Chapter 1

Principles of Prosperity

Our Economy: The Sum of Many Voluntary Transactions

On my way to the office each morning, I stop to buy a cup of coffee. The coffee costs me $1.49. I buy it for one reason: The cup of coffee is worth more to me than the $1.49 in my pocket. If this were not the case, I'd keep the $1.49 and forgo the coffee. The owner of the coffee shop has the opposite view. To him, the $1.49 is worth more than the cup of coffee, so he sells me the cup. The two of us have exactly opposite views regarding the value of the cup of coffee and therein lies the opportunity for our mutual gain from a single transaction. I gain the coffee that I value more, he gains the cash that he values more, and, most importantly, we are both better off for having made the trade.

This example may seem too ordinary to be noteworthy. In fact, it is exemplary of the most important principle of economics. That is, both parties to any voluntary exchange gain from the transaction. That is why they enter into it. No one is able to determine the value of a transaction better than the people engaged in it. No one knows better than I do how much I value the cup of coffee I buy each morning. No one knows better than the coffee shop owner how much he values producing and selling that cup of coffee in the morning. We each know our own self interest better than anyone else possibly could.

Thus, in a free society in which transactions are honest, purely voluntary, and absent fraud, every transaction is an economically good one[1]—benefiting both parties to it. Buying or selling a cup of coffee, a sweater, a stock, a movie ticket, or a life insurance policy; renting a car or a vacation home; or placing a deposit with a bank—every voluntary transaction between people, businesses, or any combination thereof, is an economically good transaction in that it benefits all parties involved. Otherwise they would choose not to be a party to it.

The economy is nothing more than the sum total of all of these transactions. The more economic activity, the larger the economy, and the more people improve their lives. The most important and constructive thing the government can do in the economic realm is to ensure that people are free to engage in these mutually beneficial transactions and to resist policies that hamper these transactions. There are several ways in which governments can facilitate exchange. Unfortunately, there are an almost unlimited number of ways in which governments can impede exchange.

Four fundamental principles, if adhered to, maximize the opportunity for voluntary exchange and thus for prosperity. Whether we are talking about complex exchanges like a major corporate merger, or simple ones like my daily cup of coffee, these four principles of prosperity provide the indispensible preconditions for the vibrant exchanges that enable economic growth. They are: private property rights; a relatively unfettered free market; low tax burden and government spending levels; and a stable currency.

When governments follow these four principles, people spontaneously cooperate, innovate, and elevate their individual and collective well-being. Prosperity is inevitable. Conversely, without these principles, a free and vibrant economy as we know it would cease to exist. There have been plenty of communist and socialist countries that demonstrate just how true this is. The extent to which governments adhere to these principles generally determines the level of prosperity countries achieve.

Because America has observed these principles more consistently and to a greater extent than most other countries, we have become one of the most prosperous countries in the world. But there is plenty of room for improvement in America's commitment to these principles. Because our government often strays from them, America is not as prosperous as it could and should be. For reasons political, ideological, and intellectual, government policies sometimes run diametrically opposed to these principles, and we pay the price for these mistakes with less prosperity. We will discuss a number of these policy errors at length in later chapters because these flaws can be remedied. When government policy encourages and ensures private property rights, a free market, low tax burden and government spending levels, and a stable currency, the result is stronger economic growth, more opportunities, higher wages, and a better living standard for our society. This goal is well worth striving for.

The First Principle: Property Rights—Ownership Is the Foundation of Markets

Private ownership of property is the foundation upon which a free economy is built. Because most economic transactions involve the exchange of property, clearly defined ownership and relatively unfettered rights attached to ownership are necessary preconditions to a free and vibrant economy.

Property takes many forms. The word first brings to mind real estate—land, buildings, houses—also called real property. But it also includes personal property, sometimes called chattel in the common law tradition. Personal property is, generally speaking, things that are not permanently affixed to land and thus movable. Goods, clothes, money, and my morning cup of coffee are all considered personal property. Finally, intellectual property refers to the result of personal creative effort, like songs, books, and the design of a commercial product, machine, software, or logo.

