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The Ethics of Economic Freedom

Herbert Giersch

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THE ETHICS OF ECONOMIC FREEDOM

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Herbert Giersch

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Foreword

Michael James

The widespread conviction that the market promotes greed and selfishness is perhaps the greatest intellectual obstacle to the spread of economic freedom. It stems largely from the fallacy that individualism is identical with egoism, and collectivism with altruism. But as Sir Karl Popper pointed out so effectively in *The Open Society and its Enemies*, social groups can behave selfishly, while individuals can and do make sacrifices to help other individuals. In a political world dominated by special interest groups (representing capital no less than labour), it's hard to maintain that there is anything necessarily virtuous about collective action.

But perhaps a deeper objection to the market comes from believing that individual action promotes exclusively either the interests of the actor or the interests of others. Christian and post-Christian morality stress the virtue of 'selflessness', as if doing good was a negative-sum activity in which the loss suffered by the actor is proof of the good done to others. Yet although human welfare is often promoted in this way, we also believe that self-help is a virtue, and deliberate dependency on the compassion of others a vice. There is in short, a good deal of moral confusion around. In this context, the ethical case for the market order, though made with incomparable deftness over two centuries ago by Adam Smith, still needs to be restated with patience and clarity.

Professor Giersch's perceptive essay stresses the moralising effects of the 'extended self-interest' that can find expression only in the market order, in which individuals who remain unacquainted with one another can nevertheless cooperate to their mutual advantage. In this he brings to mind not only Smith but also C.L. Montesquieu, another 18th-century social thinker, who observed that the barbarians of Northern Europe had been civilised by the spread of commerce. Professor Giersch shows how and why the market order is superior to any other in sustaining basic moral rules like truthfulness and honesty, as well as secondary virtues like broadmindedness and consideration for others. Opponents of economic freedom have yet to show why their collectivist alternatives would not reproduce the dismal situation of the communist countries, where the official ideology is mocked by a reality in which individuals can take care of themselves only through systematic cheating and brutal disregard for others.

The CIS is grateful both to Professor Giersch for the opportunity to reproduce his paper, and to Professor Wolfgang Kasper for translating it from the original German.

About the Author

Herbert Giersch has been President of the Kiel Institute of World Economics and Professor of Economics at the University of Kiel, Germany, for the past twenty years. Prior to that he worked at the OECD, taught economics at the University of the Saar and was an influential member of the German Council of Economic Advisers, which has shaped economic policy-making in West Germany and Europe. He has served on numerous international and national commissions, including the OECD's McCracken Committee (1977), which shifted the emphasis from Keynesian demand management to supply-side economics. He has been a long-time Member of the Mont Pelerin Society, and its immediate past President. He has written extensively in economics, policy-making and philosophy and has been editor of the internationally influential Kiel Symposia volumes. He is the author, amongst other works, of the two-volume *Allgemeine Wirtschaftspolitik [General Political Economy]*(1960 and 1977), which has been translated into several languages, and of a book entitled *Gegen Europessimismus [Against Europessimism]*(1986). Recent articles include 'On the Future of the World Economy — An Optimist's View'(1979), 'Aspects of Growth, Structural Change, and Employment — a Schumpeterian Perspective'(1979), 'Economic Policies in the Age of Schumpeter'(1987), and 'Internal and External Liberalisation for Faster Growth' (1987).

The Ethics of Economic Freedom

Herbert Giersch

The Criterion of Evolutionary Efficiency

An economic order is always based on a certain set of moral principles. This applies to a free market economy as much as to the corporatist economies of medieval cities run by the guilds or the centrally controlled economies of the Eastern Bloc. The economic order must correspond to the social order and the philosophy of the state. If these various components of the underlying philosophy are compatible, then the system is stable. And it will be efficient in so far as it has the best possible chance of standing its ground and spreading its influence in the peaceful, international competition among basic philosophies. However, the success of an economic order depends also on the efficiency of competing systems.

Economic orders can spread by population growth or emigration or by other populations freely adopting or imitating them. This is in line with Hayek's theory of social evolution: the contents of our moral rules are, according to Hayek, not a creation of human reason but the result of evolutionary processes by which groups that were lucky to chance upon the right rules were able to expand faster than others (Hayek, 1979).

