1

MIND OVER MATERIALISM

> The United States must overcome the materialist fallacy: the illusion that resources and capital are essentially things, which can run out, rather than products of human will and imagination which in freedom are inexhaustible. This fallacy is one of the oldest of economic delusions, from the period of empire when men believed that wealth was land, to the period of mercantilism when they fantasized that it was gold, to the contemporary period when they suppose it is oil; and our citizens clutch at real estate and gold as well. But economists make an only slightly lesser error when they add up capital in quantities and assume that wealth consists mainly in machines and factories. Throughout history, from Venice to Hong Kong, the fastest growing countries have been the lands best endowed not with things but with free minds and private rights to property. Two of the most thriving of the world's economies lost nearly all their material capital during World War II and surged back by emancipating entrepreneurs. The materialist vision, by contrast, leads merely to newer versions of the fate of Midas.
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> —*George Gilder, Wealth and Poverty, 1981*

There is no such thing as a natural resource, except for the mind of man. For centuries, economists have been exposing the "physical fallacy"—that is, the belief that wealth resides in tangible things, such as gold, land, raw materials, and so forth—and it seems as if we still do not understand this basic economic concept. We seem to think that *matter* is more important than *minds*, while in fact it is the exact opposite. Natural resource endowment cannot explain why Israel has a per capita gross domestic product of $17,220 compared to Saudi Arabia's $8,870. Taiwan, Hong Kong, and Singapore have no "natural resources," and yet they all have a higher standard of living than Russia and Indonesia, both rich in natural resources.

Even the conventional wisdom recited by every realtor—location, location, location—does not explain how it came to be that the 27,400 acres of Florida swampland purchased by Walt Disney in 1964, at an average price of $182 per acre, are now worth over $2 million per acre. No doubt no more land is being created, yet scarcity does not explain wealth. If it did, your children's drawings on your refrigerator would be worth at least a few months of mortgage payments.

Adam Smith (see Exhibit 1.1) brought this profound insight into his seminal book *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). He wanted to explain why some countries were wealthy, not why most countries were poor (notice the title wasn't *An Inquiry into the Nature and Causes of the Poverty of Nations*). Poverty needs no explanation, nor do we learn much from studying it, since it is the natural condition of man since he emerged from the cave. What would we do once we discovered the *root causes* of poverty? Create more of it? What needs to be explained is *wealth*, not poverty. Indeed, wealth is the only known antidote to poverty.

Smith exposed the mercantile system fallacy, commonly accepted from 1500 to 1750, that wealth consisted of money, gold, silver, and other physical representations of capital. Although mercantilism wasn't a unified economic theory of growth, it did hold sway over government officials and merchants, who were its leading advocates. The word itself comes from the Latin word *mercare*, which means "to run a trade." Not only did the mercantilists see hoarding bullion as the road to wealth, they also believed the global volume of trade is fixed. Hence, all trade becomes a zero-sum proposition—a gain in one country is a loss in the other. This led the mercantilists to believe another road to wealth was a positive balance of trade, whereby the exports of a country always exceed its imports overall. To achieve this surplus, a country was wise to impose tariffs on imports, or other protectionist policies to protect its domestic industries, in order to subsidize exports and discourage imports. The advent of double-entry bookkeeping assisted governments with accounting for this inflow and outflow of goods and services, an obsession that continues to this day.

No less a leader than Mohandas Gandhi subscribed to these views, symbolized by his proposed Indian flag with a 24-spoked blue *chakra* (wheel) in the center, representing economic self-sufficiency. Gandhi was certainly an inspiring leader, but he was a dreadful economist. The jack-of-all trades would lead a poor, nasty, brutal, and short life. Not only would he remain impecunious by attempting complete economic self-sufficiency—what economists call *autarky*—so would an entire country.

Adam Smith's work was largely a refutation of these suppositions, while also establishing a framework for how an economy creates wealth. In the introduction to his *Wealth of Nations*, Smith puts forth his definition of the real wealth in an economy:

> The annual labour of every nation is the fund which originally supplies it with all the necessaries and conveniences of life which it annually consumes, and which consist always either in the immediate produce of that labour, or in what is purchased with that produce from other nations (Smith 1998: xv).

In effect, the welfare of a nation depended on its output of production, and production itself is dependent on the specialization and division of labor. Smith intuitively understood that man was the only creature possessing the capacity to produce more of a good or service than he himself could consume to satisfy his own needs. After producing a surplus, he would then follow "a certain propensity in human nature to truck, barter, and exchange one thing for another," a trait "common to all men." This is one of

Exhibit 1.1 The gravesite of Adam Smith (1723–1790), Edinburgh, Scotland. "I Love Your Company, Gentlemen, but I Believe I Must Leave You to Go to Another World" (Smith's Last Words to his Friends).

