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In-depth book review

By James R. Lothian

[THE CHURCH AND THE MARKET: A Catholic Defense of the Free Economy. By Thomas E. Woods, Jr. Lexington Books 4501 Forbes Boulevard. Lanham, MD, 20706. 2005, 239 pp., PB $19.95].

■ In his introduction, Woods sets the stage for the detailed discussion of Catholic social thinking that follows with the statement that (p.1): "Moral principles and economic science are meant to play complementary roles. A sound moral foundation can help us to evaluate existing economic institutions in light of genuine principles of justice. Without economic knowledge, on the other hand, the moralist's advice can prove profoundly misguided, even destructive." Translated into the realm of practice, Catholics – be they laymen, religious, clergy or even popes – need to know and apply economic principles if their moral statements about economic issues are to make sense and be efficacious. As in moral philosophy more generally, one cannot ignore the "is" and go straight to the "ought."

Why the phrase "defense of the free economy" in the subtitle? As Woods goes on to make clear, in his view markets lead to superior outcomes to the alternative of government intervention in a variety of ways. Woods is certainly not alone in this judgement. I do not know of any recent polls on the subject, but my guess, based both upon my own professional interactions and my editorship of a scholarly journal in economics for close to two decades, is that a majority of research economists would concur with this general assessment, though not with some of the particulars of Woods' argument.

Woods pleads his case in the next six chapters of the book. In the seventh and last chapter, he returns to his original theme and offers a brief summary and some conclusions.

In chapter one, "The Defense of Economics," Woods provides an overview of economic method, the important informational role played by prices ("the socialist calculation problem" in his terminology), defines the nature of economic laws and advances the proposition that economics is science and hence value-free. In this latter regard, he quotes to good advantage from Fr. James Sadowsky, S.J., professor emeritus of philosophy at Fordham University, who states (p.31) "Economics indicates the probable effects of certain policies, while ethics determines what one should do." The one is descriptive; the other, prescriptive.

Woods quite rightly cites the sixteenth century Spanish scholastics associated with the University of Salamanca as examples of Catholic social thinkers who both recognized this distinction and did the hard work of getting their economic analyses right. What is amazing about these men is that they did so long before there was any such formal intellectual discipline as economics.

The specific approach to economics that Woods advocates is that of the "Austrian" school associated with, among others, the Nobelist Friedrich von Hayek and his former teacher Ludwig von Mises. Woods likens their approach to the realist positions of St. Thomas Aquinas and the late scholastics. In the process of this methodological discussion, he makes a side excursion to take a swipe or two at the "Chicago School" of economists. I will say more about these issues later.

Woods devotes the next five chapters to specific economic questions that to varying degrees have concerned Catholic social thinkers: prices, wages and labor conditions; money and banking; foreign aid and economic development; the welfare state and the family; and distributism. The focal points in most instances are the policy proposals that Catholic social thinkers have advanced and that Woods argues have often made little economic sense and that as a result have proven inimical to the goals that such thinkers have wanted to achieve. In each instance, Woods offers arguments with regard to why this is the case and why he regards the particular policies that he discusses as counterproductive.

Consider the question of wages and other forms of worker compensation, the subject of chapter two. For over one hundred years, beginning with *Rerum Novarurm*, continuing on with *Quadregesimo Anno*, *Laborem Exercens* and numerous statements by episcopal conferences, the notion of a just wage, or a living wage, have been a key feature of Catholic social thought. Much more often than not the policy proposal that has been advanced is some form of minimum wage legislation. Implicit in such proposals is the notion that prices – including wages, the price of labor services – are set arbitrarily and can, therefore, be changed with impunity by legal dictate. As Woods points out, economic theory suggests otherwise, so that what on the surface appears to be a win-win situation is, in fact, not that all. The minimum wage is harmful to the very people that the legislation is supposed to help. The reason is that the low-wage earner will simply be thrown out of work. He or she will, so to speak, be priced out of the market. If the moral good – helping the poor – is to be achieved, minimum wage legislation is the wrong way to do it. Better ways need to be found. Woods argues that over the long term, greater capital investment and the increased labor productivity and higher wage payments that result provide the cure. A more direct route to increasing labor productivity is what economists call "investment in human capital," increased education, better on-the-job training and the like. This of course is the route the Church has traditionally taken but in recent decades has de-emphasized.

