

# MORALS AND MARKETS



## The Dangerous Balance

SECOND EDITION

DANIEL FRIEDMAN  
*and* DANIEL MCNEILL

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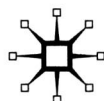
## **The Dangerous Balance**

*Second Edition*

Daniel Friedman and Daniel McNeill



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MORALS AND MARKETS

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# **Morals and Markets**

*To the memory of my mom, Marion Thelma Siegel Friedman (1918–1997).  
Biology teacher and humanist, skeptic and spiritual seeker, she first got me  
thinking about many of questions asked in this book.*

—D. F.

*To Rosalind Gold, with love.*

—D. M.

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## Prologue: A Tale of Two Tilts

**M**ikhail Gorbachev was relaxing in his lavish villa in the Crimea at 4:50 pm on August 18, 1991, when he learned he had visitors. One was a secret police official. He picked up his phone to see who the others were, but the line was dead. He tried others. They were all dead. He had heard murmurings of a coup before taking this vacation, but had waved them away. Now he gazed around at his palace, with its marble stairways and escalator down to the Black Sea, and felt dread.

"I paced the room and thought," he said later. "Not about myself, but about my family, my granddaughters."

His wife Raisa entered and they talked. She recalled the family of Czar Nicholas II, slaughtered in a cellar in 1918. Then he called the whole family in to tell them they were in real danger.

They waited.

The men arrived. It turned out they were administrators well known to him. His chief of staff, whom he had long trusted absolutely, informed him his reign was over. Gorbachev countered that he had to return to Moscow to sign an important treaty, but they said the treaty now lay in a Kremlin trash bin. They placed him under house arrest and added that Russian President Boris Yeltsin was also in custody.

The plotters then flew back to Moscow and joined the coup leaders: Gorbachev's own defense and security ministers. Many opened bottles and started drinking. The next day they told the world that Gorbachev was ill and a State Committee on the State of Emergency had taken charge. In case anyone missed the point, they sent tanks rumbling down Moscow streets.

But Yeltsin was hardly in custody. He climbed atop one tank to denounce the putsch on global TV. As the plotters got drunker and drunker, they waffled. Defiant radio stations kept broadcasting, and hundreds of thousands of protesters thronged the streets. Troops defected, and buoyant crowds pulled down statues of communist supermen. On August 21, the coup collapsed.

Gorbachev had his presidency back. Yet everything had changed. The coup triggered a cascade of events that would spread further and further.

For Gorbachev didn't have his power back. His appointees on the right had tried to oust him, and his appointees on the left had already drifted toward Yeltsin, so he stood starkly alone in the center. Indeed, he had looked impotent in the revolt, while Yeltsin seemed the bold hero.

Within a few months, Yeltsin and his counterparts in other Soviet republics shoved Gorbachev aside and broke the USSR like a walnut under a hammer. New nations like Belarus and Kazakhstan hoisted flags. After 74 years, the Soviet Union and its grueling experiment in communism had ended.

Most observers celebrated. Economists predicted a splendid future for the core of the old empire, Russia. With a bonanza of natural resources, advanced technology, and a well-educated workforce, Russia no longer had to prop up the more backward parts of the Soviet realm or contort itself to satisfy orthodoxy. True markets could pump out wealth.

Yet things got worse. Responding to critics one year later in 1992, Harvard professor Jeffrey Sachs, a top advisor to Yeltsin's government, wrote that reform would yield "very great" benefits. Data about Russia's progress after a year was "incomplete and misleading," he said, "and easily misinterpreted to give an overly bleak account... [resulting in] undue pessimism about the reform policies."

But the pessimists were way too optimistic. The economy collapsed, and during the 1990s Russia was the sort of place that gives anarchy a bad name. The new tycoons, called "oligarchs," and their partners in government and in the Mafiya, the Russian mob, destroyed almost as much Russian wealth as Hitler's invasion 50 years earlier.

The economic team had rightly viewed private ownership as essential to national growth, and began privatization in late 1993. This was a massive enterprise. The state had owned almost everything but minor personal household goods, so a vast treasure was being uprooted and floated to new destinations. The insiders of the Communist Party and KGB found the lure irresistible. In alliance with black market figures, they seized the pelf and stashed it in safe places like Switzerland.

Pillage is essentially a medieval operation, but in Russia the looters used 20th-century tactics.

The first was bank fraud, a kind of telecom Bonnie and Clyde. In this ploy, one company sent a wire transfer of funds to another, and it went through the Central Bank, as all transactions did in Russia. The Central Bank checked the first company's account, okayed the deal, and placed the funds in the second company's account. The second company then withdrew them. So far, so good. Except that the second company quickly disappeared. Then the Central Bank discovered that the first company never really had that money after all, but it too had vanished.

