

Canadian student review

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Quarterly
Student Magazine
Spring 2010

**Free trade is the
best policy**

by Tom G. Palmer

**The history of
economic freedom**

by Fred McMahon

Tear it down!

by Tim Mak

...and much more



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Canadian student review

Welcome!

Our Spring 2010 issue of *Canadian Student Review* explores recent trends in public policy, as well as policy failures of the past.

This issue includes a petition letter by Tom G. Palmer, Vice-President for International Programs and General Director for Atlas Global Initiative, which examines the recent rise of protectionism and its implications for the future of the global economy. In another article, Fred McMahon looks at the beginnings of the Fraser Institute's Economic Freedom of the World project. The failure of public housing projects in Atlanta, Georgia, is discussed in an article by Tim Mak, and the possible benefits of introducing a flat tax in Canada are considered in "Things Folks Know." This issue concludes with an excerpt from a recent "Ask the Professor" discussion about "spontaneous order" and its role in the economy.

We always welcome articles on economics and public policy from new student authors. See the back cover of this issue to find out how you can get published in *CSR*.

Best wishes,

Courtenay Vermeulen

Editor, *Canadian Student Review*



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Editor: Courtenay Vermeulen

Production: Bill C. Ray and Kristin Fryer

Contributing Editors: Amela Karabegović, Charles Lammam, Fred McMahon

CSR Staff Writers: David Karp, Tim Mak, and Cam Vidler

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Website: www.fraserinstitute.org

E-mail address: student@fraserinstitute.org

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The Fraser Institute's vision is a free and prosperous world where individuals benefit from greater choice, competitive markets, and personal responsibility. Our mission is to measure, study, and communicate the impact of competitive markets and government interventions on the welfare of individuals. Founded in 1974, we are an independent research and educational organization with locations throughout North America, and international partners in over 70 countries. Our work is financed by tax-deductible contributions from thousands of individuals, organizations, and foundations. In order to protect its independence, the Institute does not accept grants from government or contracts for research.

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Why is the market considered a "spontaneous order"?



Editor's note: The Atlas Economic Research Foundation, in collaboration with the Cato Institute and other organizations, has circulated the following petition to combat recent moves toward harmful economic nationalism. You can sign this petition at <http://freedomtotrade.org>, where it is available in 32 other languages.

Free trade is the

The specter of protectionism is rising. It is always a dangerous and foolish policy, but it is especially dangerous at a time of economic crisis, when it threatens to damage the world economy. Protectionism's peculiar premise is that national prosperity is increased when government grants monopoly power to domestic producers. As centuries of economic reasoning, historical experience, and empirical studies have repeatedly shown, that premise is dead wrong. Protectionism creates poverty, not prosperity. Protectionism doesn't even "protect" domestic jobs or industries; it destroys them, by harming export industries and industries that rely on imports to make their goods. Raising the local prices of steel by "protecting" local steel companies just raises the cost of producing cars and the many other goods made with steel. Protectionism is a fool's game.

But the fact that protectionism destroys wealth is not its worst consequence. Protectionism destroys peace. That is justification enough for all people of good will, all friends of civilization, to speak out loudly and forcefully against economic nationalism, an ideology of conflict, based on ignorance and carried into practice by protectionism.

Two hundred and fifty years ago, Montesquieu observed that "Peace is the natural effect of trade. Two nations who differ with each other become reciprocally dependent; for if one has an interest in buying, the other has an interest in selling; and thus their union is founded on their mutual necessities."

Trade's most valuable product is peace. Trade promotes peace, in part, by uniting different peoples in a common culture of commerce—a daily process of learning others'

languages, social norms, laws, expectations, wants, and talents.

Trade promotes peace by encouraging people to build bonds of mutually beneficial cooperation. Just as trade unites the economic interests of Paris and Lyon, of Boston and Seattle, of Calcutta and Mumbai, trade also unites the economic interests of Paris and Portland, of Boston and Berlin, of Calcutta and Copenhagen—of the peoples of all nations who trade with other.

A great deal of rigorous empirical research supports the proposition that trade promotes peace.

Perhaps the most tragic example of what happens when that insight is ignored is World War II.

