THE ROAD TO FREEDOM

HOW TO WIN THE FIGHT FOR FREE ENTERPRISE

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The Government We Want: Uncle Sam, or Uncle Sugar?

I once took a private tour of the National Palace Museum in Taiwan. This museum contains some of the most exquisite works of Chinese art in the world, transported out of mainland China in 1949 just before the country's fall to Mao Tse-tung's communists.

Almost everybody recognizes big visual differences between Western and Eastern art. I always wondered if these differences went beyond materials and technique, though–whether there was some fundamental philosophical distinction between the Western art I had been surrounded with all my life and the artistic treasures of the East. I used the opportunity that day in the museum to ask my guide what this distinction might be.

In the West, he told me, we see a blank canvas as empty, and ready to be filled up through the artist's inspiration. A painting does not exist until the artist loads the canvas with color and images.

In the East, artists don't think of creating something from nothing. They start with the belief that the finished work already exists, and simply needs the excess parts stripped away. The easiest way to understand this is not by thinking of an artist's canvas, but rather a block of stone to be sculpted. Before the artist begins, the finished sculpture exists within the block. The artist's job is to chisel away the parts that are not part of the sculpture.

The Eastern approach is useful when it comes to how we see our government.

America is a work of art, an expression of the vision of our Founders. The vision was audacious, creative, and revolutionary. But our Founders intended the work as an ongoing project. Benjamin Franklin famously promised us a republic, "If you can keep it." Every generation, the Founders knew, must work to preserve what they left us, and make it beautiful for our current generation.

For many years we have been pursuing something like the Western artistic strategy for government. We build our system up to attain what citizens and politicians demand in the moment. Every generation, we slosh more paint onto the canvas. We search for a better system by adding laws, regulations, taxes, and social engineering. The result today is garish and ugly; it bears little resemblance to the work of our Founders.

We need the art of taking things away to reveal the American Experiment within: the constitutionally limited government that allows America to be its best self. The project we need today is not a destructive one, simply tearing down the state. It is a creative one, to chisel away the statist dross that obscures our system of liberty, individual opportunity, entrepreneurship, and self-reliance.

This chapter is a description of what I think the sculpture inside the block looks like.

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LEFT ON THEIR OWN, governments tend to grow. Politicians get attention–and applause–for *doing* things. When things are going poorly, people never call their congressman and scream, "Don't just do something, sit there!"

As we have seen, both Democrats and Republicans have contributed, over the decades, to the explosive expansion of the U.S. government. In order to reverse this trend, Americans need to lay out clear principles describing what the proper role of government is, and isn't. Advocating limited, constitutional government requires nerves of steel, a willingness to weather knee-jerk resistance ("You are cutting my Medicare!"), and–above all–an actual philosophy. It requires a way to answer the question of what exactly needs to be limited, reformed, and cut–and *why*.

So, as believers in the free enterprise system, what kind of government should we work toward? What does a government look like that is fair, allows people to earn success, and lifts up the downtrodden?

In his first inaugural address, Thomas Jefferson laid out his vision of "a wise and frugal Government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government."[1]

President Obama's vision of government is, to understate the point, a bit more expansive than Jefferson's. The U.S. government, in his view, should be judged on whether or not "it helps families find jobs at a decent wage, health care they can afford, a retirement that is dignified."[2] In a bit over 200 years, we have moved from a president who believes the purpose of government is to leave you free to live your life as you see fit, to a president who thinks that the state is included in finding you a job, getting you a doctor, ensuring you save for your retirement, and a long list of other things.

What philosophy of government preserves Jefferson's ethos, while recognizing that the world has changed in dramatic ways? In my view, America would do well to turn to the wisdom of German-born economist and Nobel laureate Friedrich Hayek. Hayek's classic book *The Road to Serfdom*, written in 1944, is obligatory reading for all advocates of free enterprise—and still provides an excellent guide to the role of government.

Conservatives admire and quote Hayek incessantly. What's surprising to some is that he taught that the government, for moral as well as efficiency reasons, can and should provide a minimum basic safety net for citizens. And like most other economists, he also believed it should address "market failures." But that's all—and that is dramatically less than what the government currently does.

