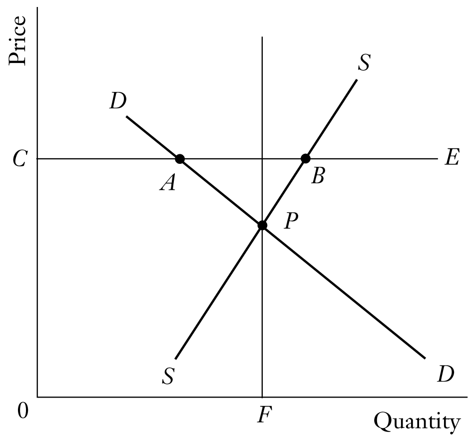

FIGURE 84. EFFECT OF A MINIMUM PRICE CONTROL

same time, discouraging buyer demand. Under selective price control, resources will leave other fields where they benefit themselves and consumers better, and transfer to this field, where they overproduce and suffer losses as a result.

This offers an interesting example of intervention tampering with the market and causing entrepreneurial losses. Entrepreneurs operate on the basis of certain criteria: prices, interest rate, etc., established by the free market. Interventionary tampering with these signals destroys the continual market tendency to adjustment and brings about losses and misallocation of resources in satisfying consumer wants.

General, over-all price maxima dislocate the entire economy and deny consumers the enjoyment of substitutes. General price maxima are usually imposed for the announced purpose of "preventing inflation"—invariably while the government is inflating the money supply by a large amount. Over-all price maxima are equivalent to imposing a *minimum* on the PPM (see Figure 85): *0F* (or S_mS_m) is the money stock in the society; D_mD_m the social demand for money; *FP* is the equilibrium PPM (purchasing power of the monetary unit) set by the market. An imposed minimum PPM above the market (*0C*) injures the clearing "mechanism" of the market. At *0C* the money stock

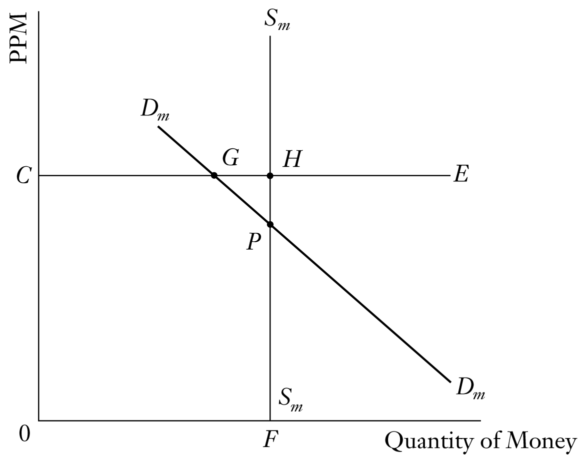

FIGURE 85. EFFECT OF IMPOSING GENERAL PRICE MAXIMA

exceeds the money demanded. As a result, people possess a quantity of money *GH* in "unsold surplus." They try to sell their money by buying goods, but they cannot. Their money is anesthetized. To the extent that a government's over-all price maximum is effective, a part of people's money becomes useless, for it cannot be exchanged. But a mad scramble inevitably ensues, with each person hoping that *his* money can be used.[21] Favoritism, lining up, bribes, etc., inevitably abound, as well as great pressure for a "black" market (i.e., *the* market) to provide a channel for the surplus money.

A general price minimum is equivalent to a *maximum* control on the PPM. This sets up an unsatisfied, excess, demand for money over the stock of money available—specifically, in the form of unsold stocks of goods in every field.

[21]Ironically, the government's destruction of part of the people's money almost always takes place *after* the government has pumped in new money and used it for its own purposes. The injury that the government imposes on the public is twofold: (1) it takes resources away from the public by inflating the currency (see below); and (2) after the money has percolated down to the public, it destroys part of the money's usefulness.

The principles of maximum and minimum price control apply to *any* prices, whatever they may be: of consumers' goods, capital goods, land or labor services, or, as we have seen, the "price" of money in terms of other goods. They apply, for example, to minimum wage laws. When a minimum wage law is effective, i.e., where it imposes a wage above the market value of a grade of labor (above the laborer's discounted marginal value product), the supply of labor services exceeds the demand, and the "unsold surplus" of labor services means *involuntary mass unemployment*. Selective, as opposed to general, minimum wage rates, create unemployment in particular industries and tend to perpetuate these pockets by attracting labor to the higher rates. Labor is eventually forced to enter less remunerative, less value-productive lines. This analysis applies whether the minimum wage is imposed by the State or by a labor union.

The reader is referred to chapter 10 above for an analysis of the rare case of a minimum wage imposed by a *voluntary* union. We saw that this creates unemployment and shifts labor to less remunerative and value-productive branches of employment, *but* that these results must be treated as voluntary. To prohibit people from joining unions and agreeing voluntarily on union wage scales and on the *mystique* of unionism would subject workers by force to the dictates of consumers and would impose a welfare loss upon the former. However, as we stated above, a spread among the workers of praxeological knowledge, of a realization that union solidarity causes unemployment and lower wage rates for many workers, would probably weaken this solidarity considerably. Empirically, on the other hand, almost all cases of effective unionism are imposed through coercion exercised by unions, i.e., through union *intervention* in the market.[22] The effects of union intervention are then the same as the

[22]In the present-day United States, much of the task of coercion has been assumed on the unions' behalf by the government. This was the essence of the Wagner Act, the law of the land since 1935. (The

same degree of government intervention would have been. As we have pointed out, the analysis of intervention applies to *whatever* agency wields the violence, whether private or governmental. Unemployment and misallocations of many workers to less efficient and lower-paying jobs again occur in this case and again involuntarily.

Our analysis of the effects of price control applies also, as Mises has brilliantly shown, to control over the price ("exchange rate") of one money in terms of another.[23] This was partially seen in Gresham's Law, one of the first economic laws to be discovered. Few have realized that this law is merely a specific instance of the general consequences of price controls. Perhaps this failure is due to the misleading formulation of Gresham's Law, which is usually phrased: "Bad money drives good money out of circulation." Taken at its face value, this is a paradox that violates the general rule of the market that the best methods of satisfying consumers tend to win out over the poorer. The phrasing has been fallaciously used even by those who generally favor the free market, to justify a State monopoly

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Taft-Hartley Act was only a relatively unimportant amendment to the Wagner Act, which continues on the books.) The crucial provisions of this act are: (1) to coerce all workers in a certain production unit (arbitrarily defined *ad hoc* by the government) into being represented by a union in bargaining with an employer, if a majority of workers agree; (2) to prohibit the employer from refusing to hire union members or union organizers; and (3) to compel the employer to bargain with this union. Thus, unions have been invested with governmental authority, and the strong arm of the government uses coercion to force workers and employers alike to deal with the unions. On special coercive privilege granted to unions, *see also* Roscoe Pound, "Legal Immunities of Labor Unions" in *Labor Unions and Public Policy* (Washington, D.C.: American Enterprise Association, 1958), pp. 145–73; and Frank H. Knight, "Wages and Labor Union Action in the Light of Economic Analysis" in Bradley, *Public Stake in Union Power*, p. 43. *Also see* Petro, *Power Unlimited*, and chapter 10, pp. 714–15 above.

[23]Mises, *Human Action*, pp. 432 n., 447, 469, 776.

over the coinage of gold and silver. Actually, Gresham's Law should read: "Money overvalued by the State will drive money undervalued by the State out of circulation." Whenever the State sets an arbitrary value or price on one money in terms of another, it thereby establishes an effective *minimum* price control on one money and a *maximum* price control on the other, the "prices" being in terms of each other. This, for example, was the essence of bimetallism. Under bimetallism, a nation recognized gold and silver as moneys, but set an arbitrary price, or exchange ratio, between them. When this arbitrary price differed, as it was bound to do, from the free-market price (and this became ever more likely as time passed and the free-market price changed, while the government's arbitrary price remained the same), one money became overvalued and the other undervalued by the government. Thus, suppose that a country used gold and silver as moneys, and the government set the ratio between them at 16 ounces of silver:1 ounce of gold. The market price, perhaps 16:1 at the time of the price control, then changes to 15:1. What is the result? Silver is now being arbitrarily undervalued by the government and gold arbitrarily overvalued. In other words, silver is fixed cheaper than it really is in terms of gold on the market, and gold is forced to be more expensive than it really is in terms of silver. The government has imposed a price maximum on silver and a price minimum on gold, in terms of each other.

The same consequences now follow as from any effective price control. With a price maximum on silver, the gold demand for silver in exchange now exceeds the silver demand for gold (conversely, with a price minimum on gold, the silver demand for gold is less than the gold demand for silver). Gold goes begging for silver in unsold surplus, while silver becomes scarce and disappears from circulation. Silver disappears to another country or area where it can be exchanged at the free-market price, and gold, in turn, flows into the country. If the bimetallism is worldwide, then silver disappears into the "black market," and official or open exchanges are made only with gold. No country, therefore, can maintain a bimetallic system in practice, since one money will always be undervalued or overvalued in terms of the other. The overvalued always displaces the other from circulation, the latter being scarce.

Similar consequences follow from such price control as setting arbitrary exchange rates on fiat moneys (see further below) and in setting new and worn coins arbitrarily equal to one another when they discernibly differ in weight.

To sum up our analysis of price control: Directly, the utility of at least one set of exchangers will be injured by the control. Indirectly, as we find by further analysis, hidden, but just as certain, effects injure a substantial number of people who *thought* they would gain in utility from the imposed controls. The announced aim of a maximum price control is to benefit the consumer by giving him his supply at a lower price; yet the objective effect is to prevent many consumers from having the good at all. The announced aim of a minimum price control is to insure higher prices to the sellers; yet the effect will be to prevent many sellers from selling any of their surplus. Furthermore, the price controls inevitably distort the production and allocation of resources and factors in the economy, thereby injuring again the bulk of consumers. And we must not overlook the army of bureaucrats who must be financed by the binary intervention of taxation and who must administer and enforce the myriad of regulations. This army, in itself, withdraws a mass of workers from productive labor and saddles them onto the remaining producers—thereby benefiting the bureaucrats, but injuring the rest of the people.

6. Triangular Intervention: Product Control

Triangular interference with an exchange can alter the *terms* of the exchange or else in some way alter the nature of the product or the persons making the exchange. The latter intervention, *product control*, may regulate the product itself (e.g., a law prohibiting all sales of liquor) or the people selling or buying the product (e.g., a law prohibiting Mohammedans from selling—or buying—liquor).

Product control clearly and evidently injures all parties concerned in the exchange: the consumers who lose utility because they cannot purchase the product and satisfy their most urgent wants; and the producers who are prevented from earning a remuneration in this field and must therefore settle for lower earnings elsewhere. Losses by producers are particularly borne by laborers and landowners specific to the industry, who must accept *permanently* lower income. (Entrepreneurial profit is ephemeral anyway, and capitalists tend to earn a uniform interest rate throughout the economy.) Whereas with *price control* one could make out a *prima facie* case that at least *one* set of exchangers gains from the control (the consumers whose buying price is pushed *below* the free-market price, and the producers when the price is pushed *above*), in product control *both* parties to the exchange invariably lose. The direct beneficiaries of product control, then, are the government bureaucrats who administer the regulations: partly from the tax-created jobs that the regulations create, and partly perhaps from satisfactions gained from wielding coercive power over others.

In many cases of product prohibition, of course, inevitable pressure develops, as in price control, for the re-establishment of the market illegally, i.e., a "black market." A black market is always in difficulties because of its illegality. The product will be scarce and costly, to cover the risks to producers involved in violating the law and the costs of bribing government officials; and the more strict the prohibition and penalties, the scarcer the product will be and the higher the price. Furthermore, the illegality greatly hinders the process of distributing information about the existence of the market to consumers (e.g., by way of advertising). As a result, the organization of the market will be far less efficient, the service to the consumer of poorer quality, and prices for this reason alone will be higher than under a legal market. The premium on secrecy in the "black" market also militates against large-scale business, which is likely to be more visible and therefore more vulnerable to law enforcement. Paradoxically, product or price control is apt to serve as a monopolistic grant (see below) of privilege *to* the black marketeers. For they are likely to be very different entrepreneurs from those who would have succeeded in this industry in a legal market (for here the premium is on skill in bypassing the law, bribing government officials, etc.).[24]

Product prohibition may either be *absolute*, as in American liquor prohibition during the 1920's, or *partial*. An example of partial prohibition is compulsory *rationing*, which prohibits consumption beyond a certain amount. The clear effect of rationing is to injure consumers and lower the standard of living of everyone. Since rationing places legal maxima on specific items of consumption, it also distorts the pattern of consumers' spending. Consumer spending is coercively shifted from the goods more heavily to those less heavily rationed. Furthermore, since ration tickets are usually not transferable, the pattern of consumer spending is even more distorted, because people who do not want a certain commodity are not permitted to exchange these coupons for goods not wanted by others. In short, the nonsmoker is not permitted to exchange his cigarette coupons for someone else's gasoline coupons which have been allocated to those who do not own cars. Ration tickets therefore cripple the entire system by introducing a new type of highly inefficient quasi "money," which must be used for purchasing in addition to the regular money.[25]

One form of partial product prohibition is to forbid all but *certain selected* firms from selling a particular product. Such

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[24]It was notorious, for example, that the bootleggers, a caste created by Prohibition, were one of the main groups *opposing* repeal of Prohibition in America.