In all its forms, the ownership of property must be clearly established in order to maximize its availability for use or exchange. There is not much doubt that the coffee shop owner owns the cup of coffee he sells to me each morning just as he is confident that the $1.49 I give him belongs to me. If either of us is wrong, the consequences are not very significant. After all, it is only $1.49, and the coffee ceases to exist as such within fifteen minutes of my buying it.

But it is a very different matter if the property in question is a substantial piece of land. A buyer with plans to build on the land will not make the purchase if he cannot be sure the seller is the rightful owner. If ownership were in doubt, the buyer risks substantial loss should the legitimate title holder one day demand the return of the property. The same is true of a car, a plane, jewelry, or anything else of value. In order to facilitate the voluntary exchange of property, a prudent government must establish clearly defined rules regarding private property ownership. These rules vary depending on the nature of the property and the manner in which it is acquired.

For instance, real property ownership is usually registered in public documents kept by local governments. Ownership of cars, planes, and boats is typically documented by state governments, which issue titles, while securities ownership is registered by federal government agencies. These are examples of the constructive role governments can play in establishing and documenting the unambiguous ownership of private property, thereby facilitating their use and exchange.

Government helps to establish rightful ownership of property in another way. Since property can be acquired or transferred in many ways, it is helpful to have clear, universally accepted rules for establishing legitimate transfers. Property can be legitimately acquired when it is purchased, traded for, inherited, found, invented, created, or received as a gift. It can be obtained illegitimately by theft or fraud. It can be taken in bankruptcy or seized by the state for a number of reasons. In all of these examples, well-defined laws, especially laws that protect owners from illegitimate loss of property through theft or fraud, are conducive to economic growth.

Finally, it should be noted that property can be privately owned through many different vehicles. People often chose to own and deploy property jointly with others through partnerships, corporations, or trusts. It is very important that these forms of ownership receive the same government recognition and protection as individual ownership. As long as the property is acquired legitimately, there is no reason why they should not.

Without the protected right to own private property and engage in the exchange of property, we would have no real economy to speak of. To see just how true that is, consider the alternative. The opposite of privately owned property is communally, or collectively, owned property. One ideal of every communist state is to restrict the ownership of all property to all people jointly, with the government controlling its usage. Many states have attempted this system to varying degrees. All such experiments have resulted in impoverishment and often tyranny.

The Rights of Ownership

Just as important as establishing lawful ownership of private property is respecting the rights of property ownership. Here government's record is much less constructive. Real ownership means the exclusive right to do as one wishes with one's property, provided one is not harming another person or another person's property. This includes the rights to use, alter, exchange, give away, or destroy one's own property. Unfortunately, governments too often succumb to the temptation to restrict the rights of property owners. When they do, they invariably diminish prosperity by impeding the voluntary exchanges that enhance wealth.

The New Jersey Highlands Water Protection and Planning Act is a perfect example of the harm government can do when it unduly restricts an owner's use of his property. Passed by the New Jersey Legislature on June 10, 2004, the Highlands act set strict restrictions on the development of land in Northwest New Jersey with the alleged goal of protecting the state's fresh water drinking supply.[2] Whether this goal was sincere is a legitimate question, but even the well-intentioned goal of protecting the state's water supply should have been accompanied by appropriate compensation. Landowners sued but court decisions have so far denied landowners their due compensation.[3]

Covering 88 towns and an 850,000-acre region, the result of the Highlands act was that thousands of landowners suddenly found themselves unable to use their private property as they wished. Developers are unable to build homes; even some farmers are unable to farm; and many wishing to sell their property have found the value of their land decreased significantly.[4]

The ripple effects of these losses are huge. Farmers and developers whose livelihoods depended on the development of their land are essentially prohibited from earning a living. Jobs are lost when the farmers and developers no longer need to employ the workers they would have used on the now-restricted land. The homes they would have built and the produce they would have grown will never reach the marketplace.

Consider Andy Drysdale, a dairy farmer in Chester Township, who planned on subdividing his 16 acres of land and retiring on the earnings. Drysdale, then 70, saw the Highlands Act squash those plans, leaving him without a retirement nest egg.[5] Or consider all the people who would have purchased homes in the Highlands area but were forced to go elsewhere. During the first half of 2005, new-home construction grew by 8 percent in New Jersey; in the seven counties affected by the Highlands Act, new-home construction decreased by 28 percent.[6] A whole range of economic transactions that would have created wealth and enriched ordinary New Jerseyans will never take place. And we have the New Jersey government to thank for that.