The Market Economy versus Collectivism

The centrally planned economy, which is the opposite of the free market economy, requires collectivism in social policy and the totalitarianism of single-party government. If an economy is to be centrally administered, the

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system must be based on social and political philosophies of collective unity that place the collective above the sum total of the individuals: the tribe, the people, the land, the nation, the Empire or the Communist International. The collective frequently sees itself united by a common will: the Movement, the Long March, the Revolution.

The feeling of collective unity is enhanced if there is a common enemy: class enemies or the world conspiracies of the plutocratic capitalists. Prominent in such systems is a xenophobic drive towards a closed society, or autarchy. Those who oppose this drive are accused of treason. Traders are denigrated as black marketeers and speculators and put into one bag with deserters. They are contrasted with 'heroes of the people' who are greatly honoured for the sacrifices they make for community interests.

The highest economic ethical value in collectivist systems is the common good. What is needed — to put it into a present-day context — is the Socialist Man, a new type of human being who derives his or her satisfaction from serving and obeying and who understands freedom only as a community objective: freedom for a positive purpose rather than freedom from coercion. Seen from an anthropological angle, this New Man resembles a member of a herd, or the prehistoric hunter-gatherer who lived in the close community of the small, face-to-face group. These age-old communal instincts often appear in young, idealistic people who are attracted to living in communities, sects or communes: all are equal, except the leaders, and the collective interest is always worth the individual sacrifice, even death in the extreme case.

Since such collective instincts are often short-lived in individuals, collective leaders indoctrinate the young with propaganda, especially in dictatorially coordinated education systems. They promise salvation, of course also in support of their own fight for power. Venceremos! The future is on our side! We are engaged in a great and holy war! We comply with providence! We obey the laws of history! Those who disagree are heretics. They belong in psychiatric wards or before People's Courts. What matters is good intentions in the correct communal spirit. Those who share the common goal cannot err. The end justifies the means. People are judged by their motives, not the consequences of their actions. The prevalent ethics are rooted in the communal spirit.

This kind of society is the opposite of a free market economy. Order in a free market economy is not provided by a central plan that reflects the collective set of values — the *volonté générale*. Instead of plan fulfilment and concrete norms that are prescribed to individuals or work brigades, the free society has as its driving force the free will of diverse individuals.

Despite this, there is a guiding, ordering principle in the free market economy. It results from the wishes of individuals and small groups, like households or families, who act as suppliers and buyers, savers and investors. Each and every one can gain from trying to discover the wishes and the potential of possible partners in the market. Each voluntary contract is capable of bestowing advantages to both sides. Otherwise such contracts would not be made or repeated. It is a game with positive results, not a zero-sum game in which one party gains what the other loses.

Such a spontaneous order cannot be described by the holistic notion of a national economy under central guidance. Rather, such an order results from a catallaxy (Hayek, 1967), an exchange society. This society is not controlled from above but guided by the fact that individual buyers' resources are constrained by their ability to supply goods or services to others and by market prices that reflect the scarcity of what is being demanded and supplied.

Since the use and production of goods and services is regulated spontaneously through prices — and not by central command — coordination is horizontal and, therefore, rather democratic. For that reason, the market economy is the proper economic order of a free society and an open world. One may participate or leave it. As long as the government does not rule this out, everyone can decide for himself or herself. Everyone is free to withdraw into isolation, but that of course means forgoing the great advantages available from the national or international division of labour of hands and heads to which our Western civilisation owes its prosperity.

A multilateral exchange system must be based on private property. What one does not own, one cannot offer for sale; and what one cannot own, one will not demand. Because private property makes possible exchange and trade, as well as the division of labour and specialisation, it is one of the most beneficial social inventions of mankind. Privately owned and utilised land can yield much more than socialised land. In the Soviet Union, for example, the acre yields of socialist land are consistently lower than those of small privately used acreages. The immense differences can only be explained in this way. Where individuals are permitted to keep the yield, they have a strong incentive to do their best.

