical care, and targeted social services to poor

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Politics on the Bench — Iowa and Beyond

by Roger Pilon

In her opinion essay in *The National Law Journal* about special-interest spending in judicial elections, former Iowa Chief Justice Marsha Ternus urged "keeping politics out of the courtroom." ("Politics on the Bench — A Judge's View of Partisanship at Play," Jan. 20.) Her concern is understandable: She and two colleagues were ousted in a 2010 retention election after the court in 2009 ruled unanimously that an Iowa statute denying civil marriage to same-sex couples violated equal protection under the Iowa Constitution. But there's more politics here than meets the eye. In fact, it's the politics Ternus didn't mention that seems to have colored her idealized view of judging, shielding her from a deeper account of why our courts have become so politicized.

Far from the angels being all on one side, it turns out that Iowa's "nonpartisan" judicial screening commission and gubernatorial appointment process is deeply political. As a July 2010 report by *The Iowa Republican* documents, not only were all seven members of the Iowa Supreme Court, save Ternus, nominated by Democratic governors, from lists presented by the commission, but all were or had been Democrats or had made significant contributions to the party or its candidates. All seven, in short, came from one party.

Ternus does not see *this* process as politicizing the court, even though the 2010 report documents how the "nonpartisan" screening commission itself grew so one-sided. Instead, she contrasts "politicized courts" — where judges, influenced from outside, "approach decisions along philosophical or ideological lines" — with "impartial courts" — where "judges holding diverse perspectives pursue a collegial approach to decision-making," effectively holding each other "accountable to the rule of law." In these, "a collective wisdom is brought to bear when judges listen to, and find value in, their colleagues' different perspectives."

A worthy aspiration, perhaps, and doubtless more likely when all your colleagues are of the same party. But judges often disagree, often simply on what the law is, especially when they hold different philosophical or ideological views. And those differences can easily preclude any "collective wisdom," much less "finding value in a colleague's different perspective." None of that, however, makes judges "politicians in robes."

In fact, the judicial "consensus" Ternus is advocating is hardly possible today because we're deeply divided along philosophical or ideological lines. Yet for the better part of our history we largely *did* agree, at least at a basic level. Our "philosophical view," rooted in the Declaration of Independence and the Constitution, was one of individual liberty through limited government. Most of life was meant to be, and was, lived apart from government.

Progressivism and Our Politicized Courts

That all changed with Progressivism, of course, with the idea that law is a vehicle not mainly for adjudicating private disputes but for pursuing grand public visions. After the slow expansion of state police power during the early decades of the twentieth century, the U.S. Supreme Court paved the way for this view following President Franklin Roosevelt's infamous court-packing threat. The demise of the doctrine of enumerated powers in 1937, which unleashed the modern redistributive and regulatory state; the bifurcation of the Bill of Rights and of judicial review a year later in *Carolene Products'* (in)famous footnote four, which enabled judges to label some rights "fundamental" and others of lesser value; and the rise thereafter of the vast administrative state all amounted to an explosion of "political law" — the law of "policy," not principle, and hence of deep political disagreement. Thus, courts today are asked to decide matters that once were left to private determination — under private law, if necessary — and often to make essentially value-laden political decisions that parade then as "law."

Take a simple current example. When the Commerce Clause was read as a power aimed mainly at ensuring unimpeded interstate commerce, as in *Gibbons v. Ogden*, not remotely was it thought to authorize anything like the massive redistributive scheme called Obamacare. Thus, if an organization wanted to offer its staff health insurance excluding contraceptive coverage it would simply transact for that in the marketplace. Today, however, the Court is asked to decide whether the administration, pursuant to a statute, can dictate that choice—a value-laden matter that would never be before the Court had it not so expanded Congress's commerce power.

The case at hand is somewhat different, of course, since it turns not only on the Iowa Constitution but, ultimately, on the Fourteenth Amendment and hence pre-dates Progressivism. But even here, had we done a better job explaining and enforcing that amendment's principles—their roots in the Declaration, as Lincoln saw—we might have been in a better position today to explain how they apply not only to New Orleans butchers, who in the *Slaughterhouse Cases* sought simply to be treated like other butchers; or to the black passengers in *Plessy* who sought an end to segregated railway cars; or to the bakers in *Lochner* who wanted only to negotiate their own terms of employment; and even to interracial and same-sex couples seeking simply to be left alone to marry, as in *Loving* and *Perry* — all of which would have meant far less government intrusion in our lives. And at bottom, isn't that what many of those who unseated Justice Ternus want?

But locked into a program for ubiquitous government, Progressives like Ternus are hard pressed to explain why government should not, through the democratic process, be setting the terms of marriage as well. They'd have been better served by the broad leave-us-alone agenda that resonates with so many of their critics.

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Welfare State Grows as Self-Sufficiency Declines
by
Robert Rector
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and low-income Americans. The government spent $916 billion on these programs in 2012; roughly 100 million Americans received aid from at least one of them, at an average cost of $9,000 per recipient. (These figures do not include Social Security or Medicare.)

Of the $916 billion in means-tested welfare spending in 2012, the Census counted only about 3 percent as "income" for purposes of measuring poverty. In other words, the government's official "poverty" measure is not helpful for measuring actual living conditions.

On the other hand, the Census poverty numbers do provide a very useful measure of "self-sufficiency": the ability of a family to sustain an income above the poverty threshold without welfare assistance. The Census is accurate in reporting there has been no improvement in self-sufficiency for the past 45 years.

Ironically, self-sufficiency was Johnson's original goal in launching his War on Poverty. Johnson promised his war would remove the "causes not just the consequences of poverty." He stated, "Our aim is not only to relieve the symptom of poverty, but to cure it and, above all, to prevent it."

Johnson did not intend to put

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more Americans on the dole. Instead, he explicitly sought to reduce the future need for welfare by making lower-income Americans productive and self-sufficient.

By this standard, the War on Poverty has been a catastrophic failure. After spending more than $20 trillion on Johnson's war, many Americans are less capable of self-support than when the war began.

This lack of progress is, in a major part, due to the welfare system itself. Welfare breaks down the habits and norms that lead to self-reliance, especially those of marriage and work. It thereby generates a pattern of increasing intergenerational dependence. The welfare state is self-perpetuating: By undermining productive social norms, welfare creates a need for even greater assistance in the future.

The poverty rate is better understood as self-sufficiency rate. That is, we should measure how many Americans can take care of themselves and their families. Reforms should focus on changing the incentive structure of welfare programs — to point the way toward self-sufficiency.

Robert Rector is a Senior Research Fellow at The Heritage Foundation.

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