[25]The workings of rationing (as well as the socialist system in general) have never been more vividly portrayed than in Henry Hazlitt's *The Great Idea*.

partial exclusion means that these firms are granted a *special privilege* by the government. If such a grant is given to one person or firm, we may call it a *monopoly* grant; if to several persons or firms, it is a *quasi-monopoly* grant.[26] Both types of grant may be called *monopolistic*. An example of this type of grant is *licensing*, where all those to whom the government refuses to give or sell a license are prevented from pursuing the trade or business. Another example is a *protective tariff* or *import quota*, which prevents competition from beyond a country's geographical limits. Of course, outright monopoly grants to a firm or compulsory cartelization of an industry are clear-cut grants of monopolistic privilege.

It is obvious that a monopolistic grant directly and immediately benefits the monopolist or quasi monopolist, whose competitors are debarred by violence from entering the field. It is also evident that would-be competitors are injured and are forced to accept lower remuneration in less efficient and value-productive fields. It is also patently clear that the consumers are injured, for they are prevented from purchasing products from competitors whom they would freely prefer. And this injury takes place, it should be noted, apart from any effect of the grant on prices.

In chapter 10 we buried the theory of monopoly price; we must now resurrect it. The theory of monopoly price, as developed there, is illusory when applied to the free market, but it applies fully in the case of monopoly and quasi-monopoly grants. For *here* we have an identifiable distinction: not the spurious distinction between "competitive" and "monopoly" or "monopolistic" price, but one between the *free-market price* and the *monopoly price*. The "free-market price" is conceptually identifiable and definable, whereas the "competitive price" is not.

[26]We might well call the latter an *oligopoly* grant, but this would engender hopeless confusion with existing oligopoly theory. On the latter, see chapter 10 above.

The theory of monopoly price, therefore, properly contrasts it to the free-market price, and the reader is referred back to chapter 10 for a description of the theory which can now be applied here. The monopolist will be able to achieve a monopoly price for the product if his demand curve is inelastic above the free-market price. We have seen above that on the free market, *every* demand curve to a firm is *elastic* above the free-market price; otherwise the firm would have an incentive to raise its price and increase its revenue. But the grant of monopoly privilege renders the consumer demand curve less elastic, for the consumer is deprived of substitute products from other potential competitors. Whether this lowering of elasticity will be sufficient to make the demand curve to the firm *inelastic* (so that gross revenue will be greater at a price higher than the free-market price) depends on the concrete historical data of the case and is not for economic analysis to determine.

When the demand curve to the firm remains elastic (so that gross revenue will be lower at a higher-than-free-market price), the monopolist will not reap any *monopoly gain* from his grant. Consumers and competitors will still be injured because their trade is prevented, but the monopolist will not gain, because his price and income will be no higher than before. On the other hand, if his demand curve is inelastic, then he institutes a monopoly price so as to maximize his revenue. His production has to be restricted in order to command the higher price. The restriction of production and higher price for the product both injure the consumers. Here the argument of chapter 10 must be reversed. We may no longer say that a restriction of production (such as in a voluntary cartel) benefits the consumers by arriving at the most value-productive point; on the contrary, the consumers are now injured because their free choice would have resulted in the free-market price. Because of coercive force applied by the State, they may not purchase goods freely from all those willing to sell. In other words, any approach *toward* the free-market equilibrium price and output point for any product benefits the consumers and thereby benefits the producers as well. Any departure *away* from the free-market price and output injures the consumers. The monopoly price resulting from a grant of monopoly privilege leads away from the free-market price; it lowers output and raises prices beyond what would be established if consumers and producers could trade freely.

And we cannot *here* use the argument that the restriction is voluntary because the consumers make their own demand curve inelastic. For the consumers are only *fully* responsible for their demand curve on the *free market*; and only *this* demand curve can be fully treated as an expression of their voluntary choice. Once the government steps in to prohibit trade and grant privileges, there is no longer wholly voluntary action. Consumers are forced, willy-nilly, to deal with the monopolist for a certain range of purchases.

All the effects which monopoly-price theorists have mistakenly attributed to voluntary cartels, therefore, *do* apply to governmental monopoly grants. Production is restricted, and factors are released for production elsewhere. But *now* we can say that this production will satisfy the consumers less than under free-market conditions; furthermore, the factors will earn less in the other occupations.

As we saw in chapter 10, there can never be lasting monopoly *profits*, since profits are ephemeral, and all eventually reduce to a uniform interest return. In the long run, monopoly returns are imputed to some *factor*. What is the factor being monopolized in this case? It is obvious that this factor is the *right* to enter the industry. In the free market, this right is unlimited to all and therefore unowned by anyone. The right commands no price on the market because everyone already has it. But here the government has conferred special privileges of entry and sale; and it is these *special* privileges or rights that are responsible for the extra monopoly gain from a monopoly price, and to which we may impute the gain. The monopolist earns a monopoly gain, therefore, *not* for owning any truly productive factor, but from owning a special privilege granted by the government. And this gain does not disappear in the long-run ERE as do profits; it is permanent, so long as the privilege remains and consumer valuations continue as they are.

Of course, the monopoly gain may well be capitalized into the asset value of the firm, so that *subsequent* owners, who invest in the firm after the capitalization took place, will be earning only the equal interest return. A notable example of the capitalization of monopoly (or rather, quasi-monopoly) rights is the New York City taxicab industry. Every taxicab must be licensed, but the city decided, years ago, not to issue any further licenses, or "medallions," so that any new cab owner must purchase his medallion from some previous owner. The (high) price of medallions on the market is then the capitalized value of the monopoly privilege

As we have seen, all this applies to a quasi monopolist as well as to a monopolist, since the number of the former's competitors is also restricted by the grant of privilege, which makes his demand curve less elastic. Of course, *ceteris paribus*, a monopolist is in a better position than a quasi monopolist, but how much each benefits depends purely on the data of the particular case. In some cases, such as the protective tariff, the quasi monopolist will end, in the long run, by not gaining anything. For since freedom of entry is restricted only to foreign firms, the higher returns accruing to firms newly protected by a tariff will attract more domestic capital to that industry. Eventually, therefore, the new capital will drive the rate of earnings down to the interest rate usual in all of industry, and the monopolistic gain will have been competed away.[27]

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[27]Monopoly privilege is granted by a government, which has power only over its own geographic area. Therefore, monopoly prices achieved within an area are always, on the market, subject to devastating competition from other countries. This is increasingly true as civilization advances and transportation costs decline, thus subjecting local monopolies to ever greater threats of competition from other areas. Hence, any domestic monopoly will tend to reach out to restrict foreign competition and block efficient interregional trade: It is no wonder that the tariff used to be called "The Mother of Trusts."

Monopolistic grants can be either direct and evident, such as compulsory cartels or licenses; less direct, such as tariffs; or highly indirect, but nevertheless powerful. Ordinances closing businesses at specific hours, for example, or outlawing pushcart peddlers or door-to-door salesmen, are illustrations of laws that forcibly exclude competition and thereby grant monopolistic privileges. Similarly, *antitrust laws* and prosecutions, while seemingly designed to "combat monopoly" and "promote competition," actually do the reverse, for they coercively penalize and repress efficient forms of market structure and activity. Even such a seemingly remote action as conscription has the effect of forcibly withdrawing young men from the labor market and thereby giving their competitors a monopolistic, or rather a *restrictionist*, wage.[28] Unfortunately, we have not the space here to investigate these and other instructive cases.

7. *Binary Intervention: The Government Budget*

Binary intervention occurs, we have seen, when the intervener forces someone to transfer property to him. All government rests

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We might note here that on a truly free market there would be no need for any separate "theory of international trade." Nations become significant economically only with government intervention, either by way of monetary intervention or barriers to trade.

[28]Monopolistic privileges to *businesses may* confer a monopoly price, depending on the elasticity of the firm's demand curve. Privileges to workers, on the other hand, *always* confer a higher, restrictionist price at lower than free-market output. The reason is that a business can expand or contract its production at will; if, then, a few firms are granted the privilege of producing in a certain field, they may expand production, if conditions are ripe, and *not* reduce total supply. On the other hand, aside from hours worked, which is not very flexible, restriction of entry into a labor market must *always* reduce the total supply of labor in that industry and therefore confer a restrictionist price. Of course, a *direct* restriction on production such as conservation laws always reduces supply and thereby confers a restrictionist price.

on the coerced levy of *taxation*, which is therefore a prime example of binary intervention. Government intervention, consequently, is not only triangular, like price control; it may also be binary, like taxation, and is therefore imbedded into the very nature of government and governmental activity.

For years, writers on public finance have been searching for the "neutral tax," i.e., for that system of taxes which would keep the free market intact. The object of this search is altogether chimerical. For example, economists have often sought uniformity of taxes, so that each person, or at least each person in the same income bracket, pays the same amount of tax. But this is inherently impossible, as we have already seen from Calhoun's demonstration that the community is inevitably divided into tax*payers* and tax-*consumers*, who, of course, cannot be said to pay taxes at all. To repeat the keen analysis of Calhoun (see note 6 above): "nor can it be otherwise; unless what is collected from each individual in the shape of taxes shall be returned to him in disbursements, which would make the process nugatory and absurd." In short, government bureaucrats *do not pay* taxes; they *consume* the tax proceeds. If a private citizen earning $10,000 income pays $2,000 in taxes, the bureaucrat earning $10,000 does not *really* pay $2,000 in taxes also; that he supposedly does is simply a bookkeeping fiction.[29] He is *actually* acquiring an income of $8,000 and paying no taxes at all.

Not only bureaucrats will be tax-consumers, but, to a lesser degree, other, private members of the population as well. For example, suppose that the government taxes $1,000 away from private people who would have spent the money on jewels, and uses it to purchase paper for government offices. This induces a shift in demand away from jewels and toward paper, a decline in

[29]It will be more convenient to use dollars rather than gold ounces in this section; but we still assume complete equivalence of dollars and gold weights. We do not consider *monetary* intervention until the end of this chapter.

the price of jewels, and a flow of resources from the jewelry industry; conversely, paper prices will tend to increase, and resources will flow into the paper industry. Incomes will decline in the jewelry industry and rise in paper.[30] Hence, the paper industry will be, to some extent, beneficiaries of the government budget: of the tax-and-expenditure process of government. But not just the paper industry. For the new money received by the paper firms will be paid out to their suppliers and original factor-owners, and so on as the ripples impinge on other parts of the economy. On the other hand, the jewelry industry, stripped of revenue, reduces *its* demands for factors. Thus the burdens and benefits of the tax-and-expenditure process diffuse themselves throughout the economy, with the strongest impact at the points of first contact—jewelry and paper.[31]

Everyone in the society will be either a net taxpayer or a tax-consumer and this to different degrees, and it will be for the data of each specific case to determine where any particular person or industry stands in this distribution process. The only certainty is that the bureaucrat or politician in office receives 100 percent of his governmental income from tax proceeds and pays no genuine taxes in return.

The tax-and-expenditure process, therefore, will inevitably distort the allocation of productive factors, the types of goods produced, and the pattern of incomes, from what they would be on the free market. The larger the *level* of taxing and spending, i.e., the bigger the government budget, the greater the distortion will tend to be. And moreover, the larger the budget in relation

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[30]This does not mean that resources will flow directly out of jewelry and into paper. It is more likely that resources will flow into and out of industries similar to each other, occupationally and geographically, and that resources will readjust, step by step, from one industry to the next.

[31]In the long run of the ERE, of course, all firms in all industries earn a uniform interest return, and the bulk of the gains or losses are imputed back to the original specific factors.

to market activity, the greater the burden of government on the economy. A larger burden means that more and more resources of society are being coercively siphoned off from the producers into the pockets of government, those who sell to government, and the subsidized favorites of government. In short, the higher the relative level of government, the narrower the base of the producers, and the greater the "take" of those expropriating the producers. The higher the level of government, the less resources will be used to satisfy the desires of those consumers who have contributed to production, and the more resources will be used to satisfy the desires of nonproducing consumers.

There has been a great deal of controversy among economists on how to approach the analysis of taxation. Old-fashioned Marshallians insist on the "partial equilibrium" approach of looking only at a particular type of tax, in isolation, and then analyzing its effects; Walrasians, more fashionable today (and exemplified by the late Italian public finance expert, Antonio De Viti De Marco), insist that taxes cannot be considered at all in isolation, that they may be analyzed only in conjunction with what the government does with the proceeds. In all this, what would be the "Austrian" approach, had it been developed, is being neglected. This holds that both procedures are legitimate and necessary to analyze the taxing process fully. In short: the level of taxes-and-expenditures may be analyzed and its inevitable redistributive and distortive effects discussed; and, *within* this aggregate of taxes, individual types of taxes may then be analyzed in isolation. Neither the partial nor the general approaches should be overlooked.