LET'S BEGIN WITH the idea of the minimum safety net, since the easiest—and most frequently cited—criticism of the free enterprise movement is that its proponents want to instate a purely Darwinian society, in which the weakest members are left on their own, without any support from the government. In 2011, President Obama said this of his political opponents: "Their philosophy is simple: we are better off when everyone is left to fend for themselves and play by their own rules."[3]

I have almost never heard conservatives and free enterprise advocates make such a preposterous claim. Most believe that it is appropriate for the government to provide *some* safety net for its citizens. Most are very comfortable providing some minimal standard of living in terms of food, shelter, and medical care.

Even hardline conservatives don't object to minimum basic protections for poor people, provided publicly, in some cases (and, in others, by private charities). Demagogues who accuse the political right of wanting to throw the poor out into the snow are not just exaggerating: they're simply wrong.

Still, most free enterprise advocates—and most Americans in general—believe that the government has gone too far and is mollycoddling the citizenry. A February 2009 Fox News poll shows that 76 percent of Americans believe that we now rely too much on the government and not enough on ourselves. Only 20 percent disagree with that sentiment.[4]

The basic problem is that America's minimum "safety net" has become appallingly broad. It has little to do with helping the poor, and a lot to do with passing out favors to voters and smoothing the risks out of ordinary life. For example, we often hear that Social Security is part of a basic safety net. But as currently configured, the program is in large part a benefit to middle-class people, especially the majorities that have taken more out of the system than they ever put into it. Similarly, Medicare Part D (subsidizing prescription drugs to seniors) is not part of the safety net for the poor per se; it is a $62 billion benefit that is consumed by a group that is made up primarily of middle-class Americans.[5]

The job of a social safety net starts with an answer to this question: What is an unacceptable standard of living in America? In my view, it is unacceptable for someone in America's wealthy society to go without access to basic medical care, sufficient food, and basic shelter. Pretty uncontroversial, I think.

But the safety net is *not* a means to increase material equality, a way to take any but the most grievous risks out of life, a way to pass out rewards to groups based on demographics or political clout, or a source of benefits to the middle class.

So Medicaid for people below poverty is an appropriate function of the safety net: We can and should find a way to cap its costs and preserve it, as the next chapter will detail. But the government subsidizing prescription drugs for all seniors (not just the poorest) is simply a favor to a key voting bloc, and European-style health coverage is a move toward social democracy. Food aid programs for the indigent are part of the safety net, but agricultural subsidies to prop up farmers' incomes are not. Homeless shelters are part of the safety net, but housing programs that serve the middle class like rent control and government flood insurance are not. A guaranteed minimum Social Security benefit that lifts seniors to the poverty line is part of the safety net, but paying anyone who is not poor any more than they paid in (plus a reasonable rate of return) is not.

The true safety net includes programs like food stamps so the poor can eat, Temporary Assistance for Needy Families (TANF) for low-income families with small children, Medicaid, and Supplemental Security Income (SSI) for the indigent and disabled. These federal programs are not cheap—together, family support, food assistance, Medicaid, and SSI totaled $432 billion in 2010 (a bit less than 3 percent of the GDP and 8.5 percent of the 2010 federal budget)—but they are a defensible safety net for the disadvantaged.[6]

The government could eliminate waste from these programs and spend less than it currently does. Moreover, welfare reform in the 1990s showed that these programs should never be designed as a permanent source of support, because that hurts the poor and their children. But few people, including few conservatives and free marketeers, really want to kill these programs and substitute nothing for them. The safety net—continuously improved and reformed—should continue to be there for the neediest of citizens.

Clearly, reasonable people can disagree on what "poor" means and what an "acceptable standard" for them is. But I believe that is the debate we should have, not a debate about whether the current out-of-control entitlement system—which largely benefits the nonpoor—should continue.

THE SECOND AREA of legitimate government activity is "market failure"—specific cases in which free markets don't function on their own to create efficient outcomes. Since Adam Smith published *The Wealth of Nations*, nearly all economists have agreed that such circumstances *can* justify some degree of state intervention in the system—not to weaken free enterprise, but to strengthen it.

There are four sources of market failure: monopolies, externalities, public goods, and information asymmetries.

Monopolies

A monopoly is, literally, "one seller." Monopolies are all around us. The corner bakery is technically one, as the only seller of bread on that corner, but its monopoly status poses no problem because there are other bakers on other blocks. A more worrisome monopoly is the only seller of an entire product. For example, until 1983, the phone company in America, AT&T—known back then as "Ma Bell"—was the only provider of long-distance phone service. It was horrendously expensive. (When I was a child, I remember my father sweating bullets because my mother was on a long-distance call to my aunt who lived in the next state *for nearly an hour*. Today, my kids don't even know what a "long-distance call" is.)