Unfortunately, the New Jersey Highlands Act is just one of many ways in which governments restrict the legitimate use of private property and thereby restrict economic growth. A recent Supreme Court decision (*Kelo v. New London*) determined that a local government can forcibly acquire a person's property for the purpose of transferring it to another private owner. Governments force banks to make certain loans that the banks believe may be imprudent. They prevent sports fans from selling their baseball tickets to the highest bidder by forbidding what they pejoratively call scalping. They deny restaurant owners the right to sell a glass of wine with dinner unless they acquire expensive licenses. The list goes on and on from the seemingly trivial to the very significant.

These and other restrictions on the use of private property are justified with the highly dubious notion that governments make better decisions about how people should use their property than the individual property owners themselves. When governments limit their involvement with private property to defining and protecting ownership, they facilitate the exchanges that contribute to prosperity. When they restrict the rights of people to decide for themselves what to do with their property, they inhibit those exchanges and diminish prosperity.

The Second Principle: Markets Work—Let Them!

The free market economy has been one of the greatest human inventions ever. No other economic system has ever come close to matching its ability to generate prosperity, eliminate poverty, and foster opportunity. Yet so many political figures fall victim to what Fredrik Hayek called "the fatal conceit"—the belief that they can improve upon the outcomes of the marketplace by manipulating it in ways they deem appropriate.

There are two major reasons why governments should generally leave markets alone to work their wonders without excessive interference. The first is that free markets enable the individual pursuit of self-interest to result in broad, general well-being far better than governments can. The second is that government interference in the markets is often counterproductive. Government regulations are defended as necessary to protect some segment of the public, and regulations that ensure public safety, help to reduce the risk of fraudulent transactions, or address the effects on nonparticipants to an exchange, such as pollution, all have their place. But excess regulations often fail to achieve their intended goal and carry a cost that outweighs their intended benefit.

Self-Interest Serves the General Interest

We have already seen that a voluntary exchange occurs between people only when both parties perceive themselves to benefit from the exchange. If not for each individual pursuing his self-interest, the exchange would not occur. Equally important is the fact that an economic system based on voluntary exchange inevitably elevates the well-being of the general population. Perhaps the greatest genius of a free-market economic system is the mutual benefit that arises spontaneously from the pursuit of individual self-interest.

The brilliant eighteenth-century Scottish economist Adam Smith was the first to systematically describe this remarkable mechanism in his seminal work *An Inquiry into the Nature and Causes of the Wealth of Nations,* commonly referred to as *The Wealth of Nations*:

> It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self-interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.[7]

Like all of us, the butcher, the brewer, and the baker sell their products in order to improve their own circumstances, but they can't make a sale unless they simultaneously improve the circumstances of the buyer. Their own self-interest drives them to offer the prospective consumer sufficient value to make the sale.

Furthermore, in a free-market economic system, there will always be another butcher, another brewer, and another baker competing for the same sale. Therefore, each must strive to provide as much value as possible to consumers—not out of generosity but out of self-interest. The competition inherent in a free-market system inevitably leads to innovation in products, services, and business methods that continually improve the range, quality, and value being offered to consumers.

A free-market system of voluntary exchange also serves to increase the general economic health of a society by directing goods and services to those who value them most and can be most productive with them. Coffee beans are of little use to a home builder but my coffee shop owner needs them in large quantities. Similarly, my coffee shop owner would not know what to do with a backhoe but the home builder needs one every time he starts a new home. The value of these items is simply what someone is willing to pay for them. By directing them to those who value them most, the free-market system maximizes their value and puts them to their most productive use.

Another way in which free markets dramatically enhance the level of prosperity is by allowing both specialization and a division of labor to maximize productivity.

Specializing enables people to develop their talents and skills and produce goods and services far more efficiently than others could produce them themselves. We take it for granted that we would neither want to live in a home built by my coffee shop owner, nor consume the coffee and Danishes produced by the home builder. The free-market system allows them both to specialize, and all of us benefit from the superior products that result.