There has also been a great amount of useless controversy about *which* activity of government imposes the burden on the private sector: *taxation* or *government spending*. It is actually futile to separate them, since they are both stages in the same process of burden and redistribution. Thus, suppose the government taxes the betel-nut industry one million dollars in order to buy paper for government bureaus. One million dollars' worth of resources are shifted from betel nuts to paper.

This is done in *two* stages, a sort of one-two punch at the free market: first, the betel-nut industry is made poorer by taking away its money; then, the government uses this money to take paper out of the market for its own use, thus extracting resources in the second stage. Both sides of the process are a burden. In a sense, the betel-nut industry is compelled to *pay for* the extraction of paper from society; at least, it bears the immediate brunt of payment. However, even without yet considering the "partial equilibrium" problem of how or whether such taxes are "shifted" by the betel-nut industry onto other shoulders, we should also note that it is not the only one to pay; the consumers of paper certainly pay by finding paper prices raised to them.

The process can be seen more clearly if we consider what happens when taxes and government expenditures are *not* equal, when they are not simply obverse sides of the same coin. When taxes are less than government expenditures (and omitting borrowing from the public for the time being), the government creates new money. It is obvious here that government *expenditures* are the main burden, since this higher amount of resources is being siphoned off. In fact, as we shall see later when considering the binary intervention of *inflation*, creating new money is, anyway, a form of taxation.

But what of that rare case when taxation is higher than government spending? Say that the surplus is either hoarded in the government's gold supply or that the money is liquidated through deflation (see below). Thus, assume that $1,000,000 is taken from the betel-nut industry and only $600,000 is spent on paper. In this case, the larger burden is that of taxation, which pays not only for the extracted paper but also for the hoarded or destroyed money. While the government extracts only $600,000 worth of resources from the economy, the betel-nut industry loses $1,000,000 of potential resources, and this loss should not be forgotten in toting up the burdens imposed by the government's budgetary process. In short, when government expenditures and receipts differ, the "fiscal burden" on society may be very approximately gauged by whichever is the greater total.

Since taxation cannot really be uniform, the government in its budgetary process of tax-and-spend inevitably takes coercively from Peter to give to Paul ("Paul," of course, including itself). In addition to distorting the allocation of resources, therefore, the budgetary process redistributes incomes or, rather, *distributes* incomes. For the free market does *not* distribute incomes; income there arises naturally and smoothly out of the market processes of production and exchange. Thus, the very concept of "distribution" as something separate from production and exchange can arise only from the government's binary intervention. It is often charged, for example, that the free market maximizes the utility of all, and the satisfactions of all consumers, only "*given* a certain existing distribution of income." But this common fallacy is incorrect; *there is no "assumed distribution" on the free market separate from the voluntary activities of every individual's production and exchange.* The only *given* on the free market is the *property right* of every man in his own person and in the resources which he finds, produces, or creates, or which he obtains in voluntary exchange for his products or as a gift from their producers.

The binary intervention of the government's budget, on the other hand, impairs this property right of every one in his own product and *creates* the separate process and the "problem" of distribution. No longer do income and wealth flow purely from service rendered on the market; they now flow to special privilege created by the State and away from those specially burdened by the State.

There are many economists who regard the "free market" as only being free of triangular interference; such binary interference as taxation is not considered intervention in the purity of the "free market." The economists of the Chicago School—headed by Frank H. Knight—have been particularly adept at splitting man's economic activity and confining the "market" to a narrow compass. They can thus favor the "free market" (because they oppose such triangular interventions as price control), while advocating drastic binary interventions in taxes and subsidies to "redistribute" the income determined by that market. In short, the market is to be left "free" in one sphere, while being subject to perpetual harassment and reshuffling by outside coercion. This concept assumes that man is fragmented, that the "market man" is not concerned with what happens to himself as a "subject-to-government" man. This is surely an impermissible myth, which we might call the "tax illusion"—the idea that people do not consider what they earn *after* taxes, but only before taxes. In short, if A earns $9,000 a year on the market, B $5,000, and C $1,000, and the government decides to keep redistributing the incomes so that each earns $5,000, the individuals, apprised of this, are *not* going to keep foolishly assuming that they are still earning what they did before. They are going to take the taxes and subsidies into account.[32]

Thus, we see that the government budgetary process is a coercive shift of resources and incomes from producers on the market to nonproducers; it is also a coercive interference with the free choices of individuals by those constituting the government. Below, we shall analyze the nature and consequences of government spending in more detail. At this time, let us emphasize the important point that government cannot be in any way a fountain of resources; all that it spends, all that it distributes in largesse, it must first acquire in revenue, i.e., it must first extract from the "private sector." The great bulk of the revenues of government, the very nub of its power and its essence, is taxation, to which we turn in the next section. Another method is inflation, the creation of new money, which we shall discuss further below. A third method is borrowing

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[32]For a further discussion of the economic effects of taxation, see the next section below.

from the public, which will be discussed briefly in Appendix A below.[33]

8. Binary Intervention: Taxation

A. Income Taxation

Taxation, as we have seen, takes from producers and gives to others. Any increase in taxation swells the resources, the incomes, and usually the numbers of those living off the producers, while *diminishing* the production base from which these others are drawing their sustenance. Clearly, this is eventually a self-defeating process: there is a limit beyond which the top-heavy burden can no longer be carried by the diminishing stock of producers. Narrower limits are also imposed by the *disincentive* effects of taxation. The greater the amount of taxes imposed on the producers—the tax*payers*—the lower the marginal utility of work will be, for the returns from work are forcibly diminished, and the greater the marginal utility of leisure forgone. Not only that: the greater will be the incentive to shift from the ranks of the burdened taxpayers to the ranks of the tax-*consumers*, either as full-time bureaucrats or as those subsidized by the government. As a result, production will diminish even further, as people retreat to leisure or scramble harder to join the ranks of the privileged tax-consumers.[34] In

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[33]A fourth method, revenue from sale of governmental goods or services, is a peculiar form of taxation; at the very least, to *acquire* the original assets for this "business," taxation is needed.

[34]In the less developed countries, where a money economy is still emerging from barter, any given amount of taxation will have a still more drastic effect: for it will make *monetary* incomes much less worthwhile and will shift people's efforts from trying to make money back to untaxed barter arrangements. Taxation can therefore decisively retard development from a barter to a monetary economy, or even reverse the process. *See* C. Lowell Harriss, "Public Finance" in Bernard F. Haley, ed., *A Survey of Contemporary Economics* (Homewood, Ill.: Richard D. Irwin, 1952),

the market economy, net incomes are derived from wages, interest, ground rents, and profit; and in so far as taxes strike at the earnings from these sources, attempts to earn these incomes will diminish. The laborer, faced with a tax on his wages, has less incentive to work hard; the capitalist, confronting a tax on his interest or profit return, has more incentive to consume rather than to save and invest. The landlord, a tax being imposed on his rents, will have less of a spur to allocate land sites efficiently.

It has been objected that since a man's marginal utility of money assets increases as he holds less of a stock of money, lower money income will mean an increased marginal utility of income. As a result, a tax on money incomes creates both a "substitution effect" against work and in favor of leisure (or against saving in favor of consumption) and an "income effect" working in the opposite direction. This is true, and in rare empirical cases, the latter effect will predominate. In plain language, this means that when extra penalties are placed upon man's efforts he will generally slacken them; but in some cases, he will work harder to try to offset the burdens. In the latter cases, however, we must remember that he will lose the valuable consumption good of "leisure"; he will have less leisure now than he would have if his choices were still free. Working harder under penalty is only a cause for rejoicing if we regard the matter exclusively from the point of view of those living off the producers, who will thereby benefit from the tax. The standard of living of the workers, which must include leisure, has fallen.

The income tax, by taxing income from investments, cripples saving and investment, since it lowers the return from investing

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p. 264. For a practical application, *see* P.T. Bauer, "The Economic Development of Nigeria," *Journal of Political Economy,* October, 1955, pp. 400 ff.

If any government taxes in *kind*, there is then no span of time between taxation and the extraction of physical resources from the private sector. Both take place in the same act.

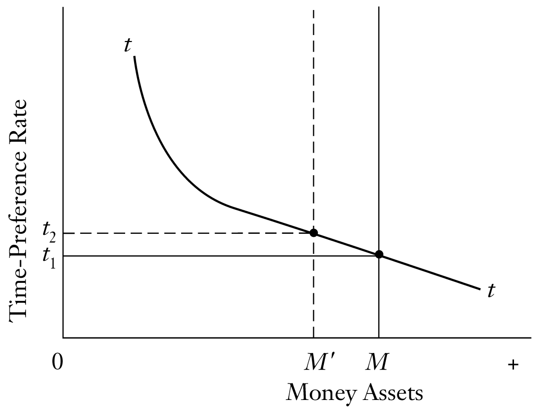

FIGURE 86. EFFECT OF INCOME TAX ON TAXPAYER'S RATIO OF CONSUMPTION TO SAVING AND INVESTMENT

below what free-market time preferences would dictate. The lower net interest return leads people to bring their savings-investment into line with the new realities; in short, the marginal savings and investments at the higher return will now be valued below consumption and will no longer be made.

There is another, unheralded reason why an income tax will particularly penalize saving and investment as against consumption. It might be thought that since the income tax confiscates a certain portion of a man's income and leaves him free to allocate the rest between consumption and investment, and since time preference schedules remain given, the proportion of consumption to saving will remain unchanged. But this ignores the fact that the taxpayer's real income and the real value of his monetary assets have been lowered by paying the tax. We have seen in chapter 6 that, given a man's time-preference schedule, the lower the level of his real monetary assets, the higher his time-preference rate will be, and therefore the higher the proportion of his consumption to investment. The taxpayer's position may be seen in Figure 86, which is essentially the reverse of the individual time-market diagrams in chapter 6. In the present case, money assets are *increasing* as we go rightward on the horizontal axis, while in chapter 6 money assets were declining. Let us say that the taxpayer's initial position is a money stock of *0M*; *tt* is his given time-preference curve. His *effective time-preference rate*, determining his consumption/investment proportion, is t_1. Now, suppose that the government levies an income tax, reducing his initial monetary assets at the start of his spending period to *0M′*. His effective time-preference rate, the intersection of *tt* and the *M′* line, is now higher at t_2. He shifts to a higher proportion of consumption and a lower proportion of saving and investment.[35]

We have now seen two reasons why an income tax will shift the social proportion toward more consumption and less saving and investment. It might be objected that the time-preference reason is invalid, since the government officials and the people they subsidize will receive the tax revenues and find that *their* money stock has increased just as that of the taxpayers has declined. We shall see below, however, that no truly productive savings and investments can be made by government, its employees, or the recipients of its subsidies.

Some economists maintain that income taxation reduces savings and investment in society in yet a third way. They assert that income taxation, by its very nature, imposes a "double" tax on savings-investment as against consumption.[36] The reasoning

[35]For this shift to occur, the individual's *real* monetary assets must decline, not just the nominal amount in terms of money. If, then, instead of this tax, there is deflation in the society, and the value of the monetary unit increases roughly proportionately everywhere, then the *nominal* fall in each individual's money stock will not be a *real* fall, and hence effective time-preference ratios will remain unchanged. In the case of income taxation, deflation will not occur, since the government will spend the revenue rather than contract the money supply. (Even in the rare case where all the tax money is liquidated by the government, the individuals taxed will lose more than others and hence will lose some real monetary assets.)

[36]Thus, cf. Irving and Herbert W. Fisher, *Constructive Income Taxation* (New York: Harper & Bros., 1942). "Double" is used in the sense of *two* instances, not arithmetically twice.

runs as follows: Saving and consumption are really not symmetrical. All saving is directed toward enjoying more consumption in the future; otherwise, there would be no point at all to saving. Saving is abstaining from possible present consumption in return for the expectation of increased consumption at some time in the future. No one wants capital goods for their own sake. They are only the embodiment of increased consumption in the future. Saving-investment is Crusoe's building the stick to obtain more apples at a future date; it fructifies in higher consumption later. Hence, the imposition of an income tax is a "double" tax on consumption, and excessively penalizes saving and investment.[37]

This line of reasoning correctly explains the investment-consumption process. It suffers, however, from a grave defect: it is irrelevant to problems of taxation. It is true that saving is a fructifying agent. But the point is that everyone knows this; that is precisely why people save. Yet, even though they know that saving is a fructifying agent, they do not save all their income. Why? Because of their time preferences for present consumption. Every individual, given his current income and value scales, allocates that income in the most desirable proportions between consumption, investment, and additions to his cash balance. Any other allocation would satisfy his desires less well and lower his position on his value scale. The fructifying power of saving is *already taken into account* when he makes his allocation. There is therefore no reason to say that an income tax doubly penalizes saving-investment; it penalizes the individual's entire standard of living, encompassing present consumption, future consumption, and his cash balance. It does not *per se* penalize saving any more than the other avenues of income allocation.