There are several problems with monopolies. In general, the lack of competition means prices tend to be high, service tends to be poor, entrepreneurs are unable to deliver innovation to consumers, and companies spend an inordinate amount of money lobbying government to maintain the one-seller privilege.

Monopolies like Ma Bell are a threat to economic prosperity and the good of citizens. When a company can establish a monopoly by forming barriers to competition, the company may prosper, but the citizenry won't; thus the government's interest in this market failure. The famous case of Standard Oil's monopoly pricing schemes of the 1880s led to the Sherman Antitrust Act of 1890, which most economists still today regard as beneficial and prudent regulation.

A related phenomenon is price fixing through the collusion of competitors, which makes an effective joint monopoly. Adam Smith wryly explained: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."[7] Manipulating a competitive market through collusion is a legitimate area of attention for government regulators. That is why it is illegal for the CEO of United Airlines to call his counterpart at Delta to talk about the prices they should charge.

These rules are not absolute, however. There are times when a monopoly makes sense—for instance, when it protects intellectual property. If you invent something, you get a patent or trademark that protects you from others who might steal your idea. If Amgen develops a new drug that cures a disease, the government says Amgen has several years to sell it without competition from generic substitutes. Microsoft has the legal right to be the only company that can use its brand and logo. Lady Gaga owns the legal rights to her songs and gets paid if you want to perform them professionally. In these cases, the government is correct in protecting monopoly power. If it did not, few would have an incentive to innovate.

Unfortunately, we should not assume that when it comes to monopoly policies, the government will sort out the "good" from the "bad" monopolies and make policy accordingly. Governments have been known to leave intellectual property unprotected, protect predatory monopolies, and even set them up in order to make money at the expense of the general public.

Remember the last time you tried to find a New York City taxi in the rain? It took twenty minutes because the city government, which sells exclusive licenses ("medallions"), limits the number of taxis to below competitive levels. Currently, the price of an individual taxi medallion—the license for one taxicab—in New York is $696,000 on the open market.[8] That's to buy the right to sell a product where competition is legally restricted in what is truly a conspiracy against the consumer.

Sometimes, the government itself operates a monopoly. In many countries, for instance, the government is the sole provider of land-line telephone service. Inevitably, it is an expensive and ghastly service—maybe even worse than Ma Bell. I lived in Spain when the government still owned the Spanish phone monopoly, *Telefónica*. Everything about it was a nightmare—people waited for months to get a new phone line, the service was miserable, and it was expensive. Why did the Spanish government own *Telefónica*? Because it was a huge cash cow and, basically, just another tax on citizens.

There are plenty of similar government monopolies in America. Does your state have a lottery? You might say it's just good clean fun, and it's better to have the government running it than a bunch of private-sector hoodlums. Think again. Private casinos have a profit margin of just a few cents on the dollar. Meanwhile, the average state government lottery pays just 52 cents for every dollar it takes in.[9] Lower-income citizens typically purchase lottery tickets; a National Bureau of Economic Research study shows that they finance the tickets largely by reducing their expenditures on necessities like housing and food.[10] The state lottery is nothing more than a government monopoly that exploits the poor and vulnerable.

So the bottom line on monopolies is that they are a source of market failure, but not in a straightforward or simple way. Sometimes, a monopoly is clearly predatory and bad; sometimes, it leads to better outcomes than competition. The right guide to regulating a monopoly should be, "What is best for the consumer?" not, "What will protect powerful industries?" nor, "What will generate the most revenues for the government?"

Unfortunately, when it comes to monopolies, the government has generally not proved itself competent or reliable in protecting the public interest.

EXTERNALITIES

Years ago when I was working on my PhD, my wife and I were living in a small apartment in a college town. I was studying a hundred hours a week and under a lot of stress. The one thing I really craved was a good night's sleep. Unfortunately, there were a lot of undergraduates in our neighborhood who were studying little, and partying a lot. Every Friday and Saturday, and many Sundays through Thursdays, our neighbors (the twelve guys living next door) made the most of their freedom, all night long. That meant lots of noise—and no sleep for me.