How could such a scheme possibly work? It required a carrot and a nasty stick: 1) modest payoffs to Central Bank employees who provided the codes to approve the bogus transfers, and 2) the murder of resisters. Over 25 bank officials met violent ends between 1992 and 1995. In a particularly exotic killing, banker Ivan Kivelidi died in 1996 after swallowing a nerve toxin placed on the lip of his cup. Bank fraud worked especially well in 1990–92 and involved tens of billions of dollars.

Capital flight was even more lucrative. The Soviet Union had kept prices artificially low, so citizens could afford basics like bread and gas. To prevent operators from selling these goods abroad and making a fast ruble, the government enforced strict export controls. In this ploy, the looter evaded them. He first



bought oil, natural gas, or even wheat at the low Soviet price. He then got permission (sometimes with a bribe) to export and sold the goods at a low price to a foreign partner or shell company. The foreign partner in turn sold on world markets at a much higher price and earned a huge profit in hard currency. The booty went into a Swiss bank account or the equivalent. This scam became easier after 1991 “reforms” eased most export controls. Crooks siphoned off some \$100 billion this way during the 1990s, wiping out the Soviet Union’s entire gold and foreign currency reserves, as well as large loans from the IMF.

Basic organized crime flourished, involving protection rackets, smuggling, drugs, and prostitution. Protection schemes were tapeworms in the economy. They sucked away business profits, boosted costs, and slowed trade. And once the Mafiya got rolling in the early 1990s, it began to move upscale. For example, it opened new casinos and took over many legitimate hotels. In 1993, Yeltsin estimated that two-thirds of all commerce was connected to organized crime—an astounding figure but in line with subsequent estimates by experts.

The biggest scam of all was auction rigging. It yielded several trillion dollars in plunder. The basic idea is simple: Hold an auction and gag everyone else. Looters often bid less than one percent of fundamental value for an asset like an oil field or factory, while their partners in the government and the mob suppressed rival offers. For example, Gazprom, with natural gas reserves worth about \$500 billion, sold to insiders for one twentieth of one cent on the dollar. Almost all state assets went on the block, in the largest and most corrupt auctions the world has ever seen.

Some top “conservatives” in the KGB and Communist Party commenced this looting around 1990 as the Soviet system was ending. But even more ruthless operators soon displaced them. In Russia, men at the edge of power often saw the opportunities sooner and more clearly than the old rulers. Of course, everyone still needed a “roof”—protection against intervention from government and other thieves—so the old-timers and their minions still got some of the loot. But Russia’s crown jewels went to men like Boris Berezovsky, the crooks who became the “oligarchs.”

As these new men soared in the 1990s, Russia’s economy starved. You could see the impact everywhere. As black-windowed Rolls-Royces purred through the streets and the new elite drank \$150 Scotch in nightclubs, the justice system and government agencies crumbled. Taxes were huge and often bizarre—there was a tax on business *losses*, for instance—but went unpaid by companies with good connections like Gazprom. Among the police and military, morale and discipline vanished, and officers survived mainly by selling weapons and protection services to the highest bidder. The 1993 Russian murder rate set new records quadrupling that of the United States in one of our worst years ever. Thugs assassinated eminent individuals, yet seemed beyond the reach of the police and courts. At the same time, Russia’s world-class medical and educational systems collapsed. Teachers could no longer earn a living wage, and doctors gave their own blood for transfusions. Live birth rates dropped while alcoholism and disease reached new highs. Life expectancy plummeted, especially for men, resulting in about 6 million excess deaths.

The final blow was a huge default on international debt in July 1998. The nation's economy fell to less than half its former size and ranked behind those of Brazil and Mexico. It was no longer a superpower.

In sum, Russia's transition from communism was among the 20th century's worst disasters. What had the US economists missed? Why did the invisible hand that bred wealth in the West steer it to criminals in Russia and cripple the state?

\* \* \*

"It felt like war," said doorman Dimitris Arvanitis. "I could not believe I was in Athens. I have never seen this in my almost 60 years of life, and I have been working here all my life."

It was morning, February 13, 2012. The previous day 80,000 Greeks had demonstrated, and violence began that night. Angry rioters flung gasoline bombs into shops and torched 48 buildings, including banks, cafes, and two movie theaters. They vandalized some 150 other buildings and injured scores of police. After sunrise, as smoke wafted up from gutted structures, pedestrians coughed from the tear gas as they stepped around shards of glass and broken marble on the sidewalk.