This Fisher argument reflects a curious tendency among economists devoted to the free market to be far more concerned

[37]These economists generally conclude that not income, but only consumption, should be taxed as the only "real" income.

about governmental measures penalizing saving and investment than they are about measures hobbling consumption. Surely an economist favoring the free market must grant that the market's voluntary consumption/investment allocations are optimal and that any government interference in this proportion, *from either direction*, is distortive of that market and of production to meet the wants of the consumers. There is nothing, after all, particularly sacred about savings; they are simply the road to future consumption. But they are, then, clearly no more important than *present* consumption, the allocations between the two being determined by the time preferences of all individuals. The economist who balks more at interference with free-market savings than he does at infringement on free-market consumption is therefore implicitly advocating statist interference in the opposite direction. He is implicitly calling for a coerced distortion of resources to lower consumption and increase investment.[38]

B. Attempts at Neutral Taxation

So far, we have discussed the impact of a tax on an individual considered by himself. Equally important is the distortion of the market's *pattern* of factor prices and incomes, created by the way taxes bear down upon different people. The free market determines an intricate, almost infinite array and structure of prices, rates, and incomes. The imposition of different taxes disrupts these patterns and cripples the market's work of allocating resources and output. Thus, if firm A pays $5,000 a year for a

[38]The bias in favor of investment, or "growth," as against present consumption, is similar to the conservationist attack on present consumption. What is so worthy about *future* consumption and so unworthy about consuming in the *present*? Perhaps what we have here is an illicit smuggling of the less rational aspects of the "Protestant ethic" into economic science. Of the many problems involved, we may mention one here: What nonarbitrary quantitative standards for thrift can the economist establish once the free market's decision is overridden?

certain type of labor, and firm B pays $3,000, laborers will tend to shift from B to A and thereby more efficiently serve the wants of consumers. But if the income earned at firm A is taxed $2,000 per annum, while income at B is taxed negligibly or not at all, the market inducement to move from B to A will totally or virtually disappear, perpetuating a misallocation of productive resources and hampering the growth and even the existence of firm A.

We have seen above that the quest for a *neutral tax*—a tax neutral to the market, leaving the market roughly as it was before the tax was imposed—is a hopeless venture. For there can be no uniformity in paying taxes when some people in society are necessarily taxpayers, while others are privileged tax-consumers. But even if we disregard these objections and fail to consider the redistributionist effects of government *spending* out of tax revenues, we cannot arrive at a system of neutral taxation.[39] Many writers have maintained that uniformly proportional income taxes for all would yield a neutral tax; for then, the relative ratios of incomes in society would remain the same as before. Thus, if A received $6,000 a year, B earned $3,000, and C $2,000, a 10-percent tax on each man would yield a "distribution" of: A, $5,400; B, $2,700; C, $1,800—the same mutual ratios as before. (This assumes, of course, no disincentive effects of the tax on the various individuals or, rather, equiproportional disincentive effects on each individual in the society—a most unlikely occurrence.) But the trouble is that this "solution" misconceives the nature of what a neutral tax would have to be. For a tax truly neutral to the free market would not be one that left income patterns the same as before; *it would be a tax which would affect the income pattern, and all other aspects of the economy, in the same way as if the tax were really a free-market price.*

[39]This is true if we also disregard the grave conceptual difficulties of arriving at a definition of "income," in accounting for the imputed monetary value of work done within a household, of averaging fluctuating incomes over various years, etc.

This is a very important correction; for we must surely realize that when a service is sold at a certain price on the free market, this sale emphatically does *not* leave income "distribution" the same as before. For, normally, market prices are *not* proportional to each man's income or wealth, but are uniform *in the sense of equal to everyone*, regardless of his income or wealth or even his eagerness for the product. A loaf of bread does *not* cost a multimillionaire a thousand times as much as it costs the average man. If, indeed, the market really behaved in this way, there would soon be no market, for there would be no advantage whatever in earning money. The more money one earned, the more, *pari passu*, the price of every good would be raised to him. Therefore, the entire civilized money economy and the system of production and division of labor based upon it would break down. Far from being "neutral" to the free market, then, a proportional income tax follows a principle which, if consistently applied, would eradicate the market economy and the entire monetary economy itself.

It is clear, then, that equal taxation of everyone—the so-called "head tax" or "poll tax"—would be a far closer approach to the goal of neutrality. But even here, there are serious flaws in its neutrality, entirely apart from the ineluctable taxpayer–tax-consumer dichotomy. For one thing, goods and services on the free market are purchased only by those freely willing to obtain them at the market price. Since a tax is a compulsory levy rather than a free purchase, it can never be assumed that each and every member of society would, in a free market, pay this equal sum to the government. In fact, the very compulsory nature of taxation implies that far less revenue would be paid in to the government were it conducted in a voluntary manner. Rather than being neutral, therefore, the equal tax would distort market results by imposing undue levies on at least three groups of citizens: the poor, the uninterested, and the hostile, i.e., those who, for one reason or another, would *not* have voluntarily paid these equal sums to the government.

Another grave problem in treating the equal tax as akin to a free-market price is that we do not know what "services" of government the people are supposed to be "purchasing." For example, if the government uses the tax to subsidize a certain favored group, it is difficult to know what sort of "service" the payers of the head tax are reaping from this act of government. But let us take a seemingly clear-cut case of pure service, police protection, and let us assume that the head tax is being paid for this expenditure. The free-market rule is that equal prices are paid for equal services; but what, here, is an "equal service"? Surely, the service of police protection is of far greater magnitude in an urban crime center than it is in some sleepy backwater, where crime is rare. Police protection will certainly cost more in the crime-ridden area; hence, if it were supplied on the market, the price paid there would be higher than in the backwater. Furthermore, a person under particular threat of crime, and who might require greater surveillance, would have to pay a higher police fee. A uniform tax would be below market price in the dangerous areas and above it in the peaceful areas. To approach neutrality, then, a tax would have to vary in accordance with the *costs* of services and not be uniform.[40] This is the neglected *cost principle* of taxation.

The cost principle, however, is hardly neutral either. Apart from the inexorable taxpayer–tax-consumer problem, there is, again, the problem of how a "service" is to be defined and isolated. What is the "service" of redistribution from Peter to Paul, and what is the "cost" for which Peter is to be assessed? And even if we confine the discussion to such common services as police protection, there are grave flaws. In the first place, the costs of government, as we shall see further below, are bound to

[40]We are not here conceding that "costs" determine "prices." The general array of final prices determines the general array of cost prices, but *then* the viability of firms is determined by whether the price that people will pay for their particular products will be enough to cover the costs, which are determined throughout the market.

be much higher than those of the free market. Secondly, the State cannot calculate well and therefore cannot gauge its costs accurately. Thirdly, costs are equal to prices only in equilibrium; since the economy is never in equilibrium, costs are never a precise estimate of what the free-market price would have been. And finally, as in the equal tax, and in contrast to the free market, the taxpayer never *demonstrates* his benefit from the governmental act; it is simply and blithely assumed that he would have purchased the service voluntarily at this price.

Still another attempt at neutral taxation is the *benefit principle*, which states that a tax should be levied equal to the benefit which the individuals receive from the government service. It is not always realized what this principle would mean: e.g., that recipients of welfare benefits would have to pay the full costs of these benefits. Each recipient of government welfare would then have to pay *more* than he received, for he would also have to pay the "handling" costs of government bureaucracy. Obviously, there would be no such welfare or any other subsidy payments if the benefit principle were maintained. Even if we again confine the discussion to services like police protection, grave flaws still remain. Let us again disregard the persistent taxpayer–tax-consumer dichotomy. A fatal problem is that we cannot measure benefits or even know whether they exist. As in the head tax and cost principles, there is here no free market where people can *demonstrate* that they are receiving a benefit from the exchange greater than the value of the goods they surrender. In fact, since taxes are levied by coercion, it is clear that people's benefits from government are considerably *less* than the amount that they are required to pay, since, if left free, they would contribute less to government. The "benefit," then, is simply assumed arbitrarily by government officials.

Furthermore, even if the benefit were freely demonstrable, the *benefit principle* would not approach the process of the free market. For, once again, individuals pay a *uniform price* for services on the free market, regardless of the extent of their subjective benefits. The man who would "walk a mile for a Camel" pays no more, ordinarily, than the man who couldn't care less. To tax everyone in accordance with the benefit he receives, then, is diametrically opposed to the market principle. Finally, if everyone's benefit is taxed away, there would be no reason for him to make the exchange or to receive the government service. On the market, not all people, not *even* the marginal buyers, pay the full amount of their benefit. The supramarginal buyers obtain unmeasurable surplus benefit, and *so do* the marginal buyers, for without such a surplus they would not buy the product. Moreover, for such services as police protection, the benefit principle would require the poor and the infirm to pay *more* than the rich and the able, since the former may be said to benefit more from protection. Finally, it should be noted that if each person's benefit from government is to be taxed away, the bureaucrats, who receive all their income from the government, would have to return their whole salary to the government and so serve without pay.[41]

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[41]Ever since Adam Smith, economists have tried, fallaciously, to use the benefit principle to justify proportional, and even progressive, taxation, on the ground that people benefit "from society" in proportion, or even more than in proportion, to their incomes. But it is clear that the rich benefit *less* from such services as police protection, since they could more afford to pay for their own than the poor. And the rich derive no benefit from welfare expenditures. Therefore, the rich derive *fewer* benefits, absolutely, from government than the poor, and the benefit principle cannot be used to justify proportional or progressive taxation.

But, it might be objected, can't we say that everyone derives proportional benefits to his income from "society," though not from government? In the first place, this cannot be established. In fact, the opposite argument would be more accurate: for since both A and B participate in society and its benefits, any differential income between A and B must be due to their own *particular* worths rather than to society. Certainly equal benefits from society cannot be used to imply a proportional tax. And, furthermore, even if the argument were true, by what legerdemain can we say that "society" is equivalent to the State ? If A, B, C, producers on the market, benefit from each other's existence as "society," how can G, the government, use this fact to establish *its* claim to *their* wealth?

We have thus seen that no principle of taxation can be neutral with respect to the free market. *Progressive* taxation, where each man pays *more* than proportionately to his income, of course makes no attempt at neutrality. If the proportional tax embodies a principle destructive to the entire market economy and the monetary economy itself, then the progressive tax does so still more. For the progressive tax penalizes the able and efficient in even greater proportion than their relative ability and efficiency. Progressive rates are a particular disincentive against especially able work or entrepreneurship. And since such ability is engaged in serving the consumer, a progressive tax levies a particular burden on the consumers as well.

In addition to the two ways discussed above by which income taxation penalizes saving, the progressive tax imposes an added penalty. For empirically, in most cases, the wealthy save and invest proportionately more of their incomes than the lower-income groups. There is, however, no apodictic, praxeological reason why this must always be so. The rule would not hold, for example, in a country where the wealthy bought jewelry while the poor thriftily saved and invested.

While the progressive principle is certainly highly destructive of the market, most conservative, pro-free-market economists tend to overweigh its effects and to underweigh the destructive effects of proportional taxation. Proportional income taxation has many of the same consequences, and therefore the *level* of income taxation is generally more important for the market than the degree of progressivity. Thus, society A may have a proportional income tax requiring every man to pay 50 percent of his income; society B may have a very steeply progressive tax requiring a poor man to pay 1/4 percent and the richest man 10 percent of his income. The rich man will certainly prefer society B, *even though* the tax is progressive—demonstrating that it is not so much the progressivity as the height of his tax that burdens the rich man.

Incidentally, the poor producer, with a lower tax upon him, will also prefer society B. This demonstrates the fallacy in the common conservative complaint against progressive taxation that it is a means "for the poor to rob the rich." For both the poor man and the rich man have, in our example, chosen progression! The reason is that the "poor" do not "rob the rich" under progressive taxation. Instead, it is the State that "robs" both through taxation, whether proportional or progressive.

It may be objected that the poor benefit from the State's expenditures and subsidies from the tax proceeds and thus do their "robbing" indirectly. But this overlooks the fact that the State can spend its money in many different ways: it may consume the products of specific industries; it may subsidize some or all of the rich; it may subsidize some or all of the poor. The fact of progressivity does not *in itself* imply that the "poor" are being subsidized en masse. Indeed, if some of the poor are being subsidized, others will probably not be, and so these latter net taxpayers will be "robbed" along with the rich. In fact, since there are usually far more poor than rich, the poor en masse may very well bear the greatest burden of even a progressive tax system.

Of all the possible types of taxes, the one most calculated to cripple and destroy the workings of the market is the *excess profits tax*. For of all productive incomes, profits are a relatively small sum with enormous significance and impact; they are the motor, the driving force, of the entire market economy. Profit-and-loss signals are the prompters of the entrepreneurs and capitalists who direct and ever redirect the productive resources of society in the best possible ways and combinations to satisfy the changing desires of consumers under changing conditions. With the drive for profit crippled, profit and loss no longer serve as an effective incentive, or, therefore, as the means for economic calculation in the market economy.