This problem was what economists call an "externality." Externalities are things that affect your well-being outside the realm of prices and free markets. A classic case—and obviously a more important one than my lack of sleep–is unabated pollution. A chemical company pours junk into a river without any law to stop it, destroying the river's life and beauty. Markets may not work to solve the problem, and it may be appropriate to pass a law saying the factory can't do that. Or in the case of my partying neighbors, many college towns have passed laws against having raucous keggers out on the porch between 10 p.m. and 6 a.m.

Externalities make markets fail, and that is why governments might legitimately pay attention to them. But government action is not the only way to solve externalities. The free market in many cases can solve this market failure even more efficiently. The economist Ronald Coase won a Nobel Prize in economics by showing that private bargaining works at least as well as government action to solve externality problems, if property rights are clearly defined.[11] So instead of a law saying a factory can't pollute the river, the law can assign the property rights over the river to the neighbors, who can then make their own decision–or even bargain with the factory owner so he has to pay them if he wants to pollute. This idea is known as the "Coase Theorem."

There are many cases in which the Coase Theorem has efficiently solved externality problems far better than government command-and-control. For example, few communities want a noisy airport in their midst. They often work simply to make all airport construction illegal, posing a huge problem in an era of expanding air travel. Some communities, however, have used their property rights to negotiate with airlines in reaching a win-win solution to price the noise of planes arriving and departing. They simply charge airlines more to land noisy planes at odd hours, and the landing fees go to the community. A noisy old DC9 arriving at midnight costs far more to land than a new 747 with a noise muffler arriving at noon.[12]

The Coase Theorem has informal implications as well. I grew up in a neighborhood where many people didn't take care of their property. The woman who lived across the street had grass so long it looked like a field of wheat. (Another family on the block was raising chickens in their living room, but at least we didn't have to look at that.) My parents thought about filing some sort of complaint, but they quickly figured out that our neighbor had the right to cut her grass or not, as she saw fit. So they solved the externality problem privately: They told my brother and me to cut her grass while she was at work, convincing us that maybe she'd be grateful and pay us later. (She didn't—and we were lucky she didn't call the cops on us for trespassing.)

Externalities can be positive, too. Beekeepers create a positive externality for farmers whose crops are pollinated by the bees. Similarly, I get a benefit for free—a positive externality—from living in a neighborhood today where the other families are decent and considerate and the kids are a good influence on mine. (Maybe they say the same about us, but I won't swear to that.)

A policy-relevant example of a positive externality is that of companies locating in a city or state and creating jobs. One of Texas's claims to fame is that it is home to sixty-four Fortune 500 companies, the most of any state.[13] Many of these companies, which moved to Texas from other parts of the country, were drawn by more than just good ol' Texas hospitality. The state offers a low-tax, low-litigation, low-union environment in return for the enormous positive externalities to the state that come from the 328,000 new jobs created between June 2009 and July 2011 (47 percent of all net job growth in the U.S. over that period).[14]

Like monopolies, externalities seem simple, until you dig in a little. Some are positive, and some are negative. Some can best be solved by the government, while others are best left alone. And as in the case of monopolies, the government has a poor record when it comes to dealing appropriately with this market failure.

Public Goods

When I was a kid, the local Catholic archbishop was a famous antiwar activist. One of his public gestures against the American military industrial complex was to refuse to pay part of his income taxes to protest the United States' continued involvement in the nuclear arms race.[15] He felt he should not have to pay for a part of the government that he did not value.

What would happen if everybody did that? Say the IRS Form 1040 were changed to let you pay whatever you thought the army and other services were worth to you. Would you pay $500? $1,000? To defend the nation at the current level, the average American would have to pay $2,462 for national defense.[16] Assuming most Americans wouldn't pay that, what would happen to the national defense? What would happen to everyone's safety?

Maybe you think the U.S. spends far too much on defense, so spending less would be just fine. If so, then apply the same reasoning to the police department or the roads system. Imagine if the government went house to house asking people for contributions to keep the bridges safe. Are you ready to try your luck on the Golden Gate Death Trap?

National defense, police, fire protection, and many other things are public goods. They are things we want and need, but which we can't practically exclude people from using if they don't pay.[17] For example, my archbishop refused to pay for the army, but he was still protected from foreign aggressors, just like the rest of us. In contrast, a "private good"–like a donut or a pencil–is excludable. If you don't pay for it, you can't have it.