Source: Photo by Paul O'Byrne

many characteristics distinguishing humans from animals, since "Nobody ever saw a dog make as fair and deliberate exchange of one bone for another with another dog" (Cohen 2001: 21).

Smith demonstrated how his ideas of specialization and division of labor created these surpluses available for exchange. Specialization of labor is the idea of people or nations producing a narrower range of goods and services than they consume, which is why modern economies are dependent on a far wider range of people to provide for their daily sustenance. The division of labor breaks down a production process into many small steps and performs those steps separately, with different workers doing different tasks, as on an assembly line. In Smith's view, while specialization makes us productive, division of labor is what makes us rich. He illustrated these principles with his famous example of the operation of a pin factory:

> One man draws out the wire, another straightens it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on is a peculiar business; to whiten it is another; it is even a trade by itself to put them into paper. . . . I have seen a small manufactory of this kind where ten men only were employed and where some of them performed two or three distinct operations. But though they were very poor, and therefore but indifferently accommodated with the necessary machinery, they could, when they exerted themselves, make among them about twelve pounds of pins a day. There are in a pound upwards of four thousand pins of a middling size. Those ten persons, therefore, could make among them upwards of forty-eight thousand pins in a day.. . .But if they had all wrought separately and independently. . .they certainly could not each of them make twenty. . .perhaps not one pin a day (Dougherty 2002: 53).

Similar to Smith's tour of the pin factory, Henry Ford had a similar epiphany when touring a Chicago meatpacking plant, where he saw animal carcasses hung on an overhead rail being moved from butcher to butcher. When Ford inquired how long they had been processing meat like this, the reply was something to the effect that, "This is how we have done it for years." A tradition in one industry became a quantum revolution in another.

Smith also refuted the mercantilist idea of bullion being the true wealth of nations, writing:

> To attempt to increase the wealth of any country, either by introducing or by detaining in it an unnecessary quantity of gold and silver, is as absurd as it would be to attempt to increase the good

> cheer of private families, by obliging them to keep an unnecessary number of kitchen utensils (O'Rourke 2007: 205).

Money is not wealth per se, it is merely how members of a society move it around. Money simply facilitates transactions, eliminating the need for a "double coincidence of wants" necessary in a barter economy. With money, a doctor doesn't have to spend time searching for a hairstylist that needs medical services at the same time she needs a haircut.

Real wealth is represented by the goods and services money can buy. If it were otherwise, any country could achieve wealth simply by printing more pieces of paper money. Hoarding precious metals is not a substitute for real wealth in an economy; otherwise, India, which had the world's largest supply of gold in 2003, would be one of the richest nations; yet it is actually one of the poorest. Perhaps this is better understood if we think of Nathan Mayer Rothschild, one of the founders of the international Rothschild banking dynasty, probably the richest man in the world at the time of his premature death in 1836 at the age of 58 from an infected abscess. Despite having the best medical care money could buy, he didn't have access to antibiotics that today could be purchased from any pharmacy for a few dollars. Would you rather have Bill Gates's income in today's world—with its abundance of goods and services—or during the time of Rothschild? Another way of articulating this is that the wealth of nations resides in consumer well-being, not profits.

DO TRADE DEFICITS DIMINISH WEALTH?

What happens when one country's imports consistently exceed its exports, creating a deficit in the international balance of trade? There is probably no greater misunderstanding about the real nature of wealth than when a discussion turns to the balance-of-trade question. Henry Hazlitt, author of *Economics in One Lesson* explained this phenomenon when he wrote: "... the same people who can be clearheaded and sensible when the subject is one of domestic trade can be incredibly emotional and muddleheaded when it becomes one of foreign trade" (Hazlitt 1979: 86–87).

I recently taught an economics course to a group of learned certified public accountants, and this one topic was the most contentious. Most everyone seemed to have an inordinate fear of China, India, and other foreign nations accumulating more and more of America's debt. I asked the group a simple question: If China and India become wealthier, is that a threat to America? The general consensus seemed to be yes, illustrating how zero-sum thinking is endemic to this discussion. Adam Smith eloquently wrote about this in 1776:

> Each nation has been made to look with an invidious eye upon the prosperity of all the nations with which it trades, and to consider their gain as its own loss. Commerce, which ought naturally to be, among nations, as among individuals, a bond of union and friendship, has become the most fertile source of discord and animosity (O'Rourke 2007: 108).