It is curious that in wartime, precisely when it would seem most urgent to preserve an efficient productive system, the cry invariably goes up for "taking the profits out of war." This zeal never seems to apply so harshly to the clearly war-borne "profits" of steel workers in higher wages—only to the profits of entrepreneurs. There is certainly no better way of crippling a war effort. In addition, the "excess" concept requires some sort of norm above which the profit can be taxed. This norm may either be a certain rate of profit, which involves the numerous difficulties of measuring profit and capital investment in every firm; or it may refer to profits at a base period before the war started. The latter, the general favorite because it specifically taps *war* profits, makes the economy even more chaotic. For it means that while the government strains for more *war* production, the excess profits tax creates every incentive toward lower and inefficient war production. In short, the EPT tends to freeze the process of production as of the peacetime base period. And the longer the war lasts, the more obsolete, the more inefficient and absurd, the base-period structure becomes.

C. Shifting and Incidence: A Tax on an Industry

No discussion of taxation, however brief, can overlook the famous problem of "the shifting and incidence" of taxation. In brief, who pays a tax? The person on whom it is levied, or someone else to whom the former is able to "shift" the tax? There are still economists, incredibly, who hew to the old nineteenth-century "equal diffusion" theory of taxation, which simply closes the problem by proclaiming that "all taxes are shifted to everyone," so that there is no need to analyze each one in particular.[42] This obscurantist tendency is fostered by treating "shifting" in too broad a way. Thus, if an income tax is levied on Jones at 80 percent, this will hurt *not only* Jones, but also—by decreasing Jones' incentives as well as capacities—other consumers by reducing Jones' work and savings. It is therefore true that the *effects* of taxation diffuse outward from the center of the target. But this is far from saying that Jones can simply shift the tax burden onto the shoulders of others. The concept of "shifting"

[42]For a critique of this doctrine, see E.R.A. Seligman, *The Shifting and Incidence of Taxation* (New York: Macmillan & Co., 1899), pp. 122–36.

will here be limited to the case where the payment of a tax can be directly transferred *from* the original payer to someone else, and will not be used when others suffer *in addition* to the original taxpayer. The latter may be called the "indirect effects" of the tax.

The first rule of shifting is that *an income tax cannot be shifted.* This formerly accepted truth in economics is now countered with the popular assumption that, for example, a tax on wages will spur unions to demand higher wages to compensate for the tax, and that therefore the tax on wages is shifted "forward" onto the employer, who, in turn, shifts it again forward onto the body of consumers. And yet almost every step in this commonly proclaimed sequence is an egregious fallacy. It is absurd, in the first place, to think that workers or unions wait quietly for a tax to galvanize them into making demands. Workers *always* want higher wages; unions always demand more. The question is: Will they get more? There is no reason to think that they can. A worker can get only the value of the discounted marginal productivity of his labor. No clamor will raise that productivity, and therefore none can raise the wage he earns from his employer. Union demands for higher wages will be treated as usual, i.e., they can be satisfied only at the cost of the unemployment of some of the work force in that industry. But this is true whether or not there has been a tax on wages; the tax will have nothing to do with the final wage set on the market.

The idea that the increased cost will be passed on to the consumer by the employer is an illustration of perhaps the single most widespread fallacy on taxation: that businessmen can simply shift their higher costs forward onto the consumers in the form of higher prices. All the economic theory expounded in this book shows the error of this doctrine. For the price of a given product is set by the demand schedules of the consumers. There is nothing in higher costs or higher taxes which, *per se*, increases these schedules; hence, *any* change in selling prices, whether higher or lower, will *decrease* the revenues of the business involved. For each business, on the market, tends to be, at all times, at its "maximum profit point" in relation to the consumers. Prices are already at their point of maximum return for the business; therefore, higher taxes or other costs imposed on the firm will reduce their net incomes rather than be smoothly and easily passed on to consumers. We thus arrive at this significant conclusion: *no tax* (not just an income tax) *can ever be shifted forward.*

Suppose that a particularly heavy tax—of whatever type—has been laid on a specific industry: say the liquor industry. What will be the effects? As we have noted, the tax will not simply be "passed on" to the consumers.[43] Instead, the price of liquor will remain the same; the net income of the firms will decline. This will mean that returns will be lower to capital and enterprise in liquor than in other industries of the economy; marginal liquor firms will suffer losses and go out of business; and, in general, productive resources of all types will flow out of liquor and into other industries. The *long-run effect*, therefore, is to decrease the supply of liquor produced, and therefore, by the law of supply and demand, to raise the price of liquor on the market. However, as we have said above, this process—this diffusion of suffering over the economy—is hardly "shifting." For the tax is not simply "passed on"; it only permeates to the consumers *through* hurting the industry taxed. The final result will be a distortion of the factors of production; fewer goods are now being produced than the consumers would prefer in the liquor industry; and too many goods, relatively to liquor, are being produced in the other industry.

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[43]Businessmen are particularly prone to this "passing on" argument—obviously in an attempt to convince consumers that *they* are really paying any tax on that industry. Yet the argument is clearly belied by the very zeal of each industry to have its taxes lowered and to fight against a tax increase. If taxes could really be shifted so easily and businessmen were simply unpaid collection agents for the government, they would never protest a tax on their industry. (Perhaps this is the reason why almost no businessmen have protested being collection agents for withholding taxes on their *workers*!)

Taxes, in short, can more readily be "shifted backward" than forward. Strictly, the result is not shifting because it is not a painless process. But it is clear that the backward process (backward to the factors of production) happens more quickly and directly than the effects on consumers. For losses or lowered profits to liquor firms will immediately lower their demand for land, labor, and capital factors of production; this falling of demand schedules will lower wages and rents earned in the liquor industry; and these lower earnings will induce a shift of labor, land and capital out of liquor and into other industries. The rapid "backward-shifting" is in harmony with the "Austrian" theory of consumption and production developed in this volume; for prices of factors are determined by the selling prices of the goods which they produce, and *not vice versa* (which would have to be the conclusion of the naive "shifting-forward" doctrine).

It should be noted that, in some cases, the industry itself can welcome a tax upon it, for the sake of conferring an indirect, but effective, monopolistic privilege on the supramarginal firms. Thus, a flat "license" tax will confer a particular privilege on the more heavily capitalized firms, which can more easily afford to pay the fee.

D. Shifting and Incidence: A General Sales Tax

The most popular example of a tax supposedly shifted forward is the *general sales tax.* Surely, for example, if the government imposes a uniform 20-percent tax on all retail sales, and if we can make the simplifying assumption that the tax can be equally well enforced everywhere, then business will simply "pass on" the 20-percent increase in all prices to consumers. In fact, however, there is no way for prices to increase at all! As in the case of one particular industry, prices were previously set, or approximately so, at the points of maximum net revenue for the firms. Stocks of goods or factors have not yet changed, and neither have demand schedules. How then could prices rise? Moreover, if we look at the general array of prices, as is proper when dealing with a general sales tax, these are determined by the supply of and the demand for money, from the goods and money sides. For the general array of prices to rise, there must be either an increase in the supply of money, a decrease in the demand schedule for money, or both. Nothing in a general sales tax causes a change in either of these determinants.[44]

Furthermore, the long-run effects of a general sales tax on prices will be smaller than in the case of an equivalent partial excise tax. A tax on a specific industry, such as liquor, will push resources out of this industry and into others, and therefore the relative price of the taxed commodity will eventually rise. In a general, uniformly enforced sales tax, however, there is no room for such shifts of resources.[45]

The myth that a sales tax can be shifted forward is comparable to the myth that a general union-imposed wage increase can be shifted forward to higher prices for consumers, thereby "causing inflation." There is here no way that the general array

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[44]It might be objected that the firms can pass along the sales tax because it is a *general* increase for all firms. Aside from the fact that no relevant general factor (supply, demand for money) has increased, the individual firm is still concerned only with its individual demand curve, and these curves have not shifted. A tax increase has done nothing to make a higher price *more profitable* than it was before.

[45]Resources can now shift only from work into idleness (or into barter). This, of course, may and probably will happen; since, as we shall see further, a sales tax is a tax on incomes, the rise in opportunity cost of leisure may push some workers into idleness and thereby lower the quantity of goods produced. To this extent, prices *will* eventually rise, although hardly in the smooth, immediate, proportionate way of "shifting." See the pioneering article by Harry Gunnison Brown, "The Incidence of a General Output or a General Sales Tax," reprinted in R.A. Musgrave and C.S. Shoup, eds., *Readings in the Economics of Taxation* (Homewood, Ill.: Richard D. Irwin, 1959), pp. 330–39. While this was the first modern attack on the fallacy that sales taxes are shifted forward, Brown unfortunately weakened the implications of this thesis toward the end of his article.

of prices can rise, and the only possible result of such a wage increase is mass unemployment.[46]

In considering the general sales tax, many people are misled by the fact that the price paid by the consumer necessarily *includes* the tax. If someone goes to a movie and pays $1.00 admission, and if he sees prominently posted the information that this covers a "price" of 85¢ and a tax of 15¢, he tends to conclude that the tax has simply been added on to the "price." But $1.00 is the price, not 85¢, the latter sum simply being the revenue accruing to the firm after taxes. The revenue to the firm has, in effect, been *reduced* to allow for payment of taxes.

This is precisely the consequence of a general sales tax. Its immediate impact lowers the gross revenue of firms by the amount of the tax. In the long run, of course, firms cannot pay the tax, the loss in gross revenue of firms being imputed backward to interest income by capitalists and to wages and rents earned by owners of original factors—labor and ground land. A decrease in gross revenue to retail firms is reflected back to a decreased demand for the products of all the higher-order firms. The major result of a general sales tax is a general reduction in the net revenues accruing to original factors. The sales tax has been *shifted backwards* to original factor returns—to interest and to all wages and ground rents. No longer does every original factor of production earn its discounted marginal product. Original factors now earn *less* than their DMVPs, the reduction consisting of the sales tax paid to the government.

Let us now integrate this analysis of the incidence of a general sales tax with our previous general analysis of the benefits and burdens of taxation. This is accomplished by remembering that the proceeds of taxation are, in turn, spent by the government. Whether or not the government spends the money for

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[46]Of course, if the money supply is increased after a wage rise, and credit expanded, prices can be raised so that money wages are again not above their discounted marginal value products.

resources for its own activities or simply transfers the money to people it subsidizes, the effect is to *shift* consumption and investment demand from private hands to the government or to government-supported individuals, by the amount of the tax revenue. The tax has been ultimately levied on the *incomes* of original factors, and the money transferred from their hands to the government. The income of the government and of those subsidized by the government has been increased at the expense of the tax producers, and therefore consumption and investment demands on the market have been shifted from the producers to the expropriators by the amount of the tax. As a consequence, the value of the monetary unit will remain unchanged (barring a difference in demands for money between the taxpayers and the tax-consumers), but the *array* of prices will shift in accordance with the shift in demands. Thus, if the market has been spending heavily on clothing, and the government uses the revenue mostly for the purchase of arms, there will be a fall in the price of clothes and a rise in the price of arms, and a tendency for nonspecific factors to shift out of the production of clothing and into the production of armaments.

As a result, there will not finally be, as might be assumed, a proportional 20-percent fall in all original factor incomes as the result of a 20-percent general sales tax. Specific factors in industries that have lost business from the shift from private to governmental demand will lose proportionately more in income; specific factors in industries gaining in demand will lose proportionately less—some may gain so much as to gain absolutely from the change. Nonspecific factors will not be affected as much proportionately, but they too will lose and gain according to the difference that the concrete shift in demand makes in their marginal value productivity.

It should be carefully noted that the general sales tax is a conspicuous example of *failure to tax consumption.* The sales tax is commonly *supposed* to penalize consumption, rather than income or capital. Yet we find that the sales tax reduces, not just consumption, but the *incomes* of original factors. *The general sales tax is therefore an income tax*, albeit a rather haphazard one. Many "right-wing" economists have advocated general sales taxation, as opposed to income taxation, on the grounds that the former taxes consumption but not savings-investment; many "left-wing" economists have opposed sales taxation for the same reason. Both are mistaken; the sales tax is an income tax, though of a more haphazard and uncertain incidence. The major effect of the general sales tax will be that of the income tax—to reduce the consumption *and* the saving-investment of the taxpayers.[47] In fact, since, as we have seen, the income tax by its nature falls more heavily on savings-investment than on consumption, we reach the paradoxical and important conclusion that a tax on *consumption* will fall more heavily on *savings-investment* than on consumption in its ultimate incidence.

E. A Tax on Land Values

Wherever taxes fall, they blight, hamper, and distort the productive activity of the market. Clearly, a tax on wages will distort the allocation of labor effort, a tax on profits will cripple the profit-and-loss motor of the economy, a tax on interest will tend

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[47]Mr. Frank Chodorov, in his *The Income Tax—Root of All Evil* (New York: Devin-Adair, 1954), fails to indicate what other type of tax would be "better" from a free-market point of view, than the income tax. It is clear from our discussion that there are few taxes indeed that will not be as bad as the income tax from the viewpoint of the free market. Certainly sales or excise taxation will not fill the bill.