International trade collapsed by 70 percent between 1929 and 1932, in no small part because of America's 1930 Smoot-Hawley tariff and the retaliatory tariffs of other nations. Economist Martin Wolf notes that "this collapse in trade was a huge spur to the search for autarky and Lebensraum, most of all for Germany and Japan."

The most ghastly and deadly wars in human history soon followed.

By reducing war, trade saves lives.

Trade saves lives also by increasing prosperity and extending it to more and more people. The evidence that freer trade promotes prosperity is simply overwhelming. Prosperity enables ordinary men and women to lead longer and healthier lives.

And with longer, healthier lives lived more peacefully, people integrated into the global economy have more time to enjoy the vast array of cultural experiences brought to them by free trade. Culture is enriched by contributions from around the world, made possible by free trade in goods and in ideas.

Without a doubt, free trade increases material prosperity. But its greatest gift is not easily measured with money. That greatest gift is lives that are freer, fuller, and far less likely to be scalded or destroyed by the atrocities of war.

Accordingly, we the undersigned join together in a plea to the governments of all nations to resist the calls of the short-sighted and the greedy to raise higher the barriers to trade. In addition, we call on them to tear down current protectionist barriers to free trade. To each government, we say: let your citizens enjoy not only the fruits of your own fields, factories, and genius, but also those of the entire globe. The rewards will be greater prosperity, richer lives, and enjoyment of the blessings of peace.

Dr. Tom G. Palmer



*Tom G. Palmer is a Senior Fellow at the Cato Institute, and Director of Cato University, the Institute's educational arm. Palmer is also the Vice President for International Programs at the Atlas Global Initiative for Free Trade, Peace, and Prosperity, which operates programs in 13 languages. He is the author of *Realizing Freedom: Libertarian Theory, History, and Practice*, published in 2009.*

The history of *Economic Freedom of the World*

FRED McMAHON

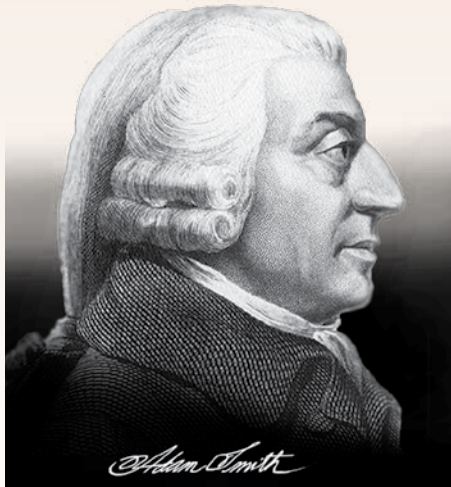
Perhaps the most famous statement about economic freedom was made almost 250 years ago in *The Wealth of Nations*. When Adam Smith famously wrote, “It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest,” he was talking about economic freedom. Neither benevolence nor coercion brought Smith his supper. Instead, it was voluntary economic exchange.

Yet, until 25 years ago, economic freedom was an intuitive concept, unmeasured and with no rigorous definition. Michael Walker, then executive director of the Fraser Institute, first noted this significant gap in knowledge during the 1984 meeting of the Mont Pelerin Society in Cambridge, England. As he later wrote:

In the course of a comment on a paper by Paul Johnson, I made reference to the famous passage in *Capitalism and Freedom* written by Milton Friedman and Rose Friedman, in which the authors note that, “Historical evidence speaks with a single voice on the relation between political freedom and a free market. I know of no example in time or place of a society that has been marked by a large measure of political freedom, and that has not also used something comparable to a free market to organize the bulk of economic activity.” ... It became clear during the course

of [the following] discussion that while Milton and Rose Friedman’s comment had been extant for three decades there had been no serious attempt to explore the relationship between economic and political freedoms in a scholarly way. (Walker, 1996: 1)[1]

That launched a still ongoing research project that would define and measure economic freedom. At the same meeting, Walker invited Milton and Rose Friedman, both of whom were in attendance, to join him in investigating economic freedom throughout the world. The three ultimately became the co-leaders of what would become the economic freedom project.