Similarly, dividing the production of a complex item into a series of discrete steps, each carried out by a different person operating cooperatively with all the others, dramatically increases the output of the group. A single person would be hard-pressed to assemble an automobile by himself even if given a considerable period of time. That same person, however, could easily master one part of the assembly process while other workers could master the remaining tasks. Together, they could assemble several cars each day.

Market competition, directing goods and services to where they are most valued and useful, and specialization and a division of labor are all made possible by the voluntary exchanges of a free market. All of these individual exchanges increase the wealth of each individual partner to each exchange and, collectively, the process enhances the quality of life for everyone.

Once again, Adam Smith made this case so well over 230 years ago in perhaps the most famous of all passages from *The Wealth of Nations*:

> Every individual … intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that

> it was not part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.[8]

Excessive Regulation Always Has Unintended, Negative Consequences

Regulations by their nature restrict or raise the cost of exchanges. Some are worth the cost. For example, the public health benefits of safely disposing toxic, industrial waste justify the higher cost this imposes on consumers. But excessive, unnecessary regulations, some of which we will consider next, inhibit productive exchanges, thereby diminishing the individual and collective wealth of society.

There are as many noble reasons for government to interfere in markets as there are cynical ones. Often it is special interests that stand to benefit at the expense of the general public that push a particular regulation. Just as often, politicians honestly think they can provide for the general public better than the free market can. But whatever the motivation or complaint, the result is almost always the same. Government regulations raise costs and produce adverse side effects that inhibit the voluntary transactions that are so integral to the growth of our economy.

Government-set prices, meant to lower costs for consumers, create scarcity when set too low as they were for gasoline during the energy crisis of the 1970s. They create windfall profits when set too high as with certain agricultural products in recent decades. Licensing requirements, intended to protect consumers, often drive up costs and limit job opportunities by needlessly restricting the number of people allowed to engage in a given trade or profession such as haircutting or taxi driving. Mandated coverage requirements for health insurance, justified as necessary to ensure access to health care, drive up the costs of insurance policies, thus leaving more people without any health insurance at all. Excessively high minimum wages, sold as protections against worker exploitation, prevent some people from earning any wages. Tariffs and quotas on imported products, promoted as a means to protect American jobs, limit choices and raise prices for consumers while destroying the jobs of American exporters who suffer from retaliatory measures.

These are just a few examples, but there are innumerable ways in which governments interfere with the operations of free markets. Whether the motivation is noble or ignoble, political or philosophical, regulations always have at least one effect in common: They hamper voluntary exchanges by forbidding them, restricting them, or raising their costs. Thus, any regulation proposed by government should be scrutinized with a very skeptical eye. And policy makers should always bear in mind that, when left alone, markets will allocate resources and facilitate the exchanges needed to elevate the general level of prosperity.

The Third Principle: Taxes and Spending—The Lower the Better

Chief Justice John Marshall famously said, "The power to tax involves the power to destroy."[9] He was right. This quote embodies one of the irrefutable laws of economics: If you tax something, you get less of it. If you tax it enough, you can destroy it altogether. This law applies to any product or service taxed directly, and it applies to the economy as a whole.

Taxes and government spending are two sides of the same coin—the coin of private wealth creation that is taken by government. Ultimately, taxes are needed to pay for all government spending—that which is legitimate and necessary and that which is illegitimate and wasteful. Governments can borrow to fund the shortfall between tax revenue and expenditures, but large borrowings over long periods of time are unsustainable.

In the long run, the level of government spending drives the level of taxes.

Unfortunately, governments are naturally biased in favor of ever more spending. In order to fund the largesse, taxpayers are burdened with high taxes and a corresponding decrease in economic growth. Maximizing prosperity requires overcoming this bias and minimizing government spending. Only then can we enjoy the low tax rates and expanded prosperity that would result.