Public goods can make markets fail, because private sellers will underprovide them when people refuse to pay. So the government doesn't fund them that way. Instead, it taxes citizens and pays for the public goods at a level that reflects public demand. It's a grand public bargain. We all recognize we want things like the police, but we don't trust ourselves or our neighbors to fund them voluntarily—so we all agree to pay, just as long as everybody else has to pay as well.

Of course, there's a dark side to this system: everyone has an opportunity to claim that his or her favorite hobbyhorse is a "public good" and needs public money. Public television? A public good, we're told—despite the lack of public demand—and thus in need of public money. Offensive art? Another public good, even if millions might say instead that it's a public *bad*. I might as well shove my way to the public trough and argue that this *book* is a public good, because America needs a strong defense of the free enterprise system, but people are simply not buying my book in sufficient quantities. Bail *me* out, Uncle Sugar!

In other words, the definition of a public good is clear, but the list of them is not. The concept is constantly abused, and government resources are wasted as a result.

Information Asymmetries

Imagine that shortly after moving to a new town, your refrigerator breaks down. Not knowing anyone in town, you randomly call a repair shop. Are you worried? Probably, if you, like me, know nothing about refrigerators. The repairman can tell you almost anything is wrong with your refrigerator ("Your D-57 hoses are all shot. I see it all the time on these models. It's gonna be about 400 bucks."), and you won't know if it is true or not. So all you can hope for is his honesty—or sufficient licensing and threat of sanctions from the government to dissuade him from cheating you.

This is a case of what economists call an "information asymmetry": where one side of a market has more information than the other and chooses to exploit the difference. In the example, the information asymmetry leads to worry and maybe an inconvenience. In the worse case, it can make markets melt down entirely. Economist George Akerlof won a Nobel Prize in economics for analyzing information asymmetries in a famous essay entitled, "The Market for 'Lemons.'"[18] He took the example of used cars, in which the dealer knows the lemons from the good cars, but buyers don't, and showed that the whole market can stop functioning as a result. On average, a car's price will be higher than a lemon is worth, but less than a good car is worth. Sellers thus have an incentive to increase the number of lemons (which turn a profit), while buyers are less and less able to afford a good car at a fair price. Slowly but surely, Akerlof showed, the lemons will dominate, and the market will dissolve.

Lemons can be people as well as cars, as every insurance company knows. One chronic information asymmetry problem is that the people who most want health insurance are those who are already sick. Insurance can't work this way because companies lose money on the sick and earn their profits on customers who *don't* get sick. If the sick are the majority buying the insurance, the rates will skyrocket, chasing away the healthy and wrecking the market.

Scandals and corruption on Wall Street are basically asymmetric information problems. A person or group trading with inside information means they know something the rest of the market doesn't. They trade on that and take profits at the expense of the uninformed.

The government can help in these situations. Policy makers can make it illegal to pass off a lemon as a good car by hiding problems. They can make it illegal for a person to tell a health insurance company that he's well when he is actually sick. They can require money-back guarantees or recourse to the attorney general when a product turns out to be defective. Similarly, the public sector can and should prohibit insider trading and many other financial market predations.

The government doesn't need to sort out all information asymmetries, however. In many cases, the private sector can do so instead. Money-back guarantees became commonplace in the retail sector in the 1960s, after high-quality companies realized that the guarantees would give them a competitive advantage by signaling to customers that they could be trusted. Car companies compete by offering better warranties than their competitors. Insurance companies require health exams before writing life insurance policies. (One hundred years ago, insurance companies were even more ingenious: Before elevators were common, health insurers would locate their offices on the upper floors of buildings and require prospective policy buyers to sign their policies at the office, in person. The idea was that if a prospective client could make it up all those stairs, he was probably healthy enough to be insured.)

Information asymmetries are a legitimate area of government involvement in the economy. But regulation is not the only—or sometimes, the best—way to solve the problem.

IN SUMMARY, there are four big sources of market failure. Sometimes markets fail; sometimes they don't. Sometimes governments fix market failure problems by intervening; sometimes they try and fail; sometimes they make things worse, by accident or on purpose. When should the government act?