Developing the economic freedom index

The project began with a series of symposia on economic freedom, which were supported financially by Liberty Fund, Inc. of Indianapolis. Three Nobel Laureates and 61 of the world’s top scholars participated in these seminars, which led to the publication of three books of essays exploring the topic (Walker, 1988; Block, 1991; Easton and Walker, 1992). In his description of the

development of the economic freedom project, Walker highlighted the contribution of Alvin Rabushka of the Hoover Institution:

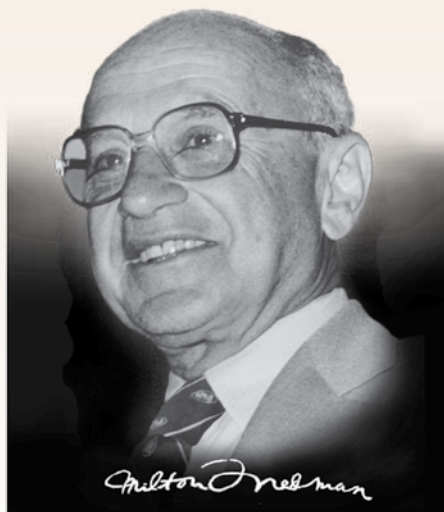
Building on the work of John Locke, Adam Smith, Milton Friedman, Murray Rothbard, and his own extensive empirical and theoretical analysis, Rabushka ... argued that private property and rule of law provided the foundation—the institutional basis—for economic freedom. Rabushka applied the concept of economic freedom to five basic areas—taxation, public spending, economic regulation of business and labour, money, and foreign trade—and outlined some ideas about how it might be measured in each of these areas. This work proved to be quite important in focusing subsequent discussion at the other symposia. (Walker, 1996: 3)

These categories evolved into the five areas currently measured by the Economic Freedom of the World Index: size of government; legal structure and security of property rights; sound money; freedom to trade; and regulation of credit, labour, and business.

The seminars and the books fully explored the theoretical and philosophical questions surrounding the nature and meaning of economic freedom. Thanks to these discussions, the concept of economic freedom is now rigorously defined, but that definition can also be made intuitive and presented simply. Economic freedom is the ability of individuals, families, and businesses to make their own economic decisions, free of coercion. The classic summary is:

Individuals have economic freedom when (a) property they acquire without the use of force, fraud, or theft is protected from physical invasions by others and (b) they are free to use, exchange, or give their property as long as their actions do not violate the identical rights of others. An index of economic freedom should measure the extent to which rightly acquired property is protected and individuals are engaged in voluntary transactions. (Gwartney et al., 1996: 12)

When they began to actually construct the economic freedom index, the leaders of the project faced an important question regarding the nature of the measurement: should it be subjective, based on experts' opinions, or should it be objective, based on third-party measurements? Several surveys of experts were undertaken, but comparisons



between different countries proved difficult since few of those surveyed possessed expert knowledge of more than one or two nations. Developing an objective measure of economic freedom was an attractive option for a number of reasons. In particular, the use of third-party data would mean that the index could be reproduced by other researchers, a key principle of empirical research.

The index now contains 42 separate variables to measure economic freedom. Most are based on hard economic data, but some variables (particularly those measuring legal structures, where hard data is typically not available) are based on surveys, such as the *Doing Business* survey by the World Bank which surveys professionals in various nations about institutional factors. While hard data would be preferable, the use of third-party surveys maintains the reproducibility of the survey, since other researchers have access to those surveys. More importantly, it maintains objectivity. The authors and any expert panel chosen by them would have biases that would influence the results, and perhaps even influence scores for nations they liked or disliked for entirely non-economic reasons. The use of third-party data maintains the necessary distance between the researchers and the results.

Participants experimented with several ideas for constructing the index, but the first comprehensive model was developed by James Gwartney, Robert Lawson, and Walter Block. It was developed for the fourth symposium on economic freedom and refined during the fifth, leading to the publication of the first full index in 1996.

The economic freedom index today

The economic freedom index has allowed researchers around the world to test the impact of economic freedom on people's lives. Put simply, researchers have found that individuals and families, when free to do so,

know their wants and needs and look after themselves better than even the most benevolent government. Economic freedom has also been linked to democracy and other freedoms. When the government has economic power over its

citizens—over their ability to get a job, support their family, find housing, choose where they live, get a promotion—it has powerful tools of coercion.

Since the publication of the first edition of *Economic Freedom of the World* in 1996, about 350 scholarly and policy articles have used the economic freedom indexes to explore the relationship between economic freedom and other socioeconomic outcomes. For example, it was used as the key measure of good institutions in the International Monetary Fund's 2005 report on institutions, *World Economic Outlook: Building Institutions*.

