Economic Contractions in the United States: A Failure of Government

By

Charles K. Rowley* and Nathanael Smith**

*Duncan Black Professor of Economics
George Mason University
and
General Director
The Locke Institute
crowley@gmu.edu

**Research Assistant in Economics
George Mason University
and
Senior Research Fellow
The Locke Institute
nathan_smith@ksg03.harvard.edu

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*The Locke Institute
5188 Dungannon Road
Fairfax, Virginia 22030
USA
Tel: (703) 934-6934
Website: www.TheLockeInstitute.org
Email: crowley@gmu.edu
www.thelockeinstitute.org

**The Institute of Economic Affairs
2 Lord North Street
Westminster
London SW1P 3LB
England
Tel: 020 7799 8900
Email: iea@iea.org.uk
www.iea.org.uk

Preface for the Institute of Economic Affairs

The IEA has decided to join with the Locke Institute in publishing this monograph because of the important lessons it contains regarding the financial crash of 2008 and the Great Depression of the 1930s. These lessons are ignored at our peril.

The US context for the current problems in the UK is important. Although UK banks clearly made bad business decisions, much of their bad debt originates from the purchase of US securitisation issues. The commentariat in the UK and the US is responding to the crisis by calling for more financial regulation and an end to the so-called laissez-faire capitalism that is said to have given rise to these financial innovations.

Yet, it is odd that they should do so unless they are blinkered by their own ideologies. It was a US monetary boom that fed an asset price boom and encouraged investors to under-price risk. It was the operation of monetary policy over a long period that led market participants to believe that a fall in the stock market would be cushioned by a fall in interest rates. The US government and its agencies were at the heart of the development of securitisation and also encouraged it through their tax and regulatory systems. US policy, over a generation, encouraged the "bail-out" mentality which, when combined with limited liability, is bound to lead to more and more recklessness in the management of financial institutions. Furthermore, US regulation encouraged the lending to poor risks that underlies so many of the toxic securities. Whether the commentariat is right in pointing the finger at unethical bankers and structural failings in markets is largely irrelevant. The US government – and its agencies – were encouraging, if not causing, the trends in financial markets that led to the crash of 2008. The government has shown that it is not in a position to correct what some call "market failure" and thus the appropriate regulatory response must be to restore the incentives that will ensure market discipline is effective.

This is not the main subject of the monograph by Charles Rowley and Nathanael Smith. But it is an important backdrop. Rowley and Smith show how the Great Depression – almost certainly caused by incompetent monetary policy managed by a Federal government body – was not only blamed on the market (like our own financial crash) but was used as an excuse to change the face of the US in a socialist direction. The US faces this threat again today.

In the wake of the Great Depression, Hoover raised tariffs and enacted legislation that kept wages artificially high. Roosevelt raised the top rate of tax to 79% and then to 90% in 1940. He established Planning Boards and led a shift of power from the states to the Federal government and from the Congress to the executive. Importantly, many of these changes lasted decades or became irreversible. These changes happened because it was believed by many in the establishment that the depression was caused by the market and could be resolved by various forms of socialism.

Thus this expansion of socialism was based on a fallacy. It also led to disastrous results as the US had arguably the deepest and longest-lasting depression of all the major industrial countries in the 1930s. Higher taxes, planning and regulation stifled the entrepreneurial initiative that should have been at the heart of economic recovery; government spending and investment crowded out much needed private spending and investment.

In the years prior to the crash of 2008, President George W. Bush was indulging in old-fashioned crude Keynesianism at a financial level – with disastrous long-run effects. As the authors put it:

> Tax cuts and deficit spending, M2 money supply growth, and low interest rates, made the period 2001 through 2007 the most expansionary economic policy environment in the United States since the 1970s. The Bush administration, the GOP-majority Congress, and the Greenspan Federal Reserve were, in effect if not in name, engaged in a great Keynesian experiment. And in the short run, it appeared to succeed.

And, with the election of the new President, the failure of crude Keynesianism has been followed by proposals to take government intervention in the economy to ever-greater levels. Obama is following the path trodden by Roosevelt, but with the additional twist that his starting point is one of much greater government intervention in the economy: this is partly because of the permanence of Roosevelt's reforms of 70 years ago and also because of expansion of government intervention under George W. Bush. Indeed, Rowley and Smith suggest that

Obama's interventions threaten the rule of law and the primacy of property rights.