Money was a spontaneous social invention induced by private property and exchange. As the general means of exchange and the unit of account it is, so to speak, the language of the marketplace. Another spontaneous invention has been certain traditions and customs (Hayek, 1979), which — like a language — serve to reduce the costs of transaction and specialisation. These include honesty, trustworthiness, respect for the truth, reliability, punctuality in delivering and paying, and fairness to business partners. Such behaviour earns high premiums in the market, and violating the rules incurs high penalties against the violators — penalties that gradually exclude them from the system of interchange. Because reliability and trust play such a great role, there is a high incentive for individuals, and especially newcomers, to fully honour the mutual trust. Lenin said 'trust is good, but control is better'. This may apply to collectivist orders that are necessarily bureaucratic and hierarchical; but the system of voluntary horizontal cooperation in the marketplace can afford to rely on the opposite principle: trust is better.

Competition and Selfishness

All those who want to participate in the market economy have to compete with others. They have to adjust to changes, but no one needs to know the ultimate reason why. If the price of a raw material rises, it is irrelevant whether the cause of the price rise is cartellised behaviour of suppliers, a revolution, a natural disaster or the exhaustion of resources. The price gives the right signal to do something about it: to search for new resources, to utilise others more effectively, to cut back on consumption, and so on. There is no need for moral suasion or mandatory government interventions. Citizens do not have to become more perfect human beings or greater technical experts to make the system work well.

Neither does one have to tell people who compete that they must hurry along. In contrast to a socialist economy in which all are rewarded according to their needs while they ought to perform as best they can, in the market economy there is a direct correlation between performance and reward. Those who perform better for others can afford more for themselves. This game is self-regulated in the competitive process. The outcome is not predetermined, and is therefore known to no one. If the outcomes were known to participants beforehand (if we all had free allotted tickets to the drama of the future) economic life would run at a much more leisurely pace. Or it might simply run around in circles.

Self-interest is the driving force, and competition ensures that the efforts of participants turn out to be beneficial for their customers or their suppliers. As if guided by an invisible hand, people are doing out of self-interest that which benefits their fellow men. To earn an income, people serve others. To climb economically, people serve the customer. Mediocre motives thus result in admirable deeds, as if people by their nature were noble, helpful and well-intentioned.

'Non-Tuism'

People want to obtain as much as possible in exchange for what they have to offer and to pay as little as possible for what they want to acquire. This may appear hard and cold, but it is part and parcel of finding out about subjective desires and objective possibilities. Striving in the marketplace out of self-interest has been called 'Non-tuism' (Wicksteed, 1910). This word indicates that potential partners in contract are not necessarily people whom we love and who need our altruism. Instead, contract partners must agree on the price that fully expresses the value they place on the expected exchange. Otherwise, the market signals are misleading. But every market participant may search for the most advantageous contract partner. If fellow men need a gift, they may receive that as private persons whom one loves as much as one loves oneself.

It is known that market price and gift are not always so clearly separable: People agree on 'friendship prices'. But such preferment can only continue to exist in business where competition is not very intense.

Non-tuism creates the scope for altruism. The great English economist Robertson (1955) once raised the question of what it was that the economic principle economised most. His answer was: one's love for one's fellow man. This is so scarce and so precious in private life that we should not waste it in economic life where it does more harm than good. Indeed, the more precisely we calculate the price, the more we have left over to meet — now or later — the needs and wishes of the members of the family, the sect, the church, Oxfam, the Third World, or, more generally, what can be given out of love to our fellows.

Extended Self-Interest and Profit Maximisation

Narrow-mindedness and ruthlessness do not pay in the voluntary interaction of people, because exchange is not a once-off affair but a continuing process in which participants must prove their worth time and again. In the past, critics of the market economy have asserted that individuals had far too narrow a time horizon, compared to governments, because individuals were mortal. Nowadays we know better. We have learned from politicians who acted on the pretence of thinking in terms of a 'Thousand Year Reich', and who left unprecedented human misery and a huge pile of rubble behind. We now also understand the short-sightedness of politicians who want to win votes in the electoral market. Compared to the electoral game politicians play, businessmen and consumers seem to act with respectably long time horizons.

Opponents of the market system often ignore how far self-interest extends beyond the individual's life expectancy. Individuals think in terms of their families and therefore in terms of the next generations. This has always been a bourgeois virtue. But if the modern welfare state intervenes by compulsion and promises to secure everyone's future, then the family becomes superfluous and long-term provision and self-reliance are less important.