What about foreign aid – does it help the poor in the less-developed part of the world? Certainly that is the presumption of *Populorum Progresso* and many subsequent Catholic statements in the same vein. Woods argues, however, that foreign aid too is counterproductive. The reason, he says, is that governments in the less developed countries and the political elites that support them squander the funds, either lining their own pockets or engaging in dubious and economically unviable investment projects. Instead of helping the poor, these government-to-government resource transfers simply shore up *dirigiste* regimes that through their actions decrease economic efficiency and thus hamper the growth in income that is so needed if poverty in the less developed part of the world is to be reduced. To support these conclusions, Woods cites the work of the eminent development economist Peter T. (later Lord) Bauer who four decades ago, when such views more most unpopular, first pointed this out. Since Bauer first wrote on that subject, there has been a good deal of work by economists suggesting much the same thing. Woods alludes to some of this work, but might have delved into the recent literature a bit more to buttress his position. One of the key conclusions of this literature is the importance of government economic policies to the growth process. Good policies – price stability, an absence of distorting government intervention at the levels of the firm and the household, open international trade and the like – and good institutions, the enforcement of private property being major – enable growth. They provide entrepreneurs with direct incentives to engage in the myriad cost-cutting activities that led to faster economic growth. They also raise rates of return to investment and thus increase income via that channel. Bad policies and bad societal institutions have reverse effects.

Woods' chapter critiquing distributism, the notion that, as Woods puts it, the best social system is one "in which 'productive property' is widely dispersed rather than concentrated," is far-reaching. In it, he touches on, among other things, economic insecurity and the free economy, the effects of the industrial revolution, the concentration of industry, the guild system and its modern counterparts, trade unions. The discussion throughout is a mixture of economic theory and review of the relevant empirical evidence. Although the focus of the chapter is on distributism *per se*, the topics covered are of much broader interest and might very well have stood on their own.

Woods' chapter "The Welfare State, Family and Society" is highly critical of the standard package of policies that governments throughout the industrialized world have pursued in the name of helping the poor. The problem, he argues, is not simply that they have been inefficient and non-efficacious in the small. In too many instances (aid to dependent children being an example), they have introduced incentives that have led to both the breakdown of the family and the erosion of private charity. He discusses Sweden, much vaunted as a welfare-state success story, as a case in point. In this regard, he writes (p. 157): "the real problems [with the welfare state] are cultural, social, and moral. The welfare state has not only encouraged perverse and destructive behavior, but it has also led to an idolatrous devotion to the central state, with its implied promise of a simple and costless political solution to every ill. . . . Over and against such false promises, we should turn once again to the families, churches, and cal institutions that we have allowed to atrophy under the domination of the central government, and which constitute what Edmund Burke aptly called the 'little platoons' of civilization."

Is Woods' central thesis that economic analysis is a requisite for sound Catholic social policy correct? Is he also correct in arguing that some of the key propositions of what has come to be regarded as "the" Catholic position on social policy - e.g., the minimum wage, foreign aid, and most recently, opposition to free trade – have been totally misguided? I certainly believe so. To my mind, moreover, he makes his case for both quite cogently and in a highly readable way. I also agree with very many, though not all, of his arguments with regard to specifics.

For the past two years, I have been one of a group of lecturers in a course offered at Fordham on Catholic social thinking for the Jesuit scholastics. In my lectures, I argue very much the same as Woods and, in fact, use many of the same examples. In the future, I intend to use his book as one of the readings. I will not recommend it to my students unqualifiedly, however, for two reasons.