This monograph by Rowley and Smith is important for the debate in the UK – and particularly important for the audience that the IEA tries to reach. A false understanding of the Great Depression, its causes and its aftermath is embedded in UK political discourse – even in intellectual circles. There is a danger that a false understanding of the causes of the crash of 2008, and the scale of government intervention that preceded it, will also become embedded. If that happens, then it will be that much more difficult to win the argument for the free economy.

But the authors go further than providing an historical account and critique. They propose a series of interesting and radical policy reforms which, at the same time, are within the realms of the politically possible – assuming, of course, that we have politicians with sufficient vision to implement them. Not all the proposals will obtain agreement from all supporters of the free market. Those relating to the conduct of monetary policy will be particularly controversial, but they should all form part of a vibrant debate amongst supporters of a free economy who come from different theoretical schools.

All supporters of a free economy will be in agreement though that we should not surrender intellectual ground to those who suggest that the Great Depression was caused by free market forces, that George W. Bush allowed unfettered market forces to prevail and that the crash of 2008 was caused by deregulation. Essentially this is an argument about education in recent economic history and the IEA is pleased to be associated with publishing Charles Rowley and Nathanael Smith's monograph in order that this process of education is advanced.

Philip Booth
Editorial and Programme Director, Institute of Economic Affairs;
Professor of Insurance and Risk Management; Cass Business School, City University, London, UK.
June 2009

The views expressed in this monograph are, as in all IEA publications, those of the authors and not those of the Institute (which has no corporate view), its managing trustees, Academic Advisory Council Members or senior staff.

The Authors

Charles K. Rowley

Charles Rowley was born in Southampton, England in 1939. He was educated at the University of Nottingham where he obtained a First Class Honours Degree in Economics in 1960 and a Ph. D. in Economics in 1964. He taught at the Universities of Nottingham, Kent, York and Newcastle upon Tyne and held summer fellowships in the Center for Socio-Legal Studies at Wolfson College, Oxford before migrating to the United States in January 1984 to join the Center for Study of Public Choice at George Mason University.

Dr. Rowley has written and edited some 40 books and some 200 scholarly papers in the fields of industrial organization, public choice, welfare economics, international trade and law-and-economics. His work consistently emphasizes the importance of private property rights, limited government and the rule of law as the basis for a free and prosperous society. Among his recent books are *The Right to Justice* (1992), *Property Rights and the Limits of Democracy* (edited 1993), *Trade Protection in the United States* (with Willem Thorbecke and Richard Wagner) (1995), *The Political Economy of the Minimal State* (edited 1996) and *Classical Liberalism and Civil Society* (edited1997). He also edited *Public Choice Theory* (three volumes 1993), *Social Choice Theory* (three volumes 1993), *The Economics of Budget Deficits* (two volumes, with William F. Shughart, II and Robert D. Tollison, 2002), *The Encyclopedia of Public Choice* (two volumes, with Friedrich Schneider, 2004), and *The Origins of Law and Economics: Essays by the Founding Fathers* (with Francesco Parisi, 2005). Most recently, he has edited, with introductions, in ten volumes, *The Selected Works of Gordon Tullock* (2004-6).

Dr. Rowley was a Founding Editor, 1980-1986, of *The International Review of Law and Economics* and served as Joint Editor of *Public Choice* between 1990 and 2007. He is Duncan Black Professor of Economics at George Mason University, General Director of the Program in Economics, Politics and the Law in the James Buchanan Center for Political Economy, and General Director of *The Locke Institute*, an independent non-profit educational foundation located in Fairfax, Virginia and dedicated to the advancement of a classical liberal political economy.

Nathanael Smith

Nathanael Smith is currently studying for a Doctoral Degree in Economics at George Mason University. He is a Senior Research Fellow at The Locke Institute in Fairfax, Virginia. He obtained a Bachelor's Degree in History and Economics from Notre Dame University and a Master's Degree in Public Administration and International Development from Harvard University. He worked as an analyst at the World Bank between October 2003 and July 2004, as a fiscal policy research analyst at The Cato Institute between August 2004 and July 2005, and as a consultant at the World Bank between August 2005 and January 2008. He has published a number of short articles in TCS Daily and a co-authored scholarly paper on Islam and Democracy (with Charles Rowley) in the June 2009 Issue of *Public Choice*.