Mr. Chodorov, furthermore, is surely wrong when he terms income and inheritance taxes *unique* denials of the right of individual property. Any tax whatever infringes on property right, and there is nothing in an "indirect tax" which makes the infringement any less clear. It is true that an income tax forces the subject to keep records and disclose his personal dealings, thus imposing a further loss in his utility. The sales tax, however, also forces record-keeping; the difference again is one of degree rather than of kind, since here the directness covers only retail storekeepers instead of the bulk of the population.

to consume capital, etc. One commonly conceded exception to this rule is the doctrine of Henry George that ground-landowners perform no productive function and that therefore the government may safely tax site value without reducing the supply of productive services on the market. This is the *economic*, as distinguished from the moral, rationale for the famous "single tax." Unhappily, very few economists have challenged this basic assumption, the single-tax proposal being generally rejected on grounds purely pragmatic ("there is no way in practice of distinguishing site from improvement value of land") or conservative ("too much has been invested in land to expropriate the landowners now").[48]

Yet this central Georgist contention is completely fallacious. The owner of ground land performs a very important productive service. He finds, brings into use, and then allocates, land sites to the most value-productive bidders. We must not be misled by the fact that the physical stock of land is fixed at any given time. In the case of land, as of other material goods, it is not just the physical good that is being sold, but a whole bundle of services along with it—among which is the service of transferring

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[48]Thus, even so eminent an economist as F.A. Hayek has recently written:

> This scheme [the single tax] for the socialization of land is, in its logic, probably the most seductive and plausible of all socialist schemes. If the factual assumptions on which it is based were correct, i.e., if it were possible to distinguish clearly between the value of the "permanent and indestructible powers" of the soil . . . and . . . the value due to . . . improvement . . . the argument for its adoption would be very strong. (F.A. Hayek, *The Constitution of Liberty* [Chicago: University of Chicago Press, 1960], pp. 352–53)

Also see a somewhat similar concession by the Austrian economist von Wieser. Friedrich Freiherr von Wieser, "The Theory of Urban Ground Rent" in Louise Sommer, ed., *Essays in European Economic Thought* (Princeton, N.J.: D. Van Nostrand, 1960), pp. 78 ff.

ownership from seller to buyer, and doing so efficiently. Ground land does not simply exist; it must be *served to* the user by the owner (one man, of course, can perform both functions when the land is "vertically integrated").[49] The landowner earns the highest ground rents by allocating land sites to their most value-productive uses, i.e., to those uses most desired by consumers. In particular, we must not overlook the importance of *location* and the productive service of the site-owner in assuring the most productive locations for each particular use.

The view that bringing sites into use and deciding upon their location is not really "productive" is a vestige from the old classical view that a service which does not tangibly "create" something physical is not "really" productive.[50] Actually, this function is just as productive as any other, and a particularly

[49]I do not know anyone who has brought out the productivity of landowners as clearly as Mr. Spencer Heath, an ex-Georgist. *See* Spencer Heath, *How Come That We Finance World Communism?* (mimeographed MS., New York: Science of Society Foundation, 1953); *idem*, *Rejoinder to 'Vituperation Well Answered' by Mr. Mason Gaffney* (New York: Science of Society Foundation, 1953); *idem*, *Progress and Poverty Reviewed* (New York: The Freeman, 1952).

[50]Spencer Heath comments on Henry George as follows:

> Wherever the services of land owners are concerned he is firm in his dictum that *all* values are physical . . . In the exchange services performed by [landowners], their social distribution of sites and resources, no physical production is involved; hence he is unable to see that they are entitled to any share in the distribution of physical things and that the rent they receive . . . is but recompense for their non-coercive distributive or exchange services. . . . He rules out all creation of values by the services performed in [land] distribution by free contract and exchange, which is the sole alternative to either a violent and disorderly or an arbitrary and tyrannical distribution of land. (Heath, *Progress and Poverty Reviewed*, pp. 9–10)

vital function it is. To hamper and destroy this function would wreck the market economy.[51]

F. Taxing "Excess Purchasing Power"

In this necessarily hasty overview of the high spots of taxation theory, we have space for only one more comment: a criticism of the very common view that, in a business boom, the government should increase taxation "in order to sop up excess purchasing power," and thereby halt the inflation and stabilize the economy. We shall discuss the problems of inflation, stabilization, and the business cycle below; here, let us note the oddity of assuming that a *tax* is somehow less of a social cost, less of a burden, than a *price*. Thus, suppose, in a boom, that Messrs. A, B, and C, with the money they have on hand, would spend a certain amount on some commodity—say pipes—at a certain market price, e.g., $10 per pipe. The government decides that this is a most unfortunate situation, that the market price is—by some arbitrary, undivulged standard—"too high," and that therefore it must help its subjects by taxing their money away from them, and thus lowering prices. Suppose, indeed, that A,

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[51]For the effects of the "single tax" and for other criticisms, *see* Murray N. Rothbard, *The Single Tax: Economic and Moral Implications* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1957); Rothbard, "A Reply to Georgist Criticisms" (mimeographed MS., Foundation for Economic Education, 1957); and Frank H. Knight, "The Fallacies in the 'Single Tax,'" *The Freeman*, August 10, 1953, pp. 810–11. One of the more amusing objections is that of the dean of Georgist economists, Dr. Harry Gunnison Brown. Although the Georgists base much of their economic case on a sharp distinction between ownership of land and ownership of improvements on that land, Brown tries to refute the disruptive economic effects of the single tax by implicitly assuming that land and improvements are owned by the same people anyway! Actually, of course, the disruptive effects remain; vertical integration by individuals or firms does not remove the economic principle from either of the integrated stages of production. *See* Harry Gunnison Brown, "Foundations, Professors and 'Economic Education,'" *The American Journal of Economics and Sociology*, January, 1958, pp. 150–52.

B, and C are taxed sufficiently to lower the pipe price to, say, $8. By what reasoning are they better off, now that taxes have been increased by precisely the amount that their monetary funds have dwindled? In short, the "tax price" has gone up in order that the prices of other goods may decline. Why is a voluntary price, paid willingly by buyers and accepted by sellers, somehow "bad" or burdensome for the buyers, while at the same time a "price" levied compulsorily on the same buyers for dubious governmental services for which they have not demonstrated a need is somehow "good"? Why are high prices burdensome and high taxes not?

9. Binary Intervention: Government Expenditures[52]

A. The "Productive Contribution" of Government Spending

Government expenditures are a coerced transfer of resources from private producers to the uses preferred by government officials. It is customary to classify government spending into two categories: *resource-using*, and *transfer*. Resource-using expenditures frankly shift resources from private persons in society to the use of government: this may take the form of hiring bureaucrats to work for government—which shifts labor resources directly—or of buying products from business firms. Transfer payments are pure subsidy spending—when the government takes from Peter to pay Paul. It is true that, in the latter case, the government gives "Paul" money to decide the allocation as he wishes, and in a sense we may analyze the two types

[52]Government expenditures are made from government revenue. In the preceding section we have dealt with the major source of governmental revenue, taxation. Below we shall deal with inflation, or money creation, and in the present section a discussion of government "enterprise" is included. For a brief treatment of the final major source of government revenue—borrowing from the public—see Appendix A below.

of spending separately. But the similarities here are greater than the differences. For, in both cases, resources are seized from private producers and shifted to the uses which government officials think best. After all, when a bureaucrat receives his government salary, this payment is in the same sense a "transfer payment" from the taxpayers, and the bureaucrat is also free to decide how further to allocate the income at his command. In both cases, money and resources are shifted from producers to nonproducers, who consume or otherwise use them.[53]

This type of analysis of government has been neglected because economists and statisticians tend to assume, rather blithely, that government expenditures are a measure of its productive contribution to society. In the "private sector" of the economy, the value of productive output is sensibly gauged by the amount of money that consumers spend voluntarily on that output. Curiously, on the other hand, the government's "productive output" is gauged, not by what is *spent on* government, but by what government itself spends! No wonder that grandiose claims are often made for the unique productive power of government spending, when a mere increase in that spending serves to raise the government's "productive contribution" to the economy.[54]

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[53]It may be objected that while bureaucrats may not be producers, other "Pauls" who receive subsidies on occasion are basically producers on the market. To the extent that they receive subsidies from the government, however, they are being nonproductive and living off the producers by compulsion. What is relevant, in short, is the extent to which they are in a *relation of State* to their fellow men. We might add that, in this work, the term "State" is never meant in an anthropomorphic manner. "State" really means people acting toward one another in a systematically "stateish" relationship.

I am indebted to Mr. Ralph Raico, of the University of Chicago, for the "relation of State" concept.

[54]Originally, Professor Simon Kuznets contended that only *taxes* should gauge the government's productive output, thus measuring product by revenue as in the case of private firms. But taxes, being compulsory,

What, then, *is* the productive contribution of government? Since the value of government is not gauged on the market, and the payments to the government are not voluntary, it is impossible to estimate. It is impossible to know how much would be paid in to the government were it purely voluntary, or indeed, whether one central government in each geographical area would exist at all. Since, then, the only thing we do know is that the tax-and-spend process diverts income and resources from what they would have been doing in the "private sector," we must conclude that the government's productive contribution to the economy is precisely zero. Furthermore, even if it be objected that governmental services are worth *something*, it would have to be noted that we are again suffering from the error pointed out by Bastiat: a sole emphasis on what is *seen*, to the neglect of what is *not* seen. We may see the government's hydroelectric dam in operation; we do *not* see the things that private individuals would have done with the money—whether buying consumers' goods or investing in producers' goods—but which they were compelled to forgo. In fact, since private consumers would have done something else, something more desired, and therefore from their point of view more *productive*, with the money, we can be sure that the loss in productivity incurred by the government's tax and spending is greater than whatever productivity it has contributed. In short, strictly, the government's productivity is not simply zero, but *negative*, for it has imposed a loss in productivity upon society.[55]

Government expenditure is often referred to as "investment" resulting in "capital." And we have heard much in recent years about Soviet and other multi-Year Plans busily engaged in

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cannot be used as a productive gauge. In contrast to the present method of national income accounting, Kuznets would have eliminated all government *deficit*s from its "productive contribution."

[55]Even for those who do not accept this analysis, any who believe, empirically, that waste in government exceeds 50 percent of its expenditures would have to agree that our assumption is more accurate than the current estimate of 100 percent productivity by the government.

building up "capital" by government action. Yet it is illegitimate to use the term "capital" for government expenditures. Capital is the status of productive goods along the path to eventual consumption. In any sort of division-of-labor economy, capital goods are built, not for their own sake by the investor, but in order to use them to produce lower-order and eventually consumers' goods. In short, a characteristic of an investment expenditure is that the good in question is not being used to fulfill the needs of the investor, but of someone else—the consumer. Yet, when government confiscates resources from the private market economy, it is precisely defying the wishes of the consumers; when government invests in any good, it does so to serve the whims of government officials, not the desires of consumers. Therefore, no government expenditures can be considered genuine "investment," and no government-owned assets can be considered capital. Government expenditures are divisible into two parts: *consumption* expenditures by government officials, beneficiaries of government subsidies, and other nonproductive recipients; and *waste* expenditures, where government officials really believe that they are "investing" in "capital." These waste expenditures result in *waste assets*.[56] The consumption of the governmentally privileged is, of course, in a different category from private consumption, since it is necessarily *at the expense* of the private consumption of producers. We may therefore call the former "antiproductive consumption."[57]

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[56]If a waste asset owned by the government is sold to private enterprise, *then* all or part of it might become a capital good. But this potential does not make the good capital while used by the government. It might be objected that government purchases are genuine investments when used by a government "enterprise" that charges prices on the market. We shall see, however, that this is not really enterprise but *playing at* enterprise.

See below for a more detailed discussion of the waste involved in waste assets.

[57]This is to be distinguished from the classical concept of "nonproductive consumption" as all consumption above that needed to maintain the productive capacity of the laborer.

B. Subsidies and Transfer Payments

Let us delve a little further into the typology of government spending. Transfer spending or subsidies distort the market by coercively penalizing the efficient for the benefit of the inefficient. (And it does so even if the firm or individual is efficient without a subsidy, for its activities are then being encouraged beyond their most economic point.) Subsidies prolong the life of inefficient firms and prevent the flexibility of the market from fully satisfying consumer wants. The greater the extent of government subsidy, the more the market is prevented from working, the more resources are frozen in inefficient ways, and the lower will be the standard of living of everyone. Furthermore, the more government intervenes and subsidizes, the more caste conflict will be created in society, for individuals and groups will benefit only *at one another's expense*. The more widespread the tax-and-subsidy process, the more people will be induced to abandon production and join the army of those who live coercively off production. Production and living standards will be progressively lowered as energy is diverted from production to politics and as government saddles a dwindling base of production with a growing and more top-heavy burden of the State-privileged. This process will be all the more accelerated because those who succeed in any activity will invariably tend to be those who are best at performing it. Those who particularly flourish on the free market, therefore, will be those most adept at production and at serving their fellow men; those who succeed in the political struggle for subsidies, on the other hand, will be those most adept at wielding coercion or at winning favors from wielders of coercion. Generally, different people will be in the different categories of the successful, in accordance with the universal specialization of skills. Furthermore, for those who are skillful at both, the tax-and-subsidy system will encourage and promote their predatory skills and penalize their productive ones.