Death by Taxes

A tax on a product is a cost not intrinsic to the production of the product but imposed arbitrarily by government. Since a producer must recover all of his costs in order to make a profit and stay in business, he generally has to pass on the full cost of any tax to potential consumers in the form of higher prices. This tax creates a wedge between the provider of a product and its consumer, raising the cost to the consumer without enhancing the value of the product. This wedge separates consumers from producers—that is, it prevents voluntary exchanges—in proportion to its size.

Even a very small tax will prevent some sales. I am willing to exchange the $1.49 in my pocket for my morning cup of coffee. But if the government raises the sales tax, even by just a few pennies, I may decide to brew my morning cup in the office instead of buying it at the shop. Or I may forgo buying a second cup later in the morning. Some coffee drinkers will inevitably cut back on their consumption even if the tax hike is just a penny. The greater the tax increase, the fewer cups of coffee sold. The relationship between the tax rate and the decline in sales may not be linear—it may vary over time and from product to product—but the basic effect is always the same: Higher taxes result in fewer transactions and lower sales.

And taxes can take many forms. In some ways the sales tax just described is one of the less objectionable forms. At least it is transparent—the consumer/taxpayer sees exactly what the government is taking from him on every transaction. Many other forms of taxation are much less transparent, but they are at least as damaging to an economy. Corporations are subject to all kinds of taxes: income taxes, windfall profit taxes, and user fees, which are taxes by another name. In my home state of Pennsylvania, corporations are even required to pay a tax on their accumulated capital regardless of whether or not they are profitable! But all of these taxes get passed on to consumers in the form of higher prices for the goods and services produced. In this sense, corporations do not really pay any taxes—instead they collect them from their customers and pass them on to the government while making fewer sales as a result.

People pay the taxes that governments force businesses to collect, but people also pay a wide range of taxes directly. Sales taxes, payroll taxes, income taxes, capital gains taxes, and property taxes are just a few of the kinds of taxes that creative politicians have imposed on people. While all of these inhibit economic growth, some are more damaging than others.

Most harmful to prosperity are those taxes that discourage productive activity. Income taxes and capital gains taxes discourage work and investment, respectively. The higher the tax one has to pay on the last dollar earned, the less it pays to work—literally. Less pay for work makes alternative activities like leisure, recreation, or simple inactivity relatively more attractive. The equation is simple: The higher we tax people's incomes, the less they work.

Capital gains are the economic rewards for successfully taking financial risk. Investments that generate rewards generally contribute to economic growth—hence the reward. When governments impose a tax on capital gains, they create an asymmetry in risk-reward calculations that discourages risk taking. A dollar lost on an investment often means the investor loses 100 cents. In other words, he bears the loss in its entirety. If the government imposes a 20 percent tax on capital gains, then a dollar reward on an investment yields the investor only 80 cents after taxes. Any investment in which an investor must fully absorb any loss but can keep only a portion of the gain is less attractive than one in which gains and losses are treated equally.

While some taxes do more economic harm than others, all taxes do less harm as the tax rate decreases. For any kind of tax and any given level of tax revenue sought, economic growth is inhibited least when taxes are applied on the broadest possible base and at the lowest possible rates. If a retail sales tax, for example, is meant to produce a particular amount of revenue, exempting certain categories of goods from the tax requires that other goods be subject to a higher rate than if all items were taxed equally. This unequal treatment leads to excessive allocations of resources to the untaxed items, and results in suboptimal economic growth.

The Problem with Government Spending

Of course, over time, taxes can only be as low as government spending permits. Unfortunately, the natural tendency of governments is always to increase spending. There are several reasons for this economically unhelpful proclivity, but they generally boil down to two. The first is the law of concentrated benefits outweighing dispersed burdens. The second is the fact that people naturally tend to focus on observable benefits and ignore invisible costs.

Concentrated Benefits Beat Dispersed Burdens Spending money ingratiates politicians to the beneficiaries of the spending. Whether it is money for education, subsidies for heating oil, or funds for bridge building, there are usually two broad categories of people who want the government to increase any particular spending: the people meant to receive the benefit—the student, the home owner, the traveler—and the people who are paid to deliver the benefit—the teachers, the oil distributors, the construction companies. Both groups always demand that the government spend more on them. The concentrated benefits they stand to receive make it worthwhile for them to lobby government aggressively, either directly or through surrogates.