One of the reasons the United States of America is such a relatively wealthy country is that it maintains a free trade zone among its 50 states. The Constitution prohibits the states from interfering with trade among their respective citizens; there are no tariffs or import, export, or other restrictions within the 50 states. No individual state worries if it is running a deficit with another. Economist Russell Roberts posed this challenging question in his delightful academic novel, *The Choice: A Fable of Free Trade and Protectionism*:

> Shouldn't Florida help out Minnesota by importing just as many oranges from Minnesota as Minnesota imports from Florida? Trade flows should be unequal. . . . if you pick any one state in the United States and look at its trade position with respect to other states, you'd see a lot of deficits and surpluses (Roberts 2001: 67).

Trade deficits and surpluses are merely accounting conventions with no explanatory relationship to the underlying reality of an economy, which is why accountants and economists have different worldviews. If a free trade zone works internally for the United States, why would it not work internationally among the countries of the world?

It helps to keep in mind that *countries* do not trade, *people* do. In any transaction, as Adam Smith pointed out, both parties must gain for it to take place at all—the antithesis to a zero-sum condition. You buy a Lexus only because you perceive it as being of higher value than the price you are paying. The government, for all practical purposes, has nothing to do with it. As individuals, we run trade surpluses and deficits all the time. I run a deficit with my local grocery store, importing more from them than I sell to them. You run a large surplus with your employer, who pays you more than you buy in products or services from them in return. So what? The resulting accounting deficits and surpluses simply do not reflect the economic reality behind these billions and billions of individual transactions around the world. This is what Adam Smith meant when he wrote, "Nothing can be more absurd than this whole doctrine of the balance of trade."

The gains from trade are what we import, not export. The purpose of production, in the final analysis, is consumption. The more imports we can acquire for fewer exports, the wealthier we are, either as individuals or as a country. Other countries face the same realities, and we are no more likely to obtain the goods and services we desire by trading pieces of green paper with other nations than we are to send letters to the North Pole and get gifts from Santa Claus. Being a creditor or debtor nation simply has no correlation with a country's standard of living. Thomas Sowell exposes this fallacious concept in *Basic Economics*:

> In general, international deficits and surpluses have had virtually no correlation with the performance of most nations' economies.

> Germany and France have had international trade surpluses while their unemployment rates were in double digits. Japan's postwar rise to economic prominence on the world stage included years when it ran deficits, as well as years when it ran surpluses. The United States was the biggest debtor nation in the world during its rise to industrial supremacy, became a creditor as a result of lending money to its European allies during the First World War, and has been both a debtor and a creditor at various times since. Through it all, the American standard of living has remained the highest in the world, unaffected by whether it was a creditor or a debtor nation (Sowell 2000: 288).

No one revealed the specious reasoning behind balance-of-trade concerns better than the French economist, statesman, and author Frédéric Bastiat (1801–1850), whom the Austrian economist Joseph Schumpeter said was "the most brilliant economic journalist who ever lived." Bastiat used entertaining fables and carried the logic of the proponents of protectionism to their logical extreme, with biting wit. One of his most famous essays, "Petition of the Candlemakers," was a parody letter from the manufacturers of "candles, tapers, lanterns... and generally of everything connected with lighting," arguing against the unfair competition—since its price was zero—of the sun.

Bastiat understood that exports were merely the price we pay for imports, and having to work harder to pay for those imports did not lead to wealth. Using impeccable logic, Bastiat wondered if exports are good and imports are bad, would the best outcome be for the ships carrying goods between countries to sink at sea, hence creating exports with no imports?

In another of his famous parodies, "The Right Hand and the Left (a Report to the King)," he made this obvious in a most satirical and effective manner. It is such an important point, since it also debunks another famous economist's theory of value, it is worth quoting from at some length (see Sidebar).

Sire,

When we see the advocates of free trade boldly disseminating their doctrine, and maintaining that the right to buy and to sell is included in the right to own property. . ., we may quite properly feel serious concern about the fate of our domestic industry; for to what use will the French people put their hands and their minds when they live under a system of free trade?

The government that you have honored with your confidence has been obliged to concern itself with so grave a situation, and has sought in its wisdom to discover a means of protection that might be substituted for the present one, which seems endangered. They propose *that you forbid your loyal subjects to use their right hands*.

Sire, do not do us the injustice of thinking that we have lightly adopted a measure that at first sight may seem bizarre. Deep study of *the protectionist system* has revealed to us this syllogism, upon which the whole of it is based:

The more one works, the richer one is.

The more difficulties one has to overcome, the more one works.

Ergo, the more difficulties one has to overcome, the richer one is.

What, in fact, is *protection*, if not an ingenious application of this line of reasoning, so cogent and conclusive that it must resist even the subtlety of M. Billault himself?

Let us personify the country and view it as a collective being with thirty million mouths and, as a natural consequence, sixty million hands. It makes a clock that it intends to exchange in Belgium for ten quintals of iron.

But we tell it: ''Make the iron yourself.''

''I cannot,'' it replies; ''it would take too long. I could not make more than five quintals in the time that I can make one clock.''

