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## **Capitalism, Scandal, and the Government**

**by Richard M. Ebeling**

Every few years voices are heard heralding and warning of a “crisis of capitalism.” The 20th century saw an unending series of such voices of doom that the free market had shown its injustice towards and exploitation of the ordinary working man or that free enterprise fostered ‘merchants of death’ who dragged innocent people into wars for purposes of earning armaments profits.

In the 1930s the claim was made that massive unemployment, idle factories, and the productive potential for plenty in the midst of wide poverty demonstrated that capitalism had “failed” mankind. In the 1950s and 1960s the charge was made that capitalism created a wasteful ‘affluent society’ that lulled people into a false sense of security and happiness by supplying a horn of superfluous plenty.

Also, beginning in the 1960s and 1970s, the accusation began to be made that capitalism was destroying the planet through disregard for the environment and wildlife because of the supposed perverse incentives under private property that led men never to think about tomorrow. In the 1980s the indictment against capitalism was that it produced a society of greed and selfishness that dehumanized man and human relationships.

The 1990s saw the claim that capitalism generated “irrational exuberance” and a crass materialism. In addition, it was said that globalization was enslaving the world to a handful of capitalist corporations searching the planet for profits with no loyalty to nations or the well-being of those they employed and exploited in poor Third World countries.

Now, in the light of high-profile accounting frauds and misrepresentations by a number of large corporate enterprises, it is said that “the proof is in.” Unregulated, free-market capitalism is both unethical and harmful to the financial future of millions who naively trusted in the free-enterprise “dream” of wealth and security without government safety nets and compulsory standards for business conduct.

Indeed, on the opinion page of the New York Times on July 21, 2002, Alan Blinder, a professor of economics at Princeton University, a former vice chairman of the Federal Reserve and author of a widely used textbook on the principles of economics, even argued that it was the private sector that wanted more regulation against the uncertain and unstable currents of unhampered capitalism.

Blinder asked,

“Can it be true that financial markets want the government to regulate them more? Paradoxically, the answer is yes. The markets have long been ambivalent toward government. When things go well, they want to be left alone. But when things start to fall apart, they want Washington’s help.... While changes in private-sector behavior will eventually fix many of today’s accounting and corporate governance problems, the markets are clamoring for decisive government actions now.”

Now it is not surprising to find some private-sector interests, when “hard times” fall upon them, attempting to obtain government assistance, support, and protection in the face of losses that they may be suffering or falling market share.

The profits they earn seem natural enough and rightfully theirs. But when profits turn to losses and falling revenues threaten bankruptcy, the cause is too frequently seen as some “unnatural” or “abnormal” event that falls “unfairly” on them and for which government — at the tax-payer’s and consuming public’s expense — should provide them a financial cushion.

But what policy advocates like Blinder have in mind is that free markets are inherently open to abuse and dishonesty that require the protecting hand of government to keep the economic system on an even keel. Without regulation, scandals and financial catastrophes are inevitable. Indeed, two days later on the New York Times opinion page, Lester C. Thurow, professor at the Sloan School of Management at MIT, said,

“The Enrons, WorldComs and Tycos are not abnormalities in a ‘basically sound system.’ Scandals are endemic to capitalism. The best any government can do is contain the damage, and the best any individual investor can do is get out of harm’s way.”

In Thurow’s view, it is “naive” to think that it is possible “to alter this culture” of the market economy.

## **Freedom and self-interest**

Since the beginning of time men have been motivated by “greed,” “selfishness,” and “egoistic” desire for “more” of the material objects of the world that serve their comforts and pleasures. After all, for each of us the world revolves around ourselves — we walk around in our individual bodies, around which everything else has its place and position; we look at the world through our respective individual pair of eyes, scanning the horizon, and we think about and act upon the world on the basis of our respective individual mental processes.

Even when we try our best to mentally put ourselves in another person’s situation to understand the world as he sees it, we do it from our own position in time and space, in the context of our own experiences. We cannot escape being distinct egos. And we cannot escape wanting to improve our circumstances as we see them.