In Memory of

Ralph Harris and Arthur Seldon
The Founding Fathers of the Institute of Economic Affairs

They dedicated their lives both to rolling back the state
and to promoting *laissez-faire* capitalism

Frontispiece

A comprehensive and coherent assessment of the current economic contraction, one that largely rebuts attribution of failure to capitalism or the market. The targets become the practicing politicians of all parties, whose cumulative mistakes have now hurt us all. We have learned some things from comparable experiences of the 1930s' Great Depression, perhaps enough to reduce the severity of the current contraction. But we have made no progress toward putting limits on political leaders, who act out their natural proclivities without any basic understanding of what makes capitalism work.

James M. Buchanan
Nobel Laureate in Economic Sciences, 1986

Foreword

*By William F. Shughart II**

It is now conventional to draw parallels between the sharp recession into which the United States and most of Europe plunged at the end of 2007 and the Great Depression of 1929–1945. The two events surely have much in common. Both were preceded by excessively loose monetary policies that fueled speculative asset bubbles – in the prices of real estate during the late 20th and early 21st centuries and in the market values of publicly traded equities during the Roaring Twenties. Both triggered epic responses from central governments worldwide after the bubbles inevitably burst, financial institutions collapsed, investors and businesses retrenched and unemployment spiked. Financed primarily by borrowing and informed by a fatal Keynesian conceit that governmental intervention can soften, indeed circumvent, painful but purgative market corrections, the Great Depression gave birth in America to Herbert Hoover's Reconstruction Finance Corporation and to Franklin D. Roosevelt's New Deal. Fiscal "stimulus" on a much larger scale, the Troubled Asset Relief Program, intended to clear balance sheets of toxic mortgage-backed securities and similarly worthless paper claims, and taxpayer-financed bailouts of banks, insurers, automobile manufacturers and other privately owned companies deemed too big to fail because of the perils of "systemic risk" are the accepted policy prescriptions for reversing today's economic decline.

But except for the warrants they supplied for unprecedented growth in the public sectors' size and scope, the comparisons between now and then are overwrought. By the time FDR moved into the White House in March 1933, thousands of banks had failed, US Gross Domestic Product had fallen by one-third and one in four Americans was out of work. By way of contrast, GDP has declined at an annualized rate of roughly 6.6% since December 2007 and the US unemployment rate stands, in spring 2009, at just under 9%. Those numbers unquestionably are cause for concern, but not for media-inspired panic. The crisis of the present day may deepen, of course; as of this writing, however, the economic data hardly justify the $3 trillion (or more) already committed by presidents George W. Bush and Barack Obama to a set of programs hopefully mimicking their collective hero FDR's triple goal of "relief, recovery and reform".

Nevertheless, as documented in this insightful monograph by Charles Rowley and Nathanael Smith, the Great Depression teaches important lessons about today's economy. Those lessons do not necessarily apply to the proximate causes of economic recession or depression in general, however. After all, economists have not 80 years on reached consensus as to whether the collapse that followed the stock market crash of October 1929 represented a failure of monetary policy, of fiscal policy, of international trade policy, or was instead caused by breakdowns in credit markets or in consumer confidence and business expectations. Complex events normally are not susceptible to simple explanation.

The key truth emphasized in the monograph at hand is that people have more to fear from governmental responses to economic crisis than from crisis itself. It is indisputable that the policies of the New Deal prolonged and deepened a downturn in business activity that otherwise likely would have been sharper, but briefer, as had been the experiences in all previous recessions. Despite all the legislative activity of FDR's famous First Hundred Days and of their nearly decade-long sequel, the US unemployment rate did not fall into the range of single digits until America had declared war on Japan on December 8, 1941, and Adolph Hitler soon thereafter foolishly had declared war on the United States. US GDP in real terms did not return to its 1929 level until Dwight Eisenhower was midway through his first term in office.

The Second World War may have solved the global unemployment problem but, as Robert Higgs has shown, it did not by any means restore prosperity. Conscription into the armed forces of millions of men, the shifting under a regime of war socialism of scarce resources into the production of armaments, and the rationing of rubber, sugar, gasoline and other consumer goods hardly were recipes either for liberty or affluence. Economic growth returned to pre-1929 trajectory only when, after Allied victory over the Axis powers in 1945 and, contra Keynes and Cambridge, Washington had cut it its war-related expenditures sharply, lowered personal and corporate income tax rates and reduced its war-time budget deficits. Such evidence flies in the face of the conclusions of Paul Krugman, Christina Romer, Lawrence Summers and other contemporary philosopher-kings (and queens), who argue that the New Deal failed to turn the economy around simply because it was too timid.