The index now measures economic freedom in 141 nations and territories, representing 95% of the world's population. Members of the Economic Freedom Network, which publishes the report, promote economic freedom in 76

different nations and territories, including Israel and the Gaza Strip, Pakistan and India, Cambodia and Vietnam, Georgia and Russia, and Colombia and Venezuela, to name a few.

A new tool has recently been developed by the Fraser Institute and the International Research Foundation of Oman: the Economic Freedom Audit, which was first undertaken in Oman. An audit brings together a nation's top political

leaders—usually at the cabinet minister level—policy makers, members of the media, opinion leaders, and business people to examine the nation's score on the 42 policy areas examined in the economic freedom index and compare it to the world and regional average scores and to the scores of the top 10 nations and territories. This pinpoints policy areas that need improvement and directs participants to best practices models. Because the economic freedom index provides a comprehensive description of a nation's economic policy, it can also be used to develop an economy-wide prescription for increasing prosperity and reducing poverty.

The influence and spread of the Economic Freedom of the World project has grown beyond the expectations of its

founders. It has provided, for the first time, an empirical measure to test Milton Friedman's argument that people in economically free nations live better lives than people in nations that lack economic freedom. Because of this, the index has had a strong effect on policy around the world. As Michael Walker notes:

I don't think that there is any question but that the index has changed the world in a very fundamental way. Most importantly, it has provided those who seek freedom a way to discuss it with their governments in an objective, unemotional, and comparative way. (Michael Walker, personal communication, September 2009) ■

Note

1 The opening section of this article depends largely on Walker (1996).

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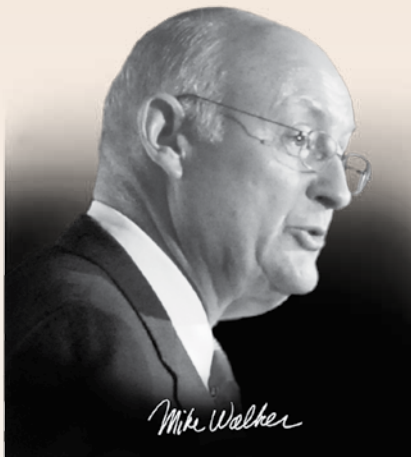
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Mike Walker



Fred McMahon is the Director of the Centre for Trade and Globalization Studies at the Fraser Institute. He manages the Economic Freedom of the World Project and examines global issues, such as development, trade, governance, and economic structure. He has an M.A. in economics from McGill University.



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Things folks know that just ain't so

A complex system of taxation in Canada is necessary

Why it ain't so...

compiled by Courtenay Vermeulen

Every spring, Canadians spend a tremendous amount of time, money, and energy filing tax returns in compliance with Canada's complex tax system. One problem with the current system is that, with so many different rules and exceptions, it is possible for two Canadians with exactly the same income to face different tax burdens. Complicating matters further are Canada's multiple tax brackets; as income rises, tax rates increase and the amount of tax people owe also increases. This system of taxation (often referred to as a "progressive" tax system) discourages productive behaviour, such as hard work and innovation, which can result in higher incomes. Is all this really necessary?

The inconvenience imposed by Canada's complex tax system could be remedied with the introduction of a flat tax. If Canada adopted a flat tax, a single tax rate would apply to all sources of income for both individuals and businesses (Rabushka and Veldhuis, 2008).

How would a flat tax work for individuals? A few basic calculations on a postcard-sized form would determine

the amount owing or refund due. First, tax filers would add up all of their income from wages, salaries, and pension benefits. Then they would subtract their personal exemption amount (the amount of income that can be earned tax-free) and multiply that number by the flat tax rate to determine their annual tax bill. Income from dividends, capital gains, interest, and fringe benefits would not be taxed individually because this income would be taxed at the business level. Approximately 85% of Canadians would only need to fill out a simple form (figure 1) to file their taxes. The remaining 15% who are self-employed would use an equally simple form to file their business taxes.

How would a flat tax work for businesses? The flat tax would replace the current corporate income tax system with a single business tax. Income derived from the sale of goods and services would be subject to the business tax, minus a few deductions. These deductions would be limited to the cost of inputs (e.g., raw materials, utility expenses, etc.), wages and salaries, and capital investments (e.g., buildings, equipment, and land).[1] The remainder would be taxed at the same rate as the income of individuals.