To justify government intervention in a market, several things must be evident. A source of market failure must be clearly present. It must involve a monopoly, a negative externality, a public good, or asymmetric information. Many government policies fail at exactly this stage. For example, President Obama claims the housing crisis was due to an information asymmetry in the form of "mortgage lenders that tricked families into buying homes they couldn't afford."[19] But does anybody *not* know that prices of homes can both rise and fall? Or whether they can make a mortgage payment on their current wage? We all know that mortgage contracts are complicated, but is it really reasonable to blame lenders and markets, instead of a lack of common sense and personal responsibility?

What about the so-called monopolistic health insurance companies and the need to regulate the price of coverage? Insurance companies are not monopolies; they face fierce competition. If Aetna doesn't offer what consumers want, charges prices that are uncompetitively high, or has lousy service, another insurer will welcome their business. (That is, unless the government regulations have already wiped out the private markets, as has happened in some places.)

A favorite "public good" of President Obama is high-speed rail. It will supposedly revolutionize the transit system and benefit everyone but people won't pay for it privately—so it requires federal subsidies. Actually, people don't want to pay for it because it isn't particularly useful and thus is not a public good. The projects that the government plans to subsidize include a $715 million project to build a hundred miles of track between the small towns of Borden and Corcoran, California, and a "high-speed" train from Iowa City that will take longer to get to Chicago than the bus does today.[20]

Let's say there *is* a source of market failure, though. That isn't enough by itself. The market also has to be *failing* in practice. There are many, many cases in which there is a source of market failure but the market works just fine, because people solve the problems themselves, without any government action at all. I've already discussed a few private-sector mechanisms that solve market failures, such as private warranties. But even more obvious is that people avoid many market failures just by being decent.

Honest businesspeople want to prosper honestly, not by cheating consumers or using predatory business tactics, even if they could get away with these things. Decent people refrain all the time from creating burdensome externalities on others (that is why you listen to the Bee Gees in your car with the windows rolled up). And most Americans do their part to provide public goods privately when they give to charity.[21] Americans have a whole system for dealing privately with market failures so they don't have to rely so much on the government. It's called "social capital," the subject of the next section of this chapter.

Still, some market failures persist. Does this mean the government should definitely act? No, not unless the state can actually solve the problem, and solve it cost effectively.

Many market failures are irremediable by government at a reasonable price. The externality of traffic noise bothers me in my office while I'm trying to work. Can the government fix this? Not without measures in which the costs would dramatically outweigh the benefits.

The same goes for the tangled web of new economic regulations created over the past few years. Remember the Consumer Protection Act of 2010 (also known as "Dodd-Frank"), which weighed in at 848 pages of legislation intended to prevent market

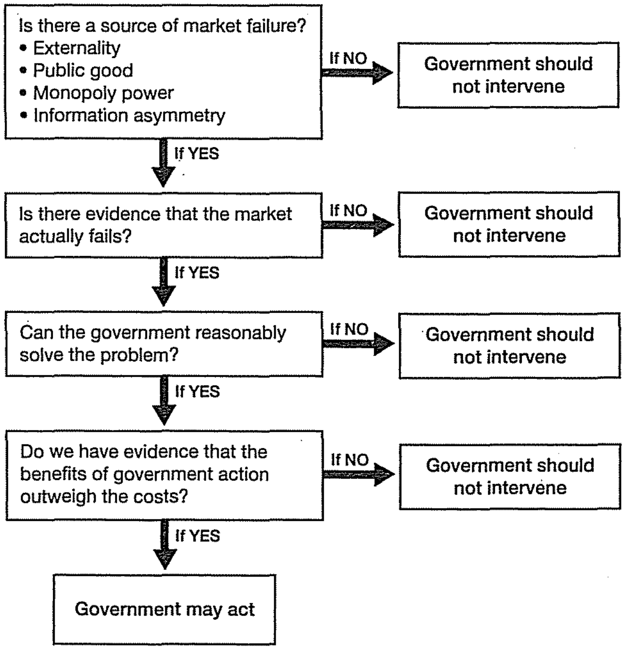

Figure 6.1. *Should the government intervene in the private market?*

failures like those that created the recent financial crisis? It was enacted ostensibly to sort out information asymmetries between informed financiers and the uninformed public. But it flunks the test of government intervention. According to the evidence so far, the law won't prevent another crisis and the regulations will cost more than they save.[22]

All together, these justifications set a high bar for government involvement in the private economy. Figure 6.1 shows the conditions that have to be met before government should act.