Finally, many opponents of the market overlook that achieving a respectable reputation beyond the present day and immediate surrounding is essential to economic self-interest. This is more true today than in earlier ages and in affluent countries more than in backward ones. Today, communication costs are low and judgments about reputations travel fast. No one can tell lies for long; narrow-mindedness leads to loss of status; and generosity bears a return. To ignore this would be unwise. For that reason, the 'secondary virtues' of extended self-interest are developed out of wisdom and insight. These virtues take on a life of their own as social norms, and the people who adopt them often do not know how much wisdom and reason they contain. Outsiders who want to feel at home must make these virtues their own. As long as they do not, they are regarded with suspicion. This may look like discrimination, but in reality it is the unavoidable entrance fee that has to be paid where different moral orders compete to maintain their internal cohesion and stability.

Business enterprises that try to maximise their profits out of self-interest must also consider the direct and indirect consequences of their decisions. Firms are bound by social structures and are therefore unable to look narrowly only at yields and costs. They have to count as costs any disadvantage or damage they impose on others, who may one day require recompense. And they count as part of the return the respect and image of their firm with customers, suppliers, collaborators and the wider public. A firm's return in this wider and longer-term sense is not merely its accounting profit but a wider benefit, even if one looks at the consequences and not at the motives for business decisions.

Enterprises may experience higher costs or lower returns than they originally anticipated. Actual profit as an accounting result is only determined after the event. Indeed, the precise size of the profit is, in a world of uncertainty, only known once enterprises are liquidated and capital gains are offset against capital losses. Over the long run, profits are, as a rule, barely higher than what is necessary to induce entrepreneurs to partake in the economic game. Profits fall when entrepreneurs crowd into the competitive game, and they rise when there is a shortage of entrepreneurs and employers. Thus, profits had to be high during post-war reconstruction in Germany; and they must always be high when there are too few entrepreneurs who are prepared to compete for labour, including the unemployed. In the long run, profit is no more than a premium to cover those risks that cannot be insured with any insurance company; it is a wage of fear and a stimulus to venture on to new ground, into new markets and new technologies, in the process of dynamic competition. This incentive function of profit is not easily visible from the viewpoint of *ex post* accounting (or national accounts). Seen from that angle, profit appears to be an unearned rent, a sign of exploitation, an invitation to planners to have a go at the system by abolishing profits. The backmirror vision of the national accounts has indirectly done much to place the market economy under attack.

In a centrally controlled economy, profit has no function as a wage of fear. The uncertainty of an open future is replaced by the phoney certainty of the plan. The readiness to bear risks that is required in the market is replaced by subordination under some presumed collective good as stipulated by the plan. In the market economy, one can say that profit is the price others have to pay to entrepreneurs for their flair in uncovering the wishes of the buyers, for anticipating future production bottlenecks, and for correctly perceiving the potential of future supply. Some may consider the price too high *ex post*; but it is not if one takes into account how many individual demands the centralised system leaves unheeded, the quality of products in such a system, and the precious time wasted by queuing.

Ruthless Competition under Wrong Prices

Some opponents of the liberty of the market used to base their criticism on the monopoly argument. Nowadays, when we have a competitive system that is open to the world and the future, they speak instead of excessive competition. They depict competition as nothing but the ruthless use of one's elbows. They are thinking less of the competition among entrepreneurs than of that among workers, whom they wish to see protected against unemployment. But in a proper market economy, unemployment can have but two causes: it can be due to a money shortage, as in the Great Depression between the wars, which could be overcome — almost miraculously — by expanding the money supply, i.e. to pay for more public spending; or it can be due to legal or arbitrated minimum wages, as is predominantly the case today, leading to a surplus supply of labour (or, if you view the matter from the supply side, as a shortage of demand for labour). Where the liberty of the market prevails, the rule is that artificially raised prices lead to insufficient demand. Those who overestimate the value of their product and demand excessive prices bundle themselves out of the market — ruthlessly.

In reality, the individual worker rarely acts in this way; those who raise the price are their organisations, their guilds. They justify this by arguing that labour is not a commodity and therefore must not be subjected to the laws of scarcity. This implies the notion of a 'just price', which has always been around. But the just price has one unfortunate characteristic: it is higher in the opinion of the seller than in the opinion of the buyer. The consequences of this are pernicious. If sellers are able to win the day, there is oversupply (as we now observe in the European agricultural markets); if buyers win out, often with the support of short-sighted governments, then there is scarcity (as for example food in the cities of less developed countries with populist governments). The trade unions once knew that wages that appeared just to the workers would create unemployment. This is why the trade union movement from the very beginning argued for the creation of unemployment insurance or the dole. Nowadays the risk of unemployment has thus been largely socialised. We consequently observe misguided behaviour (moral hazard), as is the case with all insurance that appears to be cost-free.