A flat tax would only tax business income once, eliminating the double taxation that is present in the current system. Businesses would not be permitted to deduct interest payments or any other payments to owners (fringe benefits) in the form of expenses. Excluding these kinds of deductions and making businesses pay tax on them would ensure that they are taxed only once. The income individuals and families receive from businesses would be exempt from personal taxation because it would already have been taxed at the business level.

The introduction of a flat tax would produce many benefits for Canadians. The total cost associated with paying personal income taxes, including the time Canadians spend preparing and filing taxes, and the cost of tax software and accounting services, amounts to about \$3.9 billion each year (Veldhuis, 2008). With the introduction of a flat tax, the need of many Canadians to enlist the help of an accountant to file a tax return would greatly diminish or disappear. Other compliance and administrative costs currently endured by tax filers would also decrease or disappear, and many government revenue officials in the public sector would no longer be needed.

Not only would a flat tax save Canadians considerable time and money, but it would also promote economic activity. The distortions under Canada's current

progressive tax system and the incentives created by deductions, exemptions, and credits would disappear. Canadians with the same level of income would pay the same amount of taxes, incentives for people to engage in productive economic activity would be improved, and disincentives for individuals to make capital gains would be removed (Rabushka and Veldhuis, 2008). A flat tax would encourage businesses to make capital investments, which would promote further investment, innovation, and entrepreneurship in the Canadian economy (Rabushka and Veldhuis, 2008). The overall result of these benefits would be increased economic output and higher living standards.

The same amount of tax revenue could be collected with a flat tax as with our current system of taxation. Federally, the flat tax rate required to match current levels of tax revenue would be 15%; provincially, flat tax rates would range from 6.1% in Newfoundland and Labrador to 15.5% in Quebec. With the federal and provincial flat taxes combined, Canadians' tax rates would range from 21.1% to 28.5% (Rabushka and Veldhuis, 2008).

A flat tax is easy to understand and it would greatly simplify the process of filing tax returns. It would provide Canadians with a single, low tax rate and result in a significant reduction in compliance and administrative costs. The distortions caused by our progressive tax system and other special tax incentives would be

eliminated, while incentives to engage in productive economic activity would be improved. For Canadians, a flat tax would be a convenient, efficient, and economically productive alternative to the status quo. ■

Note

1 The full value of capital investments would be deductible in the year of purchase.

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Courtenay Vermeulen is the Education Programs Coordinator at the Fraser Institute and Editor of Canadian Student Review. She obtained her bachelor's degree in commerce, specializing in international business, from the University of Victoria.



Canadians would only need to fill out a simple form

Figure 1: Sample form for federal Individual Wage Tax

Form #1—Individual Wage Tax		Tax Year 2006	
Your first name and initial	Last name	Your social insurance number	
Present home address (number and street including apartment number or rural route)		Spouse's social insurance number	
City or town, province and postal code		Your occupation	
1 Wages and salary		Spouse's occupation	
2 Pension and retirement benefits		1	_____
3 Total compensation (line 1 plus line 2)		2	_____
4 Personal Exemption		3	_____
(a) Basic personal amount (\$8,839)		4(a)	_____
(b) Spousal amount (maximum of \$7,505)		4(b)	_____
(c) Equivalent-to-spouse amount (maximum of \$7,505)		4(c)	_____
5 Total personal exemption (line 4a plus line 4b and 4c)		5	_____
6 Taxable compensation (line 3 less line 5, if positive; otherwise zero)		6	_____
7 Federal Wage Tax (15% of line 6)		7	_____
8 Tax withheld by employer		8	_____
9 Tax due (line 7 less line 8, if positive)		9	_____
10 Refund due (line 8 less line 7, if positive)		10	_____

Source: Clemens, 2008.

Tear it down!

Why public housing projects just don't work

by Tim Mak

Atlanta, home of the United States' first government-funded housing project, has finally made plans to bulldoze all of its large public housing developments.

Good riddance. When this housing project was built in 1936, President Franklin D. Roosevelt praised Georgia's capital city for building a "tribute to useful work under government supervision." But after decades of perpetual poverty, crime, and dilapidation, Atlanta is bringing these developments down.