One has to do with Woods' discussion of economic methodology. Most of this discussion is beside the point and, therefore, distracting. The fact is that there is very little, if any, substantive difference between the conclusions that would be reached on most of the issues that Woods discusses by someone who, like he, would describe himself as an "Austrian" and economists more generally. Good economic analysis is just that, and not a matter of schools of thought. Despite his arguments to the contrary, Woods in the event obviously agrees. Virtually all of the empirical evidence he cites to buttress his various arguments comes from studies by mainstream economists, a substantial proportion of whom either are or were associated with the University of Chicago.

Nor is it true, as Woods argues, that Austrian-variety economic analysis is more congenial on a philosophical level with scholasticism than neoclassical economics more generally. Economists are not philosophers and with rare exception do not venture into that field. In the actual conduct of their research, however – the presuppositions that underlie it with regard to the regularity of human behavior and the usefulness of empirical evidence – economists act very much as if they were scholastic natural-law thinkers.

The more serious problem that I have with the book centers around Woods discussion of money and banking in chapter three. Woods concludes that (p. 122) "the best monetary regime, from the point of view both of utility and of Catholic morality, is a 100 per cent reserve commodity money," that is, a monetary system in which the coinage is in gold (or another form of specie) and banks hold reserves equal to their deposit liabilities. While it is quite possible to make a coherent economic defense of such a monetary system, Woods does not do so.

The chapter, as it stands, is both confused and confusing and, hence, seriously detracts from what is in many other ways a fine book. In the chapter, Woods combines occasional bits of solid economic analysis with a series of empirically tenuous assertions, some quite tortured terminology, and a more than occasional bit of outright theoretical error.

A prime example is to be found in his

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discussion of banking. He writes: "There are moral implications of fractional-reserve banking . . . Simply put, the practice . . . amounts to institutionalized fraud. Banks that engage in this practice are inherently bankrupt, since if all their clients simultaneously demanded that their deposits be turned over to them, the bank would be forced to concede its inability to meet its obligations." This is just nonsense. A bank is a financial intermediary. It borrows funds from depositors and re-lends those funds to other firms and individuals. If the value of a bank's assets is equal to or greater than the value of its liabilities it is solvent by definition.

Part of the problem here is an exceedingly careless use of words. Lurking in the background, I suspect, is a confusion on Woods' part between what is true for one bank and what is true for the banking system as a whole. Suppose there is a sudden cash drain from an individual bank – Citibank for example – in which depositors want to withdraw more funds than the bank has immediately available. If Citibank is solvent, it can get the additional cash reserves either by borrowing them directly from other banks or by liquidating some of its non-cash assets. End of problem. If the drain affects the whole banking system, however, the first option is impossible given fractional reserves. A multiple contraction of money and credit will ensue with consequent deleterious effects on the economy. There is thus a "systemic risk." This is the kernel of truth in Woods' argument. Elimination of such systemic risk is the traditional argument for requiring banks to hold 100 per cent reserves. Risk and insolvency, however, are two different matters entirely. Referring to the former as "institutionalized fraud" is totally inappropriate and highly misleading.

The problems with Woods' arguments for the gold standard are largely, though not completely, empirical. A major benefit, he says, is that it will promote price stability. The evidence here, however, is mixed. The gold standard in the nineteenth and early twentieth centuries did lead to very long-term stability of prices, but this was certainly not true of a gold (and other commodity) standards more generally. Historically, debasements (mixing of ever greater proportions of base meals with the gold or silver coinage) and discoveries of new sources of gold or silver have led to substantial long-term increases in the general levels of prices. Over shorter, but still quite lengthy periods, moreover, prices fluctuated greatly as quantities of the specie currency exceeded or fell short of the real amounts that people wanted to hold. Nor is it true either theoretically or empirically that commodity standards are, as Woods also asserts, less prone to cyclical fluctuations. And when such fluctuations are monetarily induced, they will be readily transmitted internationally under a gold standard, as happened in the 1930s. There is a well-developed literature on these issues that Woods completely ignores.

To close on a note of criticism would, however, be unfair. Woods central message, that sound moral statements about economic issues have to be grounded in sound economics is to my mind incontrovertible. And, in the main, Woods brings this message home with well-reasoned and well-presented analysis. Both the message and the analysis deserve careful reflection. ■

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