The point of Figure 6.1 is that a great deal of what the government does *sounds* sensible, but it is not. In providing a minimum safety net or addressing market failures, the government wastes resources or tries to do things it cannot achieve cost effectively.

Even worse, much government activity doesn't even try to solve market failures or provide a safety net. In the modern *adlibocracy*, what passes for governing philosophy is little more than a bromide such as, "The government should do nice things for people." Today, the government's spending binge is largely directed toward rewarding political friends (like public-sector unions), social engineering (see ObamaCare's mandates or the housing policies that led to the current crisis), and good old-fashioned pork (look almost anywhere in the economic stimulus spending).

In the end, much of government that purports to enhance people's lives actually makes things worse for citizens and keeps them sliding toward a system they don't want. And ultimately, it helps explain why eight in ten are dissatisfied with the democratically elected government.

IF THE GOVERNMENT does its job—which is to say, refrains from acting in most cases—many market failures will go unsolved by the public sector. Principled politicians will have to tell citizens that they know things aren't perfect, but it isn't prudent for the government to step in, because it can't solve the problem—at least not in a way that uses tax dollars cost effectively.

This does not mean people can't promote other solutions, though. A dangerous progressive fallacy is that if the government doesn't solve a market failure, it will always remain unsolved. Without publicly funded trains, for instance, transportation will be inadequate. Without stringent laws, honest people will become criminals. Without money for public broadcasting, people will have no access to high-quality radio, and so on. This is ridiculous.

To resolve many actual market failures, people don't need the government at all. They need well-functioning markets, of course.

But they also need voluntary action and a healthy culture in which people do things for each other without being forced or bribed by the state. People need what scholars call "social capital," which is the trust and social cohesiveness that promote voluntary activity to meet challenges in civil society.

Trust and cohesion in healthy neighborhoods and communities make life easier, more pleasant, less bureaucratic, and more efficient.[23] In high-trust societies, it is easier to conduct business and requires fewer resources in policing and the adjudication of disputes. There is less cheating, corruption, and crime. And where there are a lot of civic institutions, people help each other for mutual benefit.

More specifically, where social capital is plentiful, people are more likely to refrain from making excess noise or letting their property deteriorate (circumventing externalities). Many minor business deals between friends require nothing but a handshake, and people don't take advantage of each other (avoiding an information asymmetry problem). If a person sees something suspicious at a neighbor's house, he goes to check on it (a public good). In all these cases, individuals are better suited than governments to solve the market failure at hand, but they require a climate of trust and voluntary action.[24]

Social capital is what encourages someone to refrain from exploiting an information asymmetry by giving back the change if a cashier gives her too much. It induces her to give to charities that provide public goods for people she won't ever meet. It holds her back from creating externalities in traffic with obnoxious driving. Every day, social capital solves small and large market failures that government can't and shouldn't address.

It is easy to see how important social capital is to people's lives. Yet strangely, until recently there were few good measures of this important quality of life issue. In response to this, researchers at several universities and foundations around the United States undertook in 2000 to measure social capital with a survey. They asked tens of thousands of citizens about their levels of trust, charity, and community involvement. Dozens of American communities were represented, from rural areas to big cities.

The results were fairly predictable: In small communities where people know their neighbors, social capital is high. In big, anonymous cities, social capital is low. For example, on an index of social trust, big cities like Chicago, Boston, and Los Angeles are near the bottom with a score of 81. The two top communities are Bismarck, North Dakota (131) and rural South Dakota (150).[25]

How do people experience these differences in everyday life today? Try driving in Chicago after a few weeks in North Dakota, and compare how others treat you. Where are you more likely to get mugged–Irene, South Dakota, or downtown Los Angeles? And if you move into a new home in downtown Boston, your neighbors might not welcome you with a fresh-baked pie. In modern America, big cities are great if you want a good restaurant or to see the opera. They're lousy for social capital.[26]

IN THE 1830S, what impressed Alexis de Tocqueville most about America was the astonishingly high levels of social capital. Probably the most famous passage in Tocqueville's classic *Democracy in America* addresses this point:

> Americans of all ages, all conditions, and all dispositions constantly form associations. . . . The Americans make associations to give entertainments, to found seminaries, to build inns, to construct churches, to

> diffuse books, to send missionaries to the antipodes; in this manner they found hospitals, prisons, and schools. If it is proposed to inculcate some truth or to foster some feeling by the encouragement of a great example, they form a society. Wherever at the head of some new undertaking you see the government in France, or a man of rank in England, in the United States you will be sure to find an association.[27]