Large, centrally run public housing projects have failed wherever they have been built—in both the United States and Canada—and the demise of these projects should be welcomed. One fundamental problem with public housing projects is the lack of property rights. Property rights have long been recognized as important to a successful development. If people own something, they have an incentive to maintain it and improve it. In this way, public ownership of housing robs tenants of the incentive to invest in their home and enhance its condition. Without this incentive, housing falls into disrepair.

Some advocates of "social justice" would suggest that public housing projects simply need more money. But the underlying problem with public housing remains: people who do not own their own homes simply do not have a reason to take care of the property, and no amount of government funding will change that.

Another significant problem with public housing developments is the concentration of poverty and crime. Cramming the worst elements of social breakdown—poverty, crime, drug use, broken families, and low levels of educational attainment—into a small space is a recipe for disaster. In a Canadian public housing development, a person is two and a half times more likely to be assaulted, over three times more likely to be the victim of a break and enter, and over five times more likely to have their car stolen than a person who does not live in public housing (DeKeseredy et al., 2003).

Further exacerbating the social impacts of crime is the use and distribution of illicit drugs. A 2003 study found that people were 63% more likely to have abused illicit drugs in the previous year if they had lived in a housing project than if they had not (DeKeseredy et al., 2003). Such widespread



drug abuse can have a significant impact on the futures of the people who live and grow up in housing projects.

The failure of government-owned housing is just another example of the unintended consequences of well-intentioned public policies. I am sure that the bureaucrats in charge of public housing programs want to help people who are living in poverty. But instead of bringing about positive change, centrally planned public housing projects may actually perpetuate their residents' unfortunate circumstances and reduce their chances to have a better life.

As Atlanta rids itself of its last public housing projects, Canada should consider following suit. It's time for the government to radically rethink its approach to housing policy. ■

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Tim Mak is a reporter for David Frum's FrumForum and a contributor to the National Post's Full Comment. In the summer of 2007, he was the Donner Canadian Awards intern at the Fraser Institute. He has previously worked at the American Enterprise Institute and in the Office of the Minister of Foreign Affairs.

HOT TOPICS!



New videos urge Canadians to “question the hype” about global warming

The Fraser Institute has released a series of videos urging Canadians to question the unfounded claims and fear-mongering of global warming activists.

The videos parody various schemes devised by environmental extremists and special interests to sway public opinion in support of new regulations that would give governments unfettered control over how people live and work.

“Global warming activist groups are some of the wealthiest special interests around the globe,” says Diane Katz, Fraser Institute Director of Risk, Environment, and Energy Policy. “They hire high-priced PR and advertising experts and enlist Hollywood stars to produce slick propaganda campaigns intended to scare people about the prospect of global warming.”

However, new evidence suggests that, contrary to the claims of global warming activists, the science is anything but settled. The Fraser Institute’s video series examines the claims of global warming alarmists with humour and irreverence. But a serious message underlies each video: people need to question the hype about global warming. ■

The videos are available at www.fraserinstitute.org/newsandevents/multimedia/2009.htm, or on YouTube at www.youtube.com/QuestiontheHype.

Study shows Americans are far more generous than Canadians

Manitoba is Canada’s most generous province for the 10th year in a row, but Americans continue to be far more generous than Canadians, according to an annual report on generosity released by the Fraser Institute.

The report, **Generosity in Canada and the United States: The 2009 Generosity Index**, shows that Manitoba has the highest percentage of tax filers among all provinces donating to registered charities (27.3%) and the highest percentage of aggregate income donated (1.02%).

“Manitoba has consistently topped the rest of Canada in terms of charitable giving, both in the number of tax filers who donate and the share of aggregate income donated,” says Niels Veldhuis, Fraser Institute Director of Fiscal Studies and co-author of the report.

At the national level, the United States surpasses Canada with 26.6% of American tax filers donating to charity, compared to 24.0% of Canadian tax filers.

Further, Americans gave 1.60% of their aggregate personal income to charity, more than double the 0.73% that Canadians donated to charity. ■

The complete study is available at www.fraserinstitute.org.



Ask the Professor

This online column examines a new topic each month through the lens of economics, philosophy, and history. Join us on the Fraser Institute website for a live online discussion with students across Canada, or post your questions for the professor today!