The taxpayers forced to pay for these benefits, on the other hand, can hardly afford to fight each government spending program, which, individually, adds only a tiny amount to their overall tax burden. Those seeking more government spending lobby aggressively for it while those paying for it are relatively silent. The path of least resistance for Congress is always to agree to more spending.

I will never forget my first days as a newly minted member of Congress when I witnessed this asymmetry in pressure for more government spending versus less. Having never served in any legislative body, I was naïve enough to be shocked by the number of people, mostly lobbyists, who wanted to meet with me immediately after being sworn into office. Much to my disappointment, the vast majority of them wanted to impress upon me how vitally important it was for the federal government to spend more money on the program from which they, or the people they represented, benefited. No one came to my office to lobby me to vote for less government spending and lower taxes.

The Seen Trumps the Unseen

It is not just a lack of resources that prevents voters from protesting. Often the general public is lulled into supporting higher spending because it cannot see the harm caused. Henry Hazlitt describes this phenomenon as:

> The persistent tendency of men to see only the immediate effects of a given policy, or its effects only on a special group, and to neglect to inquire what the long-run effects of that policy will be not only on that special

group but also on all groups. It is the fallacy of overlooking secondary consequences.[10]

The unseen, secondary effect of government spending is all the economically beneficial private sector spending that government spending prevents. As we have seen, government spending is generally paid for either by taxes or borrowing. In either case, the government is taking money out of the private sector—money that otherwise would have been spent or invested—and spending it on some politically motivated project.

When a government decides to build a bridge, the politicians responsible are usually quick to tout the number of jobs that will be created to complete the design, financing, construction, and eventual management and maintenance of the bridge. These folks become very visible as the project progresses and people tend to associate the bridge with the creation of jobs.

But this view presents only half the picture. All the money spent on the bridge project had to come from the private sector—whether taxed or borrowed. That money would have been spent on something else had the government not taken it for the bridge. So while it is true that the government creates many jobs when it undertakes such a project, it destroys at least an equal number of jobs by reducing spending elsewhere in the economy by the same amount as is spent on the bridge.

If the project in question is truly needed and would have been undertaken privately absent the government's involvement, like a strategically located bridge, then the net effect on job creation and economic output is probably only slightly negative since governments usually overpay for things.

However, governments routinely spend money on projects that no private individual or business would ever consider. A "Bridge to Nowhere,"[11] an indoor tropical rainforest in Iowa,[12] and the Cowgirl Hall of Fame[13] are just a few of the tens of thousands of ridiculous projects the U.S. federal government funds each year. These egregiously wasteful expenditures could never be justified by anyone risking their own money and are funded at the expense of productive alternatives in the private sector.

Governments also spend vast amounts of money simply redistributing income from one group of people to another through major entitlement programs. Social Security and Medicare are the two biggest programs by far and, as I explain in subsequent chapters, are completely unsustainable. Absent reform, they will lead to crippling tax increases.

The net effect of government spending is not the visible economic growth and jobs created directly, but those activities minus the economic growth and job creation that would have been created had the government left the money in the private sector. Unfortunately, this net sum is very often a negative number since private spending and investment tend to generate more productive economic activity than government spending. Thus, the unseen losses frequently cost more than the visible gains. The more governments spend, the more economic growth is diminished.

The Fourth Principle: Stable Money

We all use money almost every day. In its various forms of cash and coin, checks and deposits, it is almost as ubiquitous as air and water. While most of us intuitively know how to prudently manage our own money, the management of our country's monetary policy often elicits confusion, contradiction, bewilderment, even despair. And that's just among members of Congress!

Understanding good monetary policy need not be daunting. There are just two things to remember about money that should guide all monetary policy. First, money serves three distinct purposes that enable our economy to function efficiently. Second, money serves those three purposes best when its value is stable.

Therefore, the most important responsibility of a country's monetary authority, in our case the Federal Reserve, ought to be maintaining a stable monetary unit. To see why this is so, let us first consider the three functions of money.

The first purpose to which we put money is as a unit of measure. Much like the foot is a unit for measuring length and the pound is a unit for measuring weight, a dollar is a unit for measuring value. Since the value of all goods and services can be measured in dollars, it provides us with a very convenient way to compare the values of different things.