A common example of direct transfer subsidy is governmental *poor relief*. State poor relief is clearly a *subsidization of poverty*, for men are now automatically entitled to money from the State because of their poverty. Hence, the marginal disutility of income forgone from leisure diminishes, and idleness and poverty tend to increase further, which in turn increases the amount of subsidy that must be extracted from the taxpayers. Thus, a system of legally subsidized poverty tends to call forth more of the very poverty that is supposedly being alleviated. When, as is generally the case, the amount of subsidy depends directly on the number of children possessed by the pauper, there is a further incentive for the pauper to breed more children than otherwise and thereby multiply the number of paupers—and even more dependent paupers—still further.[58] The sincerity of the State's desire to promote charity towards the poor may be gauged by two perennial drives of government: to suppress "charity rackets" and to drive individual beggars off the streets because the "government makes plenty of provision for them."[59] The effect of both measures is to cripple voluntary

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[58]As Thomas Mackay aptly stated: "We can have exactly as many paupers as the country chooses to pay for." Thomas Mackay, *Methods of Social Reform* (London: John Murray, 1896), p. 210. Private charity to the poor, on the other hand, would not have the same vicious-circle effect, since the poor would not have a continuing compulsory claim on the rich. This is particularly true where private charity is given only to the "deserving" poor. On the nineteenth-century concept of the "deserving poor," cf. Barbara Wootton, *Social Science and Social Pathology* (London: George Allen & Unwin, 1959), pp. 51, 55, and 268 ff.

[59]The reader may gauge from the following anecdote by an admirer of such a drive just *who* was the true friend of the poor organ-grinder—his customer or the government:

> During a similar campaign to clean up the streets of organ-grinders (most of whom were simply licensed beggars) a woman came up to LaGuardia at a social function and begged him not to deprive her of her favorite organ-grinder.
>
> "Where do you live?" he asked her.

individual gifts of charity and to force the public to route its giving into the channels approved by, and tied in with, government officialdom.

Similarly, governmental *unemployment relief*, often supposed to help in curing unemployment, has the precisely reverse effect: it subsidizes and intensifies unemployment. We have seen that unemployment arises when laborers or unions set a minimum wage above what they could obtain on the unhampered market. Tax aid helps them to keep this unrealistic minimum and hence prolongs the period of unemployment and aggravates the problem.

C. Resource-Using Activities

Let us now return to the resource-using activities of government, where the State professes to be providing a service of some sort to the public. Government "service" may be either furnished free or sold at a price to users. "Free" services are particularly characteristic of government. Police and military protection, firefighting, education, parks, some water supply come to mind as examples. The first point to note, of course, is that these services are not and cannot be truly *free*. A free good, as we saw early in this book, would not be a good and hence not an object of human action; it would simply exist in superabundance for all. If a good does not exist aplenty for all, then the resource is scarce, and supplying it costs society other goods forgone. Hence it cannot be free. The resources needed to supply the free governmental service are extracted from the rest of production. Payment is made, however, not by users on the basis of

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"On Park Avenue!"

LaGuardia successfully pushed through his plan to eliminate the organ-grinders and the peddlers, despite the pleas of the penthouse slummers. (Newbold Morris and Dana Lee Thomas, *Let the Chips Fall* [New York: Appleton-Century-Crofts, 1955], pp. 119–20) their voluntary purchases, but by a coerced levy on the taxpayers. A basic split is thus effected between *payment* and *receipt of service.* This split is inherent in all government operations.

Many grave consequences follow from the split and from the "free" service as well. As in all cases where price is below the free-market price, an enormous and excessive demand is stimulated for the good, far beyond the supply of service available. Consequently, there will always be "shortages" of the free good, constant complaints of insufficiency, overcrowding, etc. An illustration is the perpetual complaints about police insufficiency, particularly in crime-ridden districts, about teacher and school shortages in the public school system, about traffic jams on government-owned streets and highways, etc. In no area of the free market are there such chronic complaints about shortages, insufficiencies, and low quality service. In all areas of private enterprise, firms try to coax and persuade consumers to buy more of their product. Where government owns and operates, on the other hand, there are invariably calls on consumers for patience and sacrifice, and problems of shortages and deficiencies continually abound. It is doubtful if any private enterprise would ever do what the New York City and other governments have done: exhort consumers to use *less* water. It is also characteristic of government operation that when a water shortage develops, it is the *consumers* and not the government "enterprisers" who are blamed for the shortage. The pressure is on consumers to sacrifice, and to use less, while in private industry the (welcome) pressure is on entrepreneurs to supply more.[60]

The well-known inefficiencies of government operation are *not* empirical accidents, resulting perhaps from the lack of a civil

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[60]See Murray N. Rothbard, "Government in Business" in *Essays on Liberty* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1958), IV, 186 ff. It is therefore characteristic of government ownership and "enterprise" that the consumer becomes, not a "king" to be courted, but a troublesome fellow bent on using up the "social" product.

service tradition. They are *inherent* in all government enterprise, and the excessive demand fomented by free and other underpriced services is just one of the many reasons for this condition.

Free supply not only subsidizes the users at the expense of nonusing taxpayers; it also misallocates resources by failing to supply the service where it is most needed. The same is true, to a lesser extent, wherever the price is under the free-market price. On the free market, consumers can dictate the pricing and thereby assure the best allocation of productive resources to supply their wants. In a government enterprise, this cannot be done. Let us take again the case of the free service. Since there is no pricing, and therefore no exclusion of submarginal uses, there is no way that the government, even if it wanted to, could allocate its services to their most important uses and to the most eager buyers. All buyers, all uses, are artificially kept on the same plane. As a result, the most important uses will be slighted. The government is faced with insuperable allocation problems, which it cannot solve *even to its own satisfaction.* Thus, the government will be confronted with the problem: Should we build a road in place A or place B? There is no rational way whatever by which it can make this decision. It cannot aid the private consumers of the road in the best way. It can decide only according to the whim of the ruling government official, i.e., only if the *government officials* do the "consuming," and not the public.[61] If the government wishes to do what is best for the public, it is faced with an impossible task.

D. The Fallacy of Government on a "Business Basis"

Government may either subsidize deliberately by giving a service away free, or it may genuinely try to find the true market price, i.e., to "operate on a business basis." The latter is

[61]Thus, the government official may select a road that will yield him or his allies more votes.

often the cry raised by conservatives—that government enterprise be placed on a business footing, that deficits be ended, etc. Almost always this means raising the price. Is this a rational solution, however? It is often stated that a single government enterprise, operating within the sphere of a private market and buying resources from it, can price its services and allocate its resources efficiently. This, however, is incorrect. *There is a fatal flaw* that permeates every conceivable scheme of government enterprise and ineluctably prevents it from rational pricing and efficient allocation of resources. Because of this flaw, government enterprise can *never* be operated on a "business" basis, no matter how ardent a government's intentions.

What is this fatal flaw? It is the fact that government can obtain virtually unlimited resources by means of the coercive tax power (i.e., limited only by the total resources of society). Private businesses must obtain their funds from private investors. This allocation of funds by investors, based on time preference and foresight, "rations" funds and resources to the most profitable and therefore the most serviceable uses. Private firms can get funds *only* from consumers and investors; they can get funds, in other words, only from people who value and buy their services and from savers who are willing to risk investment of their saved funds in anticipation of profit. In short, payment and service are, we repeat, indissolubly linked on the market. But government, on the other hand, can get as much money as it likes. The free market therefore provides a "mechanism," which we have analyzed in detail, for allocating funds for future and present consumption, for directing resources to their most value-productive uses for all the people. It thereby provides a means for businessmen to allocate resources and to price services to insure optimum use. Government, however, has no checkrein on itself, i.e., no requirement of meeting a test of profit-and-loss or valued service to consumers, to permit it to obtain funds. Private enterprise can get funds only from satisfied, valuing customers and from investors guided by present and expected future profits and losses. Government gets more funds at its own whim.

With the checkrein gone, gone also is any opportunity for government to allocate resources rationally. How can it know whether to build road A or road B, whether to "invest" in a road or a school—in fact, how much to spend for all of its activities? There is no rational way that it can allocate funds or even decide how much to have. When there is a shortage of teachers or schoolrooms or police or streets, the government and its supporters have only one answer: more money. The people must relinquish more of their money to the government. Why is this type of answer never offered on the free market? The reason is that money must always be *withdrawn* from some other use in consumption or investment—and this withdrawal must be justified. On the market, justification is provided by the test of profit and loss—the indication that the most urgent wants of the consumers are being satisfied. If an enterprise or product is earning high profits for its owners, and these profits are expected to continue, more money *will be* forthcoming; if not, and losses are being incurred, money will flow *out* of the industry. The profit-and-loss test serves as the critical guide for directing the flow of productive resources. No such guide exists for government, which therefore has no rational way to decide *how much* money to spend in total or in each specific line. The more money it spends, the more service, of course, it can supply—but where to stop?[62]

Proponents of government enterprise may retort that the government should simply tell its bureau to act *as if* it were a profit-making enterprise and to establish itself in the same way as a private business. There are two basic flaws in this theory: (1) It is impossible to *play* enterprise. Enterprise means risking one's own money in investment. Bureaucratic managers and politicians have no real incentive to develop entrepreneurial skills, to really adjust to consumer demands. They

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[62]Cf. Ludwig von Mises, *Bureaucracy* (New Haven: Yale University Press, 1946), pp. 50, 53.

do not risk loss of their money in the enterprise. (2) Aside from the question of incentives, even the most eager managers *could not* function as a business. For, regardless of the treatment accorded the operation *after* it is established, the *initial* launching of the firm is made with government money, and therefore by coercive levy. A fatally arbitrary element has been "built into" the very vitals of the enterprise. Furthermore, future decisions on expenditures will be made out of tax funds and will therefore be subject to the same flaw. The ease of obtaining money will inherently distort the operations of government enterprise. Moreover, suppose that the government "invests" in an enterprise E. Either the free market, left alone, would also have invested in this selfsame enterprise, or it would not. If it would have, then the economy suffers, at the very least, from the "take" going to the intermediary bureaucracy. If not, and this is almost certain, then it follows immediately that the expenditure on E is a distortion of private utility on the market—that some other expenditure would have brought greater monetary returns. It follows once again that a government enterprise cannot duplicate the conditions of private business.

In addition, the establishment of government enterprise creates an "unfair" competitive advantage over private firms, for at least part of its capital was gained by coercion rather than service. It is clear that government, with its subsidization, can drive a private business out of the field. Private investment in the same industry will be greatly restricted, since future investors will anticipate losses at the hands of privileged governmental competitors. Moreover, since all services compete for the consumer's dollar, all private firms and all private investment will to some degree be affected and hampered. And when a new government enterprise begins, it generates fears in other industries that they will be next, that they will either be confiscated or forced to compete with government-subsidized enterprises. This fear tends to repress productive investment further and thus lower the general standard of living still more.

Another argument, used quite correctly by "leftist" proponents of government ownership, is this: If business operation is so desirable, why take such a tortuous route? Why not scrap government ownership and turn the whole operation over to private business enterprise? Why go to such elaborate lengths to try to imitate the apparent ideal (private ownership) when the ideal may be pursued directly? The call for business principles in government, therefore, makes little sense, even if that call could be successful.

Many "criteria" have been offered by writers as guides for the pricing of government services. One criterion supports pricing according to "marginal cost." As we have indicated above, however, this is hardly a criterion at all and rests on classical fallacies of price determination by costs. "Marginal" varies according to the period of time surveyed. And costs are not in fact static but flexible; they change according to prices and hence cannot be used as a guide to the setting of prices. Moreover, prices equal average costs only in final equilibrium, and equilibrium cannot be regarded as an ideal for the real world. The market only *tends toward* this goal. Finally, costs of government operation will be higher than for similar operations on the free market.[63]

Government enterprise will not only hamper and repress private investment and entrepreneurship in the same industry and in industries throughout the economy; it will also disrupt the entire labor market. For the government (*a*) will decrease production and living standards in the society by siphoning off potentially productive labor to the bureaucracy; (*b*) using confiscated funds, it will be able to pay more than the market rate for labor and hence set up a clamor by government job-seekers

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[63]Various fallacious criteria have been advanced for deciding between private and state action. One common rule is to weigh "marginal social costs" and benefits against "marginal private costs" and benefits. Apart from other flaws, there is no such entity as "society" separate from constituent individuals, so that this preferred criterion is simply meaningless.

for an expansion of the unproductive bureaucratic machine; and (*c*) the government's high tax-supported wages may well mislead workers into believing that this reflects the market wage in private industry, thus causing unwanted unemployment.