Even when we sincerely care about and are concerned about the situations in which others find themselves, our motivation in wanting to do something to, say, alleviate their suffering or misfortune is the fact that it causes us mental and emotional discomfort and is the stimulus for trying to help our fellow man.

Thus, even altruism — placing a priority on improving the conditions of others before all of our own personal and immediate wants and desires have been fully satisfied — can be seen to be selfish.

Through the ages, many people have given little thought to how their conduct and the fulfillment of their own desires may have negative impacts and effects on others. Slavery was the essence of such an attitude, under which other human beings were made the mere tool of the slaveowner's purposes. Before the introduction of slavery, you merely killed the members of the other tribe or clan, whose possessions and women you wanted for yourself. Thus, the motive to not kill the defeated foe was an egoistic act — why kill someone when I can use force or its threat to get him to do work that otherwise I would have to do for myself?

The great benefit and advancement of the classical-liberal and free-market ideal that began to formally emerge and start to have a significant impact on Western society in the 18th and 19th centuries was that it undermined the conception of the master/slave relationship.

Every man was recognized, in principle, as a self-owning, conscious being who was not to be merely the means to another's end. Each man was respected as an end in himself, an independent and free person, and not an object arbitrarily to be controlled and used.

And as Adam Smith argued eloquently in *The Wealth of Nations*, now each individual's self-interest could be advanced only by taking into consideration the interests of others.

The combination of voluntary exchange and a social system of division of labor meant that each individual could obtain the multitude of things he desired that were in the possession of others only by specializing in the production and sale of something that many of those others would be willing to take in trade for what he wanted from them.

This ideal of free association among men needed to be embodied in the political practice of the rule of law. Each human being was to have the same individual rights and equal treatment in the protection of those rights before the law.

### **Morality, ethics, and the law**

Of course, the essence of this classical-liberal ideal is a lot older than the 18th century. It is the restatement in the political realm of an older set of rules: you will not kill; you will not steal; you will not bear false witness (lie, deceive, defraud); and you will not covet other men's goods (be envious or malicious).

The early free-market economists understood the dangers from theft and fraud and considered that the prevention and punishment of such conduct were to be among those limited though essential functions of government in the free society.

But they also believed that the market itself created self-interested motives to refrain from such conduct. For example, Adam Smith once observed,

“When commerce is introduced into any country, probity and punctuality always accompany it... It is ... reducible to self-interest, that general principle which regulates the actions of every man,

and which leads men to act in a certain manner from views of advantage.... A dealer is afraid of losing his character, and is scrupulous in observing every engagement. When a person makes perhaps twenty contracts a day, he cannot gain so much by endeavoring to impose on his neighbors as the very appearance of a cheat would make him lose.... [A] prudent dealer, who is sensible of his real interest, would choose to lose what he has a right to, than give any ground for suspicion.”

When men deal with each other on a daily and regular basis, they soon learn that their own well-being requires of them a sensitivity for those with whom they trade. Losing the confidence or trust of one's trading partners through even the appearance of fraud can result in significant social and economic injury to oneself. The role of law was to support and sustain these rules of honesty in commerce.

### **The market and regulations**

But the market was considered a wiser and more trustworthy defender and punisher on a regular basis. In the financial crisis of 2002, even before legal prosecutions of those accused of fraud and corrupt management in large corporations, the market had meted out its own punishment and correction.

Stock values had fallen, bankruptcies had had to be filed, senior management had been removed from positions of authority, and the market reputations of internationally renowned accounting firms had been destroyed.

Now when the market has shown where the problems exist and pointed the finger at the likely guilty parties, the legal system can go about its work to determine violations of the law, in terms of violating individuals' contractual rights or deliberately disseminating misinformation.

In other words, the market has been working. It sent out danger signs, warning signals, and market reactions to the malfeasance as soon as a problem was discovered by those negatively affected by the deeds.