This was, in Tocqueville's mind, the secret to American success. In the eyes of a twenty-first-century social scientist, Tocqueville was simply observing the fact that social capital solved market failures that government couldn't address, given America's sparse population and ungovernable frontier. It would have been impossible to tax the population sufficiently to fund government hospitals and schools in, say, 1830s rural Nebraska. America was successful because a new nation of social entrepreneurs took these tasks upon themselves. In the process, they built strong communities of trust, reliant on themselves and not on the government. This is the legacy of freedom and limited government that Americans still say they love.

The links between social capital and America's success have been evident to social scientists for many years. In one study in the 1950s, the American political scientist Edward Banfield spent a year in a small, poor town in southern Italy.[28] His vivid observations formed the basis for his book *The Moral Basis of a Backward Society*, in which he laid out the evidence that the town was impoverished because the people did not recognize or reward meritorious behavior, had little sense of fair play, and no sense of charity toward one another.[29] He noted, for instance, that the local orphanage in the town was run by nuns in a crumbling medieval monastery. No one in the town gave a lira for its support, and not even unemployed stone masons volunteered to help in its upkeep–even though all the orphans came from the town itself.

Banfield forcefully made his point by comparing the Italian town with a comparably sized–but prosperous–little town in Utah. On one random day, the local newspaper in the Utah town contained mentions of dozens of voluntary charitable projects and activities. The local church had just raised $1,393.11 in pennies for a children's hospital 350 miles away; there was a Red Cross membership drive going on; a circus was being held to raise money for a new dormitory at the local junior college; there were meetings all over town of the Parent Teacher Association (PTA).

There are many market failures that social capital cannot solve–either that the government can and should address (for example, the public good of military power) or that may simply go unsolved (such as externalities from differences in religious practices). But social capital is an important component of a healthy nation.

Unfortunately, some experts believe social capital is generally in decline in America. Harvard political scientist Robert Putnam wrote a bestselling book in 2000 entitled *Bowling Alone*, in which he argued that people's trust in each other and tendency to participate voluntarily in their communities has plummeted in recent decades. Not all experts agree, but clearly Putnam's claim resonates with millions of Americans who have seen evidence around them of eroding social networks and falling trust in their communities.

Quite reasonably, Putnam laid the blame for falling social capital on phenomena such as television and urbanization. But there is more to it. The rise of statism described in the last chapter is also a key reason for the slide away from the self-governing ideals that Tocqueville found so striking. The voluntary sector falls as the public sector grows and takes over more functions in people's lives. More of life is identified as a competency of the government, and thus not the responsibility of individuals.

This is not just conjecture, but demonstrable truth. In dozens of studies, economists have shown that government funding "crowds out" voluntary contributions of both money and time to charities.[30] This stands to reason. If the government is supporting something, people don't "need" to. Furthermore, people will be less likely to ask for help: One major research finding is that non-profits quickly conform to government support and spend less time and effort fund-raising.[31]

This pattern is not innocuous when it comes to a flourishing nation. Government insinuates itself into more and more corners of people's lives, alienating them from each other and their communities. It obviates what philosopher Edmund Burke called the "little platoons" of ordinary life, which create meaning in a way the government never can or will. That is the conclusion of a great deal of research.[32] It is also the essence of an entire philosophical and religious principle called *subsidiarity*, which teaches that in order to help people thrive, matters ought to be handled by the smallest, lowest, or least centralized authority.[33] If the family can solve the problem, don't call on the city. If the city can solve it, don't call on the state. And so on.

In other words, if people are to flourish, they need incentives and the ability to help each other voluntarily. In many cases, this amounts to keeping the government out, even if things aren't perfect.

I AM CLEARLY MAKING A CASE for government that is far more circumscribed than the government in America today. A state that restricts itself to minimum basic standards for the poor, and sorting out market failures cost effectively, is in stark contrast to today's exploding public sector. The sculpture is much smaller than the block that currently contains it.

In this chapter, I have tried to explain *what* I believe the government should and shouldn't do. And we already know the *why*: to allow free enterprise's moral promises to help the greatest number of people flourish. Still, we need to get down to specifics and identify the actual policies Americans care most about and the ways in which we can make them into an expression of our values. That is our task for the next chapter.