The inefficiencies of government operation are compounded by several other factors. As we have seen, a government enterprise competing in an industry can usually drive out private owners, since the government can subsidize itself in many ways and supply itself with unlimited funds when desired. In cases where it cannot compete even under these conditions, it can arrogate to itself a compulsory monopoly, driving out competitors by force. This was done in the United States in the case of the post office.[64] When the government thus grants itself a monopoly, it may go to the other extreme from free service; it may charge a monopoly price. Charging a monopoly price—now identifiably different from a free-market price—distorts resources again and creates an artificial scarcity of the particular good. It also permits an enormously lowered quality of service. A governmental monopoly need not worry that customers may go elsewhere or that inefficiency may mean its demise.[65] It is particularly absurd

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[64]See the interesting pamphlet by Frank Chodorov, *The Myth of the Post Office* (Hinsdale, Ill.: Henry Regnery Co., 1948). On a similar situation in England, *see* Frederick Millar, "The Evils of State Trading as Illustrated by the Post Office" in Thomas Mackay, ed., *A Plea for Liberty* (New York: D. Appleton Co., 1891), pp. 305–25. For a portrayal of the political factors that have systematically distorted economic considerations in setting postal rates in the United States, *see* Jane Kennedy, "Development of Postal Rates: 1845–1955," *Land Economics*, May, 1957, pp. 93–112; and Kennedy, "Structure and Policy in Postal Rates," *Journal of Political Economy*, June, 1957, pp. 185–208.

[65]Only governments can make self-satisfied announcements of cuts in service in order to effect economies. In private business, economies must be made as corollaries to improvements in service. A recent example of a cut in government service—in the midst of improving private services in most other fields—was the decline in American postal deliveries from two to one a day, coupled, of course, with perennial requests for higher rates.

to call for "business principles" where a government enterprise functions as a monopoly. Periodically, for example, there are demands that the post office be put on a "business basis" and end its deficit, which must be paid by the taxpayers. But ending the deficit of an inherently and necessarily inefficient government operation does not mean going on a business basis. To cover costs, the price must be raised high enough to achieve a monopoly price and so camouflage and compensate for the government's inefficiencies. A monopoly price will levy an excessive burden on the users of the postal service, especially since the monopoly is compulsory. On the other hand, we have seen that even monopolists must abide by the consumers' demand schedule. If this demand schedule is elastic enough, it may well happen that a monopoly price will reduce revenue so much or cut down so much on its increase that a higher price will *increase* deficits rather than reduce them. An outstanding example has been the New York City subway system in recent years.[66]

E. Centers of Calculational Chaos

We have seen in chapter 10 above that one cartel or one firm could not own all the means of production in the economy, because it could not calculate prices and allocate factors

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When France nationalized the important Western Railway system in 1908, freight was increasingly damaged, trains slowed down, and accidents grew at such a pace that an economist caustically observed that the French government had added railway accidents to its growing list of monopolies. *See* Murray N. Rothbard, "The Railroads of France," *Ideas on Liberty*, September, 1955, p. 42.

[66]Ironically enough, the higher fares have driven many customers to buying and driving their own cars, thus aggravating the perennial traffic problem (shortage of government street space) even further. Another example of government intervention creating and multiplying its own difficulties! On the subways, *see* Ludwig von Mises, "The Agony of the Welfare State," *The Freeman*, May 4, 1953, pp. 556–57.

in a rational manner. And we have seen that this is the reason why State socialism could also not plan or allocate rationally. We further noted that two or more stages could not be totally integrated vertically on the market—for total integration would eliminate a whole segment of the market and establish an island of calculational and allocational chaos, an island that would preclude optimal planning for profits and maximum satisfaction for the consumers.

In the case of simple government ownership, still another extension of this thesis becomes evident. For *each* governmental firm introduces its *own* island of chaos into the economy; *there is no need to wait for full socialism for chaos to begin its work.* No government enterprise can ever determine prices or costs or allocate factors or funds in a rational, welfare-maximizing manner. No government enterprise could be established on a "business basis" even if the desire were present. Thus, any governmental operation injects a point of chaos into the economy; and since all markets are interconnected in the economy, every governmental activity disrupts and distorts pricing, the allocation of factors, consumption/investment ratios, etc. Every government enterprise not only lowers the social utilities of the consumers by forcing the allocation of funds to other ends than those desired by the public; it lowers the utility of everyone (including the utilities of some government officials) by distorting the market and spreading calculational chaos. The greater the extent of government ownership, of course, the more powerful will this impact become.

F. Conflict and the Command Posts

Aside from its purely economic consequences, government ownership has another kind of impact on society; it necessarily substitutes conflict for the harmony of the free market. Since government service means service by one set of decision-makers, it comes to mean uniform service. The desires of all those forced, directly or indirectly, to pay for the government service cannot be satisfied. Only some forms of the service can or will be produced by the government agency. As a result, government enterprise creates enormous caste conflicts among the citizens, each of whom has different ideas on the best form of service. In the final result, government enterprise can hardly fail to substitute its own values, or the values of one set of customers, for the values of all others. Artificially standardized services of poorer quality—fit to governmental taste or convenience—will hold sway, in contrast to the diversified services of higher quality which the free market supplies to fit the tastes of a multitude of individuals.

In recent years government schools in America have furnished a striking example of such problems and conflicts. Some parents prefer racially segregated schools; others prefer integrated education. Some parents want their children taught socialism; others want antisocialist teaching in the schools. There is no way that the government can resolve these conflicts. It can only impose the will of one group by coercion and leave the others dissatisfied and unhappy. Whichever type of school is chosen, some groups of parents will suffer. On the other hand, there is no such conflict on the free market, which provides any type of service demanded. On the market, those who want segregated or integrated, prosocialist or individualist, schools can have their wants satisfied. It is obvious, therefore, that governmental, as opposed to private, provision of services, lowers the standard of living of much of the population.

The degrees of government ownership in the economy vary from one country to another, but in *all* countries the State has made sure that it owns and monopolizes the vital nerve centers, the command posts of the society. It has acquired compulsory monopoly ownership over these command posts, and it has always asserted, without proof, that private ownership and enterprise in these fields is simply and a priori impossible.

Such vital command posts are defense, money (the mint and, nowadays, note issue), rivers and coastal seas, streets and highways, land generally (the "public domain" and the power of "eminent domain"), and the post office. The defense function is particularly vital to the State's existence, for on its virtual monopoly of force depends its ability to extract taxes from its citizens. Another critical command post held, though not always monopolized by, the State is education. For government schooling permits the influencing of the youthful mind to accept the virtues of the government under which it lives and of the principle of government intervention. Conservatives who often attack "socialistic" teaching in government schools are particularly wide of the mark, for the very fact that a government school exists and is therefore presumed to be good teaches its little charges the virtues of government ownership by example. And if government ownership is good and even preferable in schooling, why not for other educational media, e.g., newspapers—or for other important social services?

Even where the government does not have a compulsory monopoly of schooling, it approaches this ideal by compelling attendance of all children at either a government school or a private school approved by the government. Compulsory attendance brings into the schools those who do not desire or cannot benefit from schooling and forces them out of such competing fields as leisure and business employment.

G. The Fallacies of "Public" Ownership

Finally, government ownership is often referred to as "public" ownership (the "public domain," "public schools," the "public sector"). The implication is that when government owns anything, every member of the public owns equal shares of that property. But we have seen that the important feature of ownership is not legal formality but actual rule, and under government ownership it is the government officialdom that controls and directs, and therefore "owns," the property. Any member of the "public" who thinks he owns the property may test this theory by trying to appropriate for his own *individual* use his aliquot part of government property.[67,68]

While rulers of government own "public" property, their ownership is not secure in the long run, since they may always be defeated in an election or deposed. Hence government officials will tend to regard themselves as only transitory owners of "public" resources. While a private owner, secure in his property and its capital value, may plan the use of his resource over a long period of time in the future, the government official must exploit "his" property as quickly as he can, since he has no security of tenure. And even the most securely entrenched civil servant must concentrate on present use, because government officials cannot usually sell the capitalized value of their property, as private owners can. In short, except in the case of the "private property" of a hereditary monarch, government officials own the current *use* of resources, but not their capital value. But if a

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[67]It might be objected that individual stockholders of corporations cannot do this either, e.g., a General Motors stockholder is not allowed to seize a car in lieu of cash dividends or in exchange for his stock. Yet stockholders *do* own their company, and this example precisely proves our point. For the individual stockholder can contract out of his company; he can *sell* his aliquot shares of General Motors stock to someone else. The subject of government *cannot* contract out of that government; he cannot sell his "shares" in the post office, for example, because he has no such shares. As F.A. Harper has succinctly stated: "The corollary of the right of ownership is the right of disownership. So if I cannot sell a thing, it is evident that I do not really own it." Harper, *Liberty: A Path to Its Recovery*, pp. 106, 32. *Also see* Isabel Paterson, *The God of the Machine* (New York: Putnam's, 1943), pp. 179 ff., and T. Robert Ingram, *Schools: Government or Public?* (Houston: St. Thomas Press, n.d.).

[68]It might be noted that even if all the fallacious planks of the Henry George structure were conceded, the Single Tax program would still not follow from the premises. As Benjamin Tucker brilliantly demonstrated years ago, the most that could possibly be established would be *each man's* "right" to his tiny aliquot part of the site value of every plot of land—*not* the *State's* right to the whole value. Tucker, *Individual Liberty*, pp. 241–43.

resource itself cannot be owned, but only its current use, there will rapidly ensue an uneconomic exhaustion of the resource, since it will be to no one's benefit to conserve it over a period of time, and yet to each owner's advantage to use it up quickly. It is particularly curious, then, that almost all writers parrot the notion that private owners, possessing time preference, must take the "short view" in using their resources, while only government officials are properly equipped to exercise the "long view." The truth is precisely the reverse. The private individual, secure in his capital ownership, can afford to take the long view because of his interest in maintaining the capital value of his resource. It is the government official who must take and run, who must exploit the property quickly while he is still in command.[69]

H. Social Security

Before ending our discussion of specific governmental activities, we may note in passing a curiously popular form of government expenditure: "social security." Social security confiscates the income of wage earners, and then, most people presume, it invests the money more wisely than they could themselves, later paying out the money to the former wage earners in their old age. Considered as "social insurance," this is a typical example of government enterprise: there is no relation between premiums and benefits, the latter changing yearly under the impact of political pressures. On the free market, anyone who wishes may invest in an insurance annuity or in stocks or real estate. Compelling everyone to transfer his funds to the government forces him to lose utility. Thus, even on its face, it is difficult to understand the great popularity of the social security program. But the true nature of the program differs greatly

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[69]Those who object that private individuals are mortal, while "governments are immortal," indulge in the fallacy of conceptual realism at its starkest. "Government" is not a real acting entity, but rather a type of interpersonal action adopted by actual individuals.

from the popular image. For the government does *not* invest the funds it takes in taxes; it simply spends them, giving itself its own bonds which must later be cashed when the benefits fall due. The cash, of course, can be obtained only by *further* taxation. Thus the public must pay *twice* for one payment of social security. The program is essentially one of making more palatable a general taxation of lower-income, wage-earning groups.

I. Socialism and Central Planning

When government ownership or control extends to the entire productive system, then the economic system is called *socialism*. Socialism, in short, is the violent abolition of the market, the compulsory monopolization of the entire productive sphere by the State. There are two and only two ways that any economy can be organized. One is by freedom and voluntary choice—the way of the market. The other is by force and dictation—the way of the State. To those ignorant of economics, it may seem that the way of the market is only anarchic confusion and chaos, while the way of the State constitutes genuine organization and "central planning." On the contrary, we have seen in this book what an amazing and flexible mechanism the market is for satisfying the wants of all individuals. State operation or intervention is, on the other hand, far less efficient and creates many disruptive and cumulative problems of its own. Moreover, a socialist State, deprived of the real market and its determination of prices for producers' goods, *cannot* calculate and can therefore run a productive system only in chaotic fashion. The economics of socialism—a whole branch of economics of its own—can only be touched upon here; suffice it to say that Mises' demonstration of the impossibility of economic calculation under socialism has never been successfully refuted.[70]

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[70]See the literature referred to in chapter 10, above, on the economics of socialism. Also John Jewkes, *Ordeal by Planning* (New York: Macmillan & Co., 1948). For application to Soviet practice, *see* Boris Brutzkus, *Economic Planning in Soviet Russia* (London: Routledge, 1935)

Here we might mention just a few points on the economics of socialism. One, since ownership is, *de facto*, the control of a resource, a Nazi, Fascist, or other "centrally planned" system is as much "socialism" as a Communist regime that officially nationalizes property.[71] Secondly, the extent of socialism in the present-day world is at the same time *under*estimated in countries such as the United States and *over*estimated in Soviet Russia. It is underestimated because the expansion of government *lending* to private enterprise in the United States has been generally neglected, and we have seen that the lender, regardless of his legal status, is also an entrepreneur and part owner. The extent of socialism is overestimated because most writers ignore the fact that Russia, socialist as she is, cannot have full socialism as long as she can still refer to the relatively free markets existing in other parts of the world. In short, a single socialist country or bloc of countries, while inevitably experiencing enormous difficulties and wastes in planning, can still buy and sell and refer to the world market and can therefore at least vaguely approximate some sort of rational pricing of producers' goods by extrapolating from that market.[72] The well-known wastes

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and such recent material as G.F. Ray, "Industrial Planning in Hungary," *Scottish Journal of Political Economy*, June, 1960; E. Stuart Kirby, "Economic Planning and Policy in Communist China," *International Affairs*, April, 1958