''Utopian dreamer!'' we reply; ''that is precisely the reason why we are forbidding you to make the clock and ordering you to make the iron. Do you not see that we are providing employment for you?''

Sire, it could not have escaped your discernment that this is exactly the same as if we were to say to the country: *Work with your left hand, and not with your right*.

The old system of *restriction* was based on the idea of creating obstacles in order to multiply job opportunities. The new system of *restriction* that we are proposing to take its place is based on exactly the same idea. Sire, to make laws in this fashion is not to innovate; it is to carry on in the traditional way.

As for the efficacy of the measure, it is incontestable. It is difficult, much more difficult than people think, to do with the left hand what one is accustomed to doing with the right. You will be convinced of this, Sire, if you will deign to put our system to the test in performing some act that is familiar to you, such as, for instance, that of shuffling cards. We can, therefore, flatter ourselves on opening to labor an unlimited number of job opportunities.

Once the workers in every branch of industry are restricted to the use of their left hands alone, imagine, Sire, the immense number of people that will be needed to meet the present demand for consumers' goods, assuming that it remains constant, as we always do when we compare different systems of production. So prodigious a demand for manual labor cannot fail to bring about a considerable rise in wages, and pauperism will disappear from the country as if by magic.

But as soon as your new law is promulgated, as soon as all right hands are either cut off or tied down, things will change. Twenty times, thirty times as many embroiderers, pressers and ironers, seamstresses, dressmakers and shirtmakers, will not suffice to meet the national demand (shame to him who thinks ill of it), always assuming, as before, that it remains constant.

It is true that this assumption may be disputed by dispassionate theorists; for dresses will cost more, and so will shirts. The same could be said of the iron that we extract from our mines, as compared with what we could obtain *in exchange for the produce of our vineyards*. Hence, this argument is no more acceptable against *left-handedness* than against *protectionism*; for this high cost is itself at once the result and the sign of the superabundance of effort and labor that is precisely the basis on which, in the one case as in the other, we maintain that the prosperity of the working class is founded.

Yes, we may picture a touching scene of prosperity in the dressmaking business. Such bustling about! Such activity! Such animation! Each dress will busy a hundred fingers instead of ten. No young woman will any longer be idle, and we have no need, Sire, to indicate to your perspicacity the moral consequences of this great revolution. Not only will more young women be employed, but each of them will earn more, for all of them together will be unable to satisfy the demand; and if competition reappears, it will no longer be among the workers who make the dresses but among the fine ladies who wear them.

You see, Sire, our proposal is not only in accord with the economic traditions of the government, but is essentially moral and democratic as well.

In order to appreciate its consequences, let us assume that it has been put into effect, and, transporting ourselves in imagination into the future, let us imagine that the system has been in operation for twenty years. Idleness has been banished from the country; steady employment has brought affluence, harmony, contentment, and morality to every household; poverty and prostitution are things of the past. The left hand being very clumsy to work with, jobs are superabundant, and the pay is satisfactory. Everything has been organized on this basis; consequently, the workshops are thronged. Is it not true, Sire, that if at such a time utopian dreamers were suddenly to appear, demanding freedom for the right hand, they would throw the country into a panic? Is it not true that this supposed reform would upset everyone's life? Hence, our system must be good, since it cannot be destroyed without causing suffering.

Nevertheless, we do not intend to conceal from Your Majesty that there is one respect in which our project is vulnerable. We may be told that in twenty years all left hands will be as skillful as right hands are now, and it will then no longer be possible to count on *left-handedness* to increase the number of jobs in the country.

Our reply to this is that, according to learned doctors, the left side of the human body has a natural weakness that is completely reassuring for the future of labor.

If, then, Your Majesty consents to sign the decree, a great principle will be established: *All wealth stems from the intensity of labor*. It will be easy for us to extend and vary its applications. We shall ordain, for example, that it shall no longer be permissible to work except with the foot. This is no more impossible (as we have seen) than to extract iron from the mud of the Seine. Men have even been known to write without using either hands or feet. You see, Sire, that we shall not be lacking in means of increasing the number of job opportunities in your realm. As a last resort, we should take recourse to the limitless possibilities of amputation.

Finally, Sire, if this report were not intended for publication, we should call your attention to the great influence that all measures of the kind we are proposing to you are likely to confer upon men in power. But this is a matter that we prefer to reserve for a private audience.

Bastiat 1996: 258–265.

Bastiat passed away two years after one of the most famous economists would write a slim volume—*The Communist Manifesto*—that would have an enormous impact on world events far into the future. This economist also posited his own theory of value and how wealth is created, and since it is still misunderstood to this day—much like materialism in Adam Smith's day—we will focus on his legacy next.