Discrimination without Consequences

Where there is an excess supply of labour, employers are able to chose and, in doing so, to discriminate. If one's market competitiveness is not affected whether one hires a Catholic or a Protestant, a man or a woman, a white or a black, then one can readily yield to one's personal prejudices. The consequence is that those who are discriminated against face total unemployment instead of possibly earning just a little less. They stay on the outside because they are deprived of the opportunity to overcome widespread prejudices by proving what they are capable of.

Market, Power and the Community Spirit

Many examples teach us that good goals, if pursued by compulsion, can lead to bad results. The reason for this is that those who are directly compelled evade the compulsion. Employers escape into rationing and rationalisation; taxpayers evade tax and go into the underground economy; savers and investors move abroad. Do-gooding becomes a pain. If evasion is to be avoided, new compulsion is required. In closed societies, this leads to 'the road to serfdom' (Hayek, 1944). In open systems, there is a chance to change course — as has occurred in America and in Europe on both sides of the Rhine and the Channel during the 1980s.

People who receive government hand-outs soon come to think of them as a right; they demand more. The result is a 'claims society' that wastes its energies in distributive quarrels. The play of market competition, which generates new value, is replaced by a zero-sum game, which consumes energies that go missing elsewhere.

Moreover, those who are continually favoured by hand-outs will increasingly see themselves as dependents. A dependence mentality spreads and self-respect and self-reliance are lost. This is the dilemma of the good samaritan. True help can therefore in the long run only take the form of support to help oneself, offered with an encouraging word, as is usually the case in private life.

Those who exercise government power also face great temptations in economic policy. The temptation is either to apply the scope for administrative judgment arbitrarily, or to expand it by favouritism or cronyism (corruption). Power tends to corrupt, absolute power tends to corrupt absolutely, a saying that is frequently attributed to Lord Acton. There is hardly a social hypothesis that has stood the test of time better than this one. And there is a very short answer to the question of how to control corruption: replace power with competition. Not everything has to be initiated, promoted and brought about by the state.

The demand for (pure) public goods is much smaller in a market economy than one may assume. After all, many of the things that the state nowadays gets done by compulsion were in an earlier age created voluntarily by citizens who were driven by their community spirit, and much would also be provided in that way today. But the community spirit of the citizens wilts if an expansionary state occupies too many areas. It is said that compulsion is necessary where there are freeriders who cannot be excluded or forced to make a contribution. The exclusion principle is justified, but in practice much is accomplished by community spirit despite the fact that third parties have free use of it. There is a point beyond which exclusion costs more than it is worth.

Democracy and the Minimal State

We imperfect humans who have populated the earth since our expulsion from Paradise quite naturally strive in our own self-interest to attain political as well as economic power. If someone obtains dominant power, then he uses others as tools. The tribal society of old had to accept this in order to survive. Nowadays the democratic system gives people control. We hand over power to elected representatives for a limited time, and we can remove them from power by the vote. This ensures that people who threaten to develop into tyrants can be replaced without bloodshed. We can afford democracy with all its weaknesses **if the economy thrives,** first and foremost thanks to efficient markets.

However, large and stable majorities sometimes approximate tyranny, at least as far as minorities are concerned; and they are inclined to intervene in market processes. The market economy therefore depends not only on democracy rather than dictatorship, but also on a constitution that limits the power aspirations of those in government. In practice this means that the social welfare state must be constrained because it has the tendency to constrain the citizen; to make the family, savings and provision for a rainy day superfluous; to narrow the extended self-interest; and to let the community spirit wither away.

Such a state also has the tendency to treat its citizens as immature. An example of this is the effort by lawmakers and courts to extend liability, particularly product liability, thus making producers liable for damages that could have been avoided by careful use of the product. This has had two predictable consequences: production costs have been driven up by insurance premia; and consumers have become as irresponsible as the principle of liability assumes (moral hazard). Redistributing risks by intervention from on high to correct market outcomes induces greater neglect.