The policies of the New Deal, aimed at propping up prices and wages at a time when markets were calling for them to fall, and at restricting output when the economy was in the midst of a staggering freefall in the production of goods and services, short-circuited the therapeutic operation of unfettered market forces. More seriously, FDR's program of policy experimentation – guided by his overarching philosophy of trying something and, if that didn't work, of trying something else – fostered a climate of uncertainly that chilled business's incentives to invest in new plant and equipment and to begin hiring again. What was needed, then as now, was a policy stance that obeyed the Hippocratic Oath, which instructs physicians, first, to do no harm.

Rowley and Smith herein also summarize evidence that should not be too surprising – although it may well be so to the majority voting in November 2008 in favor of change they could believe in – that political influence shaped the distribution of New Deal spending. FDR has been accused of many things, but political naïveté is not one of them. He grasped early on that solidifying a supporting coalition comprised of blue-collar workers, farmers, big-city political machines, voters in key western swing-states, African-Americans and intellectuals, among others, was essential to his strategy for election to a second term in 1936. Federal largesse predictably flowed disproportionately from Washington to electorally critical states and special-interest groups, while the solidly Democratic South got short-shrift. That same vote motive seems to be in play in President Obama's first budget request, in the ending of his predecessor's post-9/11 tax cuts and in his support for labor unions, for single-payer (nationalized) healthcare, and for fuel-efficient vehicles, ethanol and other "green" policy initiatives.

Informed by the Virginia School of positive public choice analysis, *Economic Contractions in the United States* supplies timely and indispensable historical perspectives on the financial crisis that produced the economic recession of 2007 that still is underway. Rowley and Smith's monograph focuses attention on the salient fact that, like the Great Depression before it, the current recession is man-made. It resulted from the predictable responses of profit-seeking lenders to a sequence of public policies that supplied incentives for advancing money to borrowers who could not possibly afford to square their accounts unless the bets they (and their counterparty financial institutions) had made on continuously rising real estate prices paid off. Those bets generated handsome returns for quite some time, but the rents generally were squandered by homeowners by taking out second mortgages, cashing in their equity to finance current consumption spending. Lenders, likewise mesmerized by seemingly ever-rising collateral values – and anticipating, correctly as it turned out, that any capital losses could be shifted to the taxpayers, i.e., government-sponsored entities (GSEs), such as Fannie Mae, Freddie Mac and the Federal Housing Authority – willingly and rationally assumed more exposure to default risk.

Now that the chickens have come home to roost, what is to be done? In answering that important question, I can do no better than to recommend careful attention to chapters 5 and 6 of *Economic Contractions in the United States*, where the essential elements of a *laissez faire* program for recovery and reform ably are spelled out. At the end of the day, though, I am less sanguine than the authors about the prospects for substantive change along the lines they propose. I fear that many Americans, who have benefited greatly from free-market institutions, value government protection from downside risk more than they value opportunities to improve their standards of living. I hope that I am wrong. If so, it will be to Charles Rowley and Nathanael Smith that thanks are owed. If not, America is destined to become a simulacrum of France, overseen in the near term by an administration so profligate that his predecessor now looks like the fiscal conservative he claimed to be, and by a central bank that, under the chairmanship of Ben Bernanke, fatally has compromised its independence from the executive branch. The permanently larger public sector that in my judgment will be the chief legacy of the current recession augurs a US economy that will be much less resilient when the next crisis strikes, justifying demands for even more socialization.

* F.A.P. Barnard Distinguished Professor
Department of Economics
University of Mississippi

Editor in Chief, *Public Choice*

President-elect, Southern Economic Association

The Setting

Economic Contractions in the United States: A Failure of Government.

Charles K. Rowley and Nathanael Smith

> "An impoverished vocabulary, rich only in euphemisms, calls what has happened to the economy in consequence of the collapse a 'recession'. We are well beyond that."
>
> "Some conservatives believe that the depression is the result of unwise government policies. I believe it is a market failure."
>
> Richard A. Posner (2009) *A Failure Of Capitalism: The Crisis Of '08 And The Descent Into Depression*, vi and xii.