As a unit of measure, money also enables us to keep accounts. A person, household, or business may have thousands or millions of transactions in a given period of time. A unit of measure allows us to know, among other things, whether the net effect of these transactions is positive or negative. If my favorite coffee shop owner one day adds to his stocks of coffee cups, sugar, and muffins while selling a high volume of coffee, tea, and scones, in the absence of a single, standard unit to measure the value of all of these items, it would be pretty hard for the shop owner to know whether he made progress or lost ground that day. Money provides him with that unit of measure.

The second purpose for which money is almost indispensible is as a medium of exchange. I say almost indispensible because it is possible for an economy to run on barter, in which different goods and services are traded directly. It is just that barter is so cumbersome and inefficient that relying on it as a payment system precludes having a modern, advanced economy. Imagine a shoemaker going into the coffee shop for a cup of coffee. What if the shop owner has no need for shoes and refuses to accept them in exchange for his coffee? The shoemaker would have to find someone willing to accept his shoes in exchange for something the coffee shop owner will accept. Determining the respective quantities would vastly complicate this already onerous arrangement. Clearly, a universally accepted medium of exchange is a precondition of a strong economy.

Finally, money serves as a store of value over time. Though we take this role for granted, money's function as a store of value is really amazing, especially since paper money has no real, intrinsic value at all. A $100 bill and a $1 bill differ only in the images printed on otherwise identical, nearly worthless pieces of paper. Yet we will exchange 100 times the quantity of real goods for the former as for the latter. We do this because we have confidence that others, in turn, will accept these dollars when we want to purchase something.

One of the great virtues of money's ability to store value is that it enables us to separate our consumption from our production. Ultimately, we all produce goods and services so that, in exchange, we can consume other goods and services. But the timing of our production and consumption can vary widely. A small home builder, for instance, might build just a few homes each year and get paid once every few months when he sells a home. This builder, however, certainly needs to consume many goods—foods, clothing, shelter certainly—almost continuously. It is the fact that the money he periodically receives holds its value that enables him to live comfortably between paydays. If our money were just a medium of exchange but could not store value over time, we would have to immediately spend what we get paid. Savings would be impossible and so would a modern economy.

In all three of its vital functions—as a unit of measure, a medium of exchange, and a store of value—money only performs well when its value is stable, predictable, and perceived with confidence. It is easy to see how the voluntary exchanges that comprise any economy are impeded when this is not the case.

The whole point of a unit of measure is that it is agreed upon and constant, thereby providing a common understanding of that which is being measured. There is nothing magic about a pound consisting of 16 ounces. We have all just agreed that it does. If instead we had decided that a pound consisted of 12 ounces, the actual weights of things would not be any different; we would just count those weights differently. If, however the number of ounces to a pound varied constantly and unpredictably, then we would not know the real weight of something measured in pounds. The pound would be a useless unit of measure.

The same is true of money. As long as it is stable, whether a dollar's value is equal to 100 Yen or 1,000 Yen, 1/1,000 of an ounce of gold or a full ounce, a quart of gasoline or a gallon, it can be a perfectly good unit of measure. Problems arise when the dollar's value fluctuates. Like the previous example, if the dollar's value varied unpredictably, then we would not know the real value of things measured in dollars. Confusion would reign. Financial accounts would lose their meaning, and perhaps most importantly, vital information about scarcity and abundance, as reflected in prices, would be obscured by unreliable measurements. Money's effectiveness as a unit of measure depends on its stability.

Similarly, when the value of money is unstable, money loses its effectiveness as a medium of exchange. My favorite coffee shop owner would not know how many dollars to charge for his coffee if he did not know what a dollar was worth. If people did not know the real value of things expressed in dollars, then they would not want to use dollars as their medium of exchange. Economic activity would be severely hampered.