The cause of it all? The Greek Parliament had just approved austerity measures in order to get \$170 billion in rescue financing. The nation had to make payments on a bond the following month and needed these funds to prevent a default. In exchange, it promised the Eurozone to cut the national budget, reduce salaries, and alter an array of government practices.

The latter was ironic, because Athens was the site of the first formal democracy we know of. There, 40 times a year, adult male citizens assembled on a slope overlooking the Agora, the public square, and decided public issues by a majority vote. Athens had the most responsible system on earth, and it became the inspiration for the fledgling United States and eventually much of the world.

In 1981 Greece joined the European Community, the forerunner to the EU, and Europe felt honored to embrace it. From 1996 to 2008 the nation enjoyed the highest growth rate in the Eurozone. Salaries rose, fancy shops appeared, and gleaming new cars purred down the streets. In 2004 a proud Athens hosted the Olympic Games, and for two weeks it held the world's attention. The European Central Bank had based the euro symbol on the Greek letter epsilon, in honor of the "cradle of European civilization," and now Europe seemed the cradle of a new Greece.

Yet it all peaked in 2009, and by 2012 economic wreckage lay everywhere. Tax revenue was plunging. Workers were getting termination notices right and left. Indeed, unemployment reached Great Depression levels: 25 percent overall and almost 30 percent for Greeks between 25 and 34. Filling a 16-gallon tank of gas cost \$136, so cars spent more and more time as garage ornaments. Trash collection waned in Athens, and rats multiplied. Once quiet neighborhoods throbbed with crime, and thieves even stole ancient treasures from the museum at Olympia. The national insurance system got so unreliable that pharmacists began demanding full payment for drugs, and some patients went without medicine entirely. Malaria and HIV rates increased.

In September 2012, a general strike closed the Acropolis as well as gas stations, ferries, and schools, and hospitals resorted to emergency workers. One hospital staffer who left his post was Alkis Betses. His salary had shrunk from €1,300 to €800 (\$1,690 to \$1,040) a month, he said, and he expected it to drop to €600 (\$780). “How can you survive on €600 a month, with ever-rising taxes, and continue to pay bills and buy necessary supplies?” he asked. “If the washing machine breaks down, where do you get the money for repairs?”

Meanwhile, taxes were rising, so more and more citizens shifted transactions into the shadow economy. On one business trip to the tourist isle of Santorini, three tax collectors spotted a gas station owner demanding payment in cash to avoid declaring it as income. When they asked what he was doing, he raged at the government and snapped a bullwhip at them.

A deathly mood settled in. “There is a depression in the Greek people, in all my friends,” one college student told the *New York Times* in 2012. “They keep saying: ‘I can’t take it. There’s depression about our jobs, depression on the news, depression about the economic situation, depression in our family, depression and fighting among friends.’”

With the riots and gloom, anyone might think Greece was the biggest victim of the European crash. Yet other Europeans claimed Greece had ripped them off, that the most responsible government of antiquity was the least responsible on the continent today.

Greece had become the gangrenous leg of the Eurozone. It didn’t respond to treatment, yet no one wanted the trauma from cutting it off. The country itself was aching and every remedy worsened the pain. And at times the whole European crisis seemed to pivot around Greece.

What had happened to this fabled nation? Why did others hate it so much? And how could its prosperity just evaporate?

\* \* \*

Each of us is a wonder of balance. We may be over six feet tall and weigh 200 pounds, yet we stand effortlessly on two small feet. Even cats, with their marvelous grace, use four legs and a tail. Balance comes naturally to us since we’ve had millions of years to evolve it. We have vestibular systems in our inner ears that automatically send signals to the muscles that keep us upright. The whole thing works so well that we take it for granted, as we realize with amazement when we suffer labyrinthitis and can’t stand despite our hardest efforts.

Morals and markets lack this well-tuned balance. Though they need equilibrium, they have no vestibular system for it and no automatic signals to keep them in tune. If anything, our instincts deceive us about morality and markets, so trouble occurs more often. Yet the result is similar: Economies like Russia’s and Greece’s can lose their footing and wind up on the floor.

“Morals” has a fusty ring, through its association with nags and killjoys, but morals lie at the heart of our most gripping concerns. They are full of life and juice. They animate issues such as abortion and the death penalty. We ignore their power at our peril, as cheaters like Enron’s CEO Jeff Skilling and slugger

Mark McGwire discovered. It's unclear how many countries have learned the same lesson.