> "This land of such dear souls, this dear, dear land,
> Dear for her reputation through the world,
> Is now leased out, I die pronouncing it,
> Like to a tenement or pelting farm:
> (The United States), bound in with the triumphant sea,
> Whose rocky shore beats back the envious siege
> Of watery Neptune, is now bound in with shame,
> With inky blots and rotten parchment bonds:
> That (United States) that was wont to conquer others
> Hath made a shameful conquest of itself."
>
> William Shakespeare, *Richard II*, Act II, Sc.i
> (with apologies to Sir John of Gaunt)

1
Introduction

Free enterprise capitalism works as a wealth-creating process. Capitalism works better, in this respect, than any other economic system. The closer the economic system approaches to *laissez-faire*, the more powerful its wealth-creating impulse. That is the lesson of economics and of economic history since the late 18th century. Social market economies, in the sense of Old Europe, may have beneficial characteristics. But the last three decades in Western Europe have shown that significant, sustainable wealth-creation is not among those characteristics.

A comparison with France and Germany sheds an interesting light on the anti-capitalist rhetoric that has circulated in the past year of economic contraction in the United States. According to the OECD, Germany's GDP per capita in 2006 was $31,950; France's, $31,047; and that of the United States, $44,054. U.S. per capita GDP is 27 per cent higher than Germany's, 29 per cent higher than France's. The peak-to-trough drop in real incomes during the Great Depression of 1929-33 was 36 per cent. An "L-shaped" depression, involving continuing high unemployment and a decade or so of stagnant growth, is often cited as a worst-case scenario for the US economy's immediate future. Yet even if US per capita GDP was to fall by one-quarter, a collapse only slightly less severe than that of 1929-33, its economy would remain ahead of those of France and Germany, even in the unlikely event that the latter remain completely unaffected by the present adverse economic environment.

American liberals have long praised Continental Western Europe (as late as 1989, Nobel Laureate, Paul Samuelson actually praised the German Democratic Republic) as economic models that the United States should emulate. One might ask, then, why should the left regard a second Depression as something to be avoided? If France and Germany are really worth emulating, should not such liberals regard a fall in GDP on the scale of the Great Depression as a price worth paying for a European-style social market economy?

It is doubtful, however, whether a majority of Americans really want to trade the capitalist prosperity they have enjoyed for the past generation for the safety and stagnation of European-style social market economies. Rather, politicians and pundits are trying to convince Americans that it is possible to have *both* American-style prosperity and dynamism *and* European-Union-style social markets. Recent history suggests that this is a pipe-dream.

Business cycles (or business fluctuations as they are sometimes referred to) are normal features of a well-functioning capitalist system. Upturns in the cycle unleash entrepreneurial forces that create new products and services that both shape and cater to the changing tastes of consumers. Downturns, usually caused by the excessive expansion of the money supply in a fractionalized reserve banking system (Mises 1912, Hayek 1933, 1935), nevertheless play an indispensable role in cleansing out accumulated structural inefficiencies, just as forest fires contribute to the long-run health of a forest.

This periodic cyclical cleansing reinforces the process of "creative destruction" (Schumpeter 1942), whereby resources are moved from lower to higher valued uses in response to changes in consumer preferences and/or in technology. Only when business cycles are driven beyond their natural limits by inappropriate monetary policy does capitalism occasionally explode into hyper-inflation on the one hand, or into economic depression on the other hand. These outliers almost always represent a failure of government, not of *laissez-faire* capitalism. Such is the case today.

In a recent book, Richard Posner has unequivocally categorized the economic contraction that started in the United States in late 2007 as a *depression*, and has identified its cause primarily as a *failure of capitalism* (Posner 2009). By contrast, we suggest that the current economic recession, like the extended Great Depression of 1929-39, represents a *failure of government*, and of *state capitalism* that is its creation, certainly not a failure of *laissez-faire* capitalism.

We divide this monograph into seven chapters, including this introduction. Chapter 2 revisits in some depth the Great Depression and its aftershocks in order to determine what really went wrong. We reject the myth that conservative fiscal policies caused the collapse and that Keynesian fiscal policies pulled the US economy out of the Great Depression. Rather, excessively loose monetary policy was the cause of the stock market bubble that burst in 1929, while excessively tight monetary policy was the principal reason that a normal recession in 1929 turned into a deep depression. Later, a relaxation of monetary policy was the main reason for a brief and limited recovery after 1933. But FDR's interventionist policies and draconian tax increases delayed full economic recovery by several years by exacerbating a climate of pessimistic expectations that drove down private capital formation and household consumption to unprecedented lows.