But couldn't there have been ways to unearth the problems earlier to limit the damage and warn interested and harmed parties sooner than turned out to be the case? Isn't the market suffering from the lack of an "early warning system"? Couldn't stricter laws and more detailed government regulations serve this need in the future?

The counterargument can be made that it has been regulations that were instituted earlier that prevented a quicker market response. For example, Henry Manne, dean and professor emeritus of the George Mason University Law School, pointed out on the editorial page of the Wall Street Journal on June 26, 2002, that regulatory restrictions were put into place years ago in the belief that more competent hands could "fix the problems" and return an enterprise to a more profitable path. Laws were enacted against hostile takeovers and hobbled one of the market's methods for astute market analysts and investors to act early to remove incompetent managers by offering to buy out companies against the wishes of the existing executive power structure.

And in 1966, Henry Manne argued in *Insider Trading and the Stock Market* that regulatory restrictions against various forms of insider trading, which were not prohibited by contractual

agreement within companies themselves, delayed information about changing market conditions from being made known to the wider public through movements in stock values.

As individuals in or close to the corporations employing illegal or “creative” bookkeeping methods to maintain a false impression of profitability became aware of what was going on, they would soon take advantage of what they were discovering or suspecting before most others in the general market to start “bailing out.” This would have started sending out warning signs and signals to the public concerning potential corporate malfeasance a lot sooner than was the case.

### **The role of the government**

It’s also useful to keep in mind that this latest crisis on the financial markets is the result of the government’s monetary policies during the last decade. The events of the late 1990s had a close similarity to those of the late 1920s. Both were long periods of technological advancement and significantly greater output of goods and services produced at much lower costs of production because of improvements in productivity.

Yet in spite of the large increases in supply, prices for these goods did not generally decrease. In general they remained stable or rose slightly.

The reason for this, in both the 1920s and 1990s, was that the Federal Reserve System undertook aggressive monetary expansions that counteracted the potential decline in prices due to greater output.

But the problem, again in both periods, was that the only way the Fed can pump money into the economy is by expanding bank reserves used for lending purposes. That resulted in an artificial downward pressure on the rate of interest — the price of borrowing funds for various investment activities. Investment projects were stimulated and funded that were partly inconsistent and out of balance both with the available real savings in the economy to sustain them and with the actual demand for what those investments would be bringing to market.

Just as in 1929, in 2000 the Fed began to rein in the money supply for fear of worsening price inflation. With the money supply no longer “feeding” the investment boom the earlier monetary expansion had induced, the financial house of cards began to crumble.

The stock-market decline of the last two years has been one of the clearest manifestations of the price of monetary mismanagement on a massive scale.

The high-tech and communication industries were at the cutting edge of this massive malinvestment caused by the Federal Reserve’s monetary policy. Seeing all hope gone for the profits that either had never been there or that were beginning to evaporate in the postboom climate, some of the executives in these corporations made the decision to try to deny reality.

If only the books could be “massaged” to make some expenses seem like revenues for a while. Then, maybe, the financial storm will subside by the time it was clear that those revenues did not exist. Maybe the whole thing could be papered over with new revenues once the economy picked up and recovered enough in a few reporting quarters in the future.

The biggest cover-up in this entire financial crisis is, of course, the government's own responsibility for what has happened. Are members of the Federal Reserve board of governors being indicted for reckless mismanagement of the monetary system?

Are the regulatory agencies that make adjustment to changed market conditions more difficult being placed under scrutiny and threatened with being abolished?

Are the politicians who play on fear and ignorance among the voting public to distort the causes and cures for the present situation for their own political ends being accused of misrepresentation and fraud?

No, instead the "usual suspects" are rounded up to be charged with a "crime": "greed," "selfishness," the "profit motive," "business" and "capitalism" in general.

Once again the market economy is accused for much that has its origin in government control and regulatory power. Those who commit fraud and break contractual obligations should, certainly, be made to pay for their misconduct.

But the worst fraud is in the government itself, and as usual government not only will get off for its misdeeds but will claim that it is the champion of justice, honesty, and truth.

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