Markets need morals. A farmers' market, say, must have trust to function well. Buyers won't come if too many vegetables are rotten inside. And a market economy like the United Kingdom needs morals too, for it is a vast interlocking web of promises and understandings. We can think of a market economy as a broad vine with richly colored blossoms that rises to the sky. But morals are the trellis it hangs on, and without them, it is just a low shrub.

Though few realize it, markets have also made us more moral. They not only encourage cooperation, but since they've increased wealth, they've enabled boons like police and public health systems. As we brought morals and markets into alignment a few hundred years ago, warfare dropped off and so did crime. Markets bred the world of peace we live in today.

But if the benefits run both ways, so do the hazards.

Morals can sabotage markets. The ethical compass is a poor guide to the market landscape, and the world has seen plenty of examples of good intentions leading off the cliff. Markets can also corrupt morals, and many believe Wall Street has suffered this blight. And since we lack an inner guidance system, we not only cause such tilts, but sometimes celebrate them until it is too late.

The dangerous balance led to the crash of 2008 and the aftermath, but it also affects economies more broadly. It has deeply influenced corporate life, terrorism, the War on Drugs, and global warming, among other issues related to our happiness. It is a core dynamic of our world. It touches the lives of people everywhere.

And unfortunately it's not a simple seesaw. We can't just aim for equal weight on both sides. The balance is subtle and multidimensional, and the influences flow several ways at once. Yet we must understand it, or we're in for debacles again and again.

To grasp it, we have to look deep into history. Ultimately, Russia wound up helpless against gangsters because of ideals that go back to prehuman tribes, and Greece got into trouble partly because of moral barriers that arose from morals themselves. The great events in our economies stem from the forces that created us in the first place.

So let's go back to the origin of morals. What are they? Why do we have them?

I

# Two Halves of the Balance

*The great division of our affections is into the selfish and the benevolent.*

—Adam Smith



# The Savanna Code: What Good Are Morals?

*We must, indeed, all hang together, or assuredly we shall all hang separately.*

—Attributed to Benjamin Franklin

Dawn can be cool and quiet in Olduvai Gorge in Tanzania. The hyenas cease wailing and thorn bushes on the canyon's brink tremble in the breeze. Soon, the sun will light the gray strata of the ravine, and eventually it will rise higher in the blue sky and oppress the land with heat. Tourists will arrive from all over the globe, snapping photos and uploading them to their Facebook pages.

For Olduvai is the most famous site of our prehuman ancestors, where the maverick Louis Leakey and his wife Mary labored unknown for over 30 years, seeking our origins on a continent others scorned. In 1961 they discovered *Homo habilis*, the first member of our genus, and triggered a rush of scientists to Africa.

The 300-foot gorge is no Eden. It is dry and dotted with spindly plants. Tourists can't see the priceless fossils unless they go to museums, and more important sites now exist elsewhere in East Africa—especially in the north along the Rift Valley, beside green Lake Turkana, and in the Afar region of Ethiopia near the Red Sea.

Yet Olduvai is symbolic. And here, at the origin of humanity, the first half of the dangerous balance began to take shape.

## The Great Leap Forward

Our evolution from other creatures was swift and stunning. Today, the four great apes struggle against extinction, but our own species has eight times more biomass than all wild land vertebrates combined. From the Kanto Plain of Japan to the Antarctic ice shelf, we've altered the physical world more drastically than any other animal in history. Physically, we're much taller than chimps. We have seemingly hairless bodies, flat faces, and ultra-nimble hands, all novelties. We're smarter, with the highest brain-to-body mass ratio of any creature. We have

music, art, and language with syntax. We've built tools, from the hoe to the Large Hadron Collider, and we've left some on Mars.

And those are just the obvious differences.

Chimps will never build an Eiffel Tower, and it's not just because they lack the intelligence, dexterity, technology, and communication skills. They don't cooperate well enough. But we work together on a scale and with a finesse unseen in the planet's history. We convey complex ways of life—cultures—across generations, so we benefit from the experience and ingenuity of the long dead. And supporting it all we have morals: standards for our own behavior and the conduct we expect of others.

We developed these traits in a flicker of evolutionary time—just 2.5 million years. By one estimate, our ancestors' brains gained an average of 100,000 neurons and support cells with each generation. How did it happen? What created you and me?

These are among the most fundamental questions we can ask. They are basic to our understanding of who we are and why we act as we do. They have tantalized humanity as far back as we can see, and every culture has spun out fantasies to quell the itch. We still don't know the answers in detail, but we finally have solid evidence and many persuasive ideas.