Chapter 3 shifts attention to the two economic contractions that have occurred in the US during the first decade of the twenty-first century, that of 2001-2 and that of late 2007 onwards. We demonstrate that excessively loose monetary policies were prime causes of the stock market bubbles that burst in 2000 and in 2008 and of the housing bubble that burst in mid-2006, and that expansionist, Keynesian fiscal policies pursued by the Bush administration from 2001 onwards, though they helped to make the 2001 recession one of the mildest on record, did so at the cost of becoming the root cause of the 2008 financial crisis and economic contraction. Unfortunately, the newly-elected Obama administration, together with its Congressional allies, has chosen to double or triple Bush's Keynesian bets, trying to revive the economy by putting the government still further into debt through easy money, temporary tax cuts, and large increases in government spending. Moreover, there are troubling similarities between the emerging industrial policy of the newly-elected Obama administration and the disastrous industrial policies of FDR.

Chapter 4 outlines and challenges the hypothesis set out by a number of scholars and commentators of the 2008 financial crisis (including Posner 2009) that capitalism has failed in the United States. We distinguish between *laissez-faire* capitalism and state capitalism and demonstrate that the latter failed, not the former. State capitalism failed largely because of the state, though capitalists within the financial sector contributed to the failure through serious and widespread lapses in financial judgment and personal integrity.

Chapter 5 draws upon the experience of the Great Depression and the 2001-2009 economic experience to define a Virginia political economy program of policy reform designed to counter the current economic contraction and to restore the US economy to its New Economy rates of productivity growth evidenced throughout the period of the Great Moderation, but most especially during the 1990s.

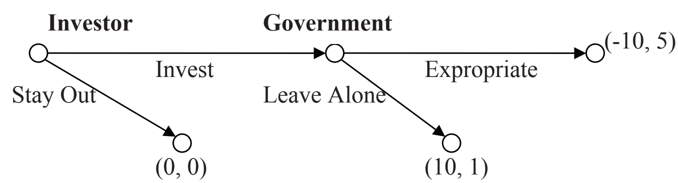
Chapter 6 draws on cutting-edge contributions in public choice economics to explain why regulation failed to prevent the 2000-2006 housing-market bubble and the 2008 financial crisis that followed its bursting. Public choice theory also provides a framework for an incentive-compatible, rules-based regulatory framework designed to prevent the recurrence of such a financial crisis in the United States.

Chapter 7 summarizes the major conclusions derived from this monograph and re-emphasizes the need for a return to some form of politically feasible approximation to *laissez-faire* capitalism, as the best way to achieve sustainable economic growth.

The Virginia School of Political Economy (Rowley and Vachris 1996, Shughart 2004, Tollison 2004) shows why Keynesian economists set themselves too easy and too useless a task when they craft advice for politicians and bureaucrats as if the latter were Platonic philosopher-kings rather than fallible and often self-seeking careerists (Buchanan and Wagner 1978). The problem is not with particular politicians, but rather, that even if there is a sound case for Keynesian-style demand management in pure macroeconomic theory (which is questionable), it is, as Buchanan and Wagner argue, "misapplied... to the political institutions of a functioning democratic society." (Buchanan and Wagner 1977, 5).

To set the scene for our unfolding analysis we present a very simple model which illustrates the virtue of market-friendly policy rules, a model that captures the most ominous policy similarities between the years after 1929 and the 2008-9 policy responses to the present crisis. Consider the two-player game shown in **Figure 1**:

Figure 1: The game theory of a capital strike



In Figure 1, an Investor has two options: Invest or Stay Out. The Government then has two options: Expropriate, or Leave Alone. The payoffs are as shown, with the Investor's payoff first, the Government's payoff second. The game can be solved by backward induction. If play reaches the second node, and the Government gets to move, it is rational for the Government to play Expropriate. Foreseeing this, the Investor in his first move, will play Stay Out, and both players receive a zero payoff. But both would be better off if the Government could somehow pre-commit to play Leave Alone, in which case the Investor will select Invest and the payoffs would be ten for the Investor, one for the Government (which benefits from more tax revenues and employment if the Investor invests). The Virginia School argues the case for constitutional rules that enable Government to bind itself to the mast and resist the siren song of intervention.

Our proposals, some at least of which are designed to appeal to the median US voter to the extent possible, seek a path to restore and deepen the institutional foundations of capitalist prosperity and growth, including individual liberty, a level playing field for business, private property rights, limited government, and the rule of law. Unfortunately the political climate, in the wake of the November 2008 elections, is currently unfavorable to a pro-capitalist reform program.

Therefore, we await a favorable wind on which to set sail to reverse the currently pro-social market economy agendas of the Obama administration and the Democrat-controlled US Congress, in order to return the United States economy, as far as is feasible within the constraints of a contemporary United States constitutional republic, to *laissez-faire* capitalism.