Here's an excerpt from the December 2009 Ask the Professor discussion about spontaneous order with Dr. Steven Horwitz, Charles A. Dana Professor of Economics at St. Lawrence University in Canton, NY. The full essay and chat history can be found at www.fraserinstitute.org in the Ask the Professor archives.

Dr. Horwitz writes:

The phrase “spontaneous order” is of twentieth century origin, but the concept underlying it has been at the core of economics and arguments for economic freedom for over 200 years. Spontaneous order (or “emergent order”) refers to the way in which the beneficial outcomes of the market economy are, in the words of eighteenth century philosopher Adam Ferguson, “the products of human action but not human design.” The beneficial order of the market is not the product of one person’s or one group’s conscious design, but is the unintended outcome of all of the freely chosen actions of human beings. In this way, spontaneous order is a broader restatement of Adam Smith’s famous “invisible hand,” which leads people acting out of self-interest to produce a result that was not part of their intention.

Jeff asks:

If companies are free to set their own prices, how is this spontaneous order?

Dr. Horwitz replies:

This is an important point. It’s true that companies can set any price they wish, but that doesn’t mean that all prices are equally likely. In fact, if firms are profit-seekers, then they will set a price that maximizes profit, and that price depends greatly on what consumers are willing to pay and what producers’ costs are. Those are two factors that companies do not control. So when firms set their price, their choices are, in one sense, wide open, but in another sense, very narrow. The price that emerges over time (for example, gas at \$1.00/litre) is one that is the result of no one party’s intentions. A

firm can’t pick whatever price it wants and expect to stay in business. Its range of choices is conditioned by the rest of the market.

In that sense, the price that emerges in the market is a spontaneous order because it is the product of interactions between sellers, buyers, the firms that sell the seller its inputs, and so on.

Put differently, why isn’t gas \$10/litre? A gas station could charge that if it wished, but it is constrained by other considerations. Hence, the price of gas is a spontaneous or emergent order.

Janice Leeds asks:

I am a believer in the herd instinct and would like to know your thoughts on its connection to spontaneous order. For example, Bernie Madoff’s Ponzi scheme was probably successful because individuals trusted the other people who believed him. Can we really call this “spontaneous,” or is it just the result of a human tendency to go with the herd?

Dr. Horwitz replies:

Great question! It’s true that people do tend to follow the lead of others and that we also tend to follow the same sorts of market signals at the same time. And sometimes this can lead to trouble, as with Madoff. But signals matter too. For example, one reason why so many people in the United States made so many bad investments in housing was that the interest rate signal they all relied on (as well as some other signals) was being distorted by bad government policy—in this case, through the central bank.

We tend to assume that government regulators are doing their jobs and would never allow a fraud as brazen as Madoff’s to be perpetrated. But if everyone relies on a signal that is clearly false, we can end up with trouble.

I really don’t like to say that these phenomena are the result of the “herd instinct.” It is more accurate to say



that humans tend to follow similar signals. In markets where signals are allowed to function, our tendency

to follow them generally results in positive outcomes. Sometimes things do go wrong, but the market has built-in correction systems. Most of the “bad” herd instinct situations we can think of—but not all—occurred because one of those signals was malfunctioning in some way.

Scott Weldon asks:

Could you compare emergent orders to Darwinism? They appear to be almost the same concept. Aren't biological organisms (such as people) the result of a long process of spontaneous ordering in reaction to the world around us?

Dr. Horwitz replies:

YES! Excellent observation, Scott. In one sense, spontaneous order is the “master concept” behind both Darwinian evolution and social evolution. Human life—natural and social—is guided by a whole set of nested and intertwined spontaneous ordering processes. It's a very beautiful vision when you think about it.

More interesting is that the social notion of spontaneous order predates the biological one. Adam Smith and others had the basic idea in the 1700s and Darwin was familiar with Smith and the other early political economists. His vision of biological evolution in the natural world was an application of the idea of social evolution. It's often argued that the social sciences “stole” this idea from Darwin, but if anything it's the other way around!

So your observation is exactly correct. The natural world and the social world are both spontaneous orders. One of the most interesting problems we face is what to do when those orders overlap and even conflict, as is sometimes the case with environmental problems. ■

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