In *An Essay on the Principle of Population* (1798), economist Thomas Malthus (1766–1834) made a famous argument that social hardship was inevitable. We breed more than we can feed, he said. Creatures always have more offspring than the environment can support, so some percentage must die in every generation. Charles Darwin read this work in 1838, and in his 1876 autobiography he said, "It at once struck me that under these circumstances favorable variations would tend to be preserved, and unfavorable ones to be destroyed. The results of this would be the formation of a new species." The environment filters for good traits. It's like a game where round after round—generation after generation—the better players advance, and the poorer ones drop out. In *The Origin of Species*, he wrote, "I have called this principle, by which each slight variation, if useful, is preserved, by the term Natural Selection."

In East Africa around 4 or 5 million years ago, a few apes moved out of the forest to dwell in a new environment: the proto-savanna, or forest interspersed with grasslands. There, Darwin's process sieved generations and changed them into new beings: australopithecines, like the famous Lucy. These creatures were no taller than a yardstick, and their brains were about the size of a chimp's. But the proto-savanna had more open space, and they often walked upright to save energy. Chimps, in contrast, can't straighten their legs and find walking arduous. The australopiths were not wholly bipedal, however, and they used their curved feet to climb trees, perhaps to sleep in safety from predators like *Dino felis*, a saber-toothed cat.

Then about 2.7 million years ago, the Northern Hemisphere began getting a little less sunlight in the summer, because of factors like the tilt of the earth's axis. The small loss of warmth triggered big effects. Glaciers formed in the Arctic, two-mile thick ice sheets spread, and sea level dropped as much as 400 feet. The boundary here is so striking that geologist Charles Lyell (1797–1875) gave the



chilly epoch that followed its own name: the Pleistocene (from the Greek for “most new”).

This era incubated us. We were born of ice.

In Africa the landscape altered. It grew drier and true savanna appeared: grassland dotted with trees, like the parks we create for our pleasure. The ancestors of gazelles, giraffes, and zebras multiplied, and herds spread. Proto-tourist Africa had arrived.

But the biggest climate change 2.7 million years ago was constant change itself. The ice sheets didn’t just expand. They spread and ebbed like tides, since the amount of summer sunlight hitting the north varied. Radical shifts occurred as often as every 10,000 years, and climate graphs of the Pleistocene, based on Greenland ice cores and Atlantic sediment cores, resemble seismographs in an earthquake.

So Africa became a yo-yo world. As glaciers advanced, drought sucked moisture out of the continent. A column of desert often stretched from the Sahara all the way down the Rift Valley to the Kalahari in the south, breaking the savanna into fragments and scrambling ecosystems. Then, as ice sheets withdrew and the planet warmed, monsoons and trade winds brought heavier rainfall. Lake Chad swelled into Mega-Lake Chad, the middle Congo River became a huge inland sea, and the savanna fused again.

In this environment, generalists thrived. We were born of change as well.

The first member of our genus, *Homo habilis*, appeared soon after the Ice Ages created a drier Africa, some 2.5 million years ago. It always walked upright, though it stood just a bit taller than the australopiths. And its brain grew 50 percent larger, to around 0.75 liters, an astonishing development, since brains are greedy for nourishment and therefore costly. (At 1.35 liters, adult human brains consume about 16 percent of our resting metabolism; for most mammals, the figure is 2 to 5 percent.) So next to the australopiths, these primates had almost godlike minds.

Why exactly did *Homo habilis* appear? A species is just a strategy for success, and the big herds were an economic opportunity. They rewarded good new strategies, just as social media and smartphone technology have recently. And carnivores made it easy. They left plenty of meat behind after a kill, so *Habilis* saw little buffets everywhere. It began taking the leftovers. And with its free hands and progressively smarter brain, *Habilis* was made for stone tools. It could carry them easily, and they let it strip a carcass better than any big cat. With sharp flakes it could slice tough hides, and with the blunter tools it could crack open thighbones to get the nutrient-rich marrow. So *Habilis* used tools routinely, and in fact its name means “handyman.”

But this advantage may not be the full story. The alternative may have been dire. Overall, the genetic chain from *Habilis* to us was tenuous and we are lucky to exist at all. Our lineage rarely had more than 20,000 to 30,000 individuals—about the population of Key West, Florida. (In comparison, there are today about 50,000 Indian elephants, an endangered species.) Presumably this was the Malthusian limit, the extent to which prehumans could feed themselves.

That limit swung up and down. When the grass withered, lakebeds cracked, herds dwindled, and the food supply shrank. As the death rate rose, prehumans