Imposing universal norms, more often than not through compulsion, damages the economy. In a free market a great variety of forms can grow. Those who want or require a foolproof product can pay the price for it; those who have learnt to be careful can save and secure the reward for self-discipline. The argument that norms have the advantage of lowering cost for producers may have some weight; but if these cost savings indeed exist, and if they outweigh the benefits of a greater variety of products, such norms will evolve spontaneously under competitive pressures to control costs. Apart from this, even purely technical norms have one great disadvantage: certain options that promise great future gain are excluded before they have been properly explored.

The prevailing moral order is also undermined by the expanding fiscal burden of the caring welfare state. High tax rates lead to tax resistance — from tax avoidance to tax evasion — just as high tariffs lead to smuggling and trade prohibitions lead to underground trading. Violating the law becomes acceptable. High wage on-costs and high consumption taxes favour the growth of the shadow economy — to the disadvantage of those who obey the law. Where the state claims a large share of the reward for any extra effort, the incentive to make such an effort is reduced and the demand for leisure grows. Today we increasingly hear complaints about a change in social values. Those who consider the change of social values not as an autonomous phenomenon, but rather as something that is politically induced, are easily denigrated by prevailing opinion as cynics. It is important that changes in moral values induced by political choices are not disregarded by the political process, especially over the long term.

When the government has blocked or distorted market signals it may sometimes be possible to extract a little more altruism by preaching and moral suasion. These moralising demands resemble advertisements by suppliers who want to sell more at an excessive price: drink more milk; eat more fish; buy British or Australian; work instead of flexing off. But unlike advertising, political moral suasion tends to stress collective purposes: the common good, the environment, exhaustible resources, full employment, monetary stability, the protection of national industry, peace, maritime resources, or the Antarctic as a common heritage of mankind. Appeals to such lofty values often cover up particular interests that are to be served:

agriculture and manufacturing serve everyone; social peace becomes an important factor of production; subsidies are a matter of social justice. Somehow 'socially weak' groups make us feel more responsible than just 'weak' groups, although the word 'social' has no meaning other than as a heart-warming, ill-defined advertising signal.

The Social Principle of Openness

There is a definition of 'social' that I find acceptable: Act on the principles that have stood the test in open groups and have proven superior in the ethical selection process. In open systems, this amounts to social conservatism. Projected into a dynamic world and into the future, one might say that a certain action is socially responsible if it corresponds to a principle that serves the survival of the group in the face of foreseeable requirements and probable future challenges and should thus become a generally accepted principle of the group. This amounts to a combination of Kant, Hayek and Schumpeter. It contains the Kantian principle of universality, the Hayekian criterion of survival and the Schumpeterian element of innovation, in this context moral innovation, which may be compared to mutation in biological evolution. In contrast to social conservatism, I would like to call this future-oriented ethical approach 'evolutionary social ethics'.

The social norm is the principle of openness. It allows conservatism in open systems and amounts to a social challenge in more or less closed systems. The more open a system, the more evolutionary capabilities it has. In an economic context the principle of openness means free access to markets for goods and services, for capital and ideas. In Europe, where so much is regulated by bureaucracy and blocked off by guild-like corporations, the principle of openness is directed against many inherited rigidities that discriminate against outsiders, including the young, women and the unemployed. Those who can supply a good or service more cheaply than established producers must be allowed to do so. Open systems encourage competition from outsiders, from new concepts and new growth. This ensures a maximum of efficiency in supplying the needs of citizens and removes unjustifiable rents from market incomes. Big structures, which easily ossify, must tolerate such outsider challenges and the creative unease they impose.

The more opportunities there are for small operators and new growth, the more they will use new developments in technical knowledge. This applies in particular to communications technology, which may serve giant centralised organisations, as Orwell expected, but can also reduce transport and transaction costs, facilitate the division of labour, and bring about decentralisation over vaster distances, which brings advantages for small groups and self-reliant persons. It is for that reason above all that the principle of openness has a future. In technology and society much depends, after all, on whether our world retains the capacity to learn. States and governments, organisations and bureaucracies do not learn, only people are able to learn — people who live in open systems and who have preserved openness in their approach.

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Herbert Giersch

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