In addition, as we saw in the example of the home builder, money is an effective medium of exchange when it is a reliable store of value over time. If the aforementioned home builder worried that the money he received for the sale of a house might lose its value, he would inevitably seek an alternative, less risky medium of exchange. One of the biggest reasons people accept paper money in exchange for the goods and services they produce is their confidence that it will allow them to buy as much tomorrow as they can today. If a monetary unit is unstable, then it cannot play this role of storing value. The risk that one's money will lose value increases the incentive to spend it quickly before it does. It is for this reason that volatility in a currency's value in general discourages savings. Conversely, if money is expected to gain value, there is an incentive to hoard it. In all of these cases, unstable money leads to distorted economic decisions and misallocated resources. These, in turn, mean less economic growth.

Since all of money's vital functions depend on its value remaining stable, one would expect a long-standing, overwhelming consensus for monetary stability among policy makers. One would be wrong. From ancient days through today, history is replete with examples of governments that have destabilized their currencies, almost always by intentionally devaluing it. This always leads to inflation, and inflation is always harmful to an economy.

Since the Federal Reserve Act of 1913 all power to control the supply of money in America has rested with the Federal Reserve Bank (the Fed). Placing so much power in the hands of unelected, and essentially unaccountable, officials would normally give great offense to my generally democratic instincts. But I have served in Congress and I am convinced that we would be in far worse shape if we let those folks run the money machines. It is hard enough to keep the Fed from inflating; we wouldn't stand a chance against Congress.

In fact, part of the reason Fed policy tends toward inflation is the fault of Congress. It is Congress, through the Federal Reserve Act, that mandates that the Fed should seek "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."[14] While all of these are worthy goals for our economy, the Fed is ill-suited for achieving the first and need not worry about the third. In attempting to actively achieve the goal of maximum employment, the Fed can easily undermine the second, and most important, goal of price stability. When the Fed maintains stable prices, the markets keep long-term interest rates in sensible ranges.

The mandated goal of maximum employment puts pressure on the Fed to add to the money supply (or "ease," in monetary parlance) whenever the economy is at less than full employment. This easing is widely believed to stimulate consumer and business demand, thereby expanding economic growth and increasing employment. But if this kind of easing begins too soon, goes too far, or lasts too long, as it did from 2002 through 2005, it can have negative, unintended consequences, including credit bubbles, devaluation, and especially inflation.

And inflation is always bad news for an economy. Inflation reduces economic growth by destabilizing money and thereby undermining all three of the key functions that money serves (as discussed previously). It also harms people and economies in other, major ways, including the inequity of punishing savers and providing a windfall to borrowers; its interference with the price mechanism; and the unproductive speculation it encourages.

Since inflation is always caused by mismanaged monetary policy, when it occurs in America, it is always the fault of the Fed. Congress should narrow the Fed's mandate to do the one thing it can and ought to do: maintain a stable currency. This, in the long run, is the best way to moderate long-term interest rates and maximize employment since this is the way to enable the dollar to perform its three vital functions well.

Where We Go From Here

The four foundational principles of prosperity already described—private property rights; relatively unfettered markets; limited government spending and low taxes; and stable money—certainly do not represent any new discoveries in the field of economics. The importance of these ideas in promoting economic growth has been well understood as classical liberal economics for hundreds of years. I think of them as the cornerstones of economic freedom. It is hard to deny how successful they have been when consistently applied.

One of the great lessons of the last century is the spectacular improvements in the human condition that have resulted from the wealth that comes with economic growth. Life spans, child survival, health care, scientific knowledge, sanitation, living conditions, opportunities to pursue interests and leisure, the state of our environment, and all forms of material well-being have improved dramatically for virtually everyone in all societies that generally follow these principles. Those that have generally neglected them, however, remain mired in the misery and deprivation of poverty.

Yet very often policy makers violate these foundational principles. Sometimes these errant policies result from ignorance. More often they are a response to political pressure applied by a narrow special interest group. In still other cases, proponents of compromising these principles are willing to sacrifice economic growth in favor of some other priority such as greater uniformity in income or diminished pollution.

But it is economic growth that makes dramatic improvement of the human condition possible. When these foundational principles are followed, free markets drive these improvements rapidly and spontaneously. On the other hand, when governments neglect these principles, the unseen and unintended consequences typically do more harm than good.

In the following chapters I consider a number of policy challenges facing the United States and the solutions that follow from observing these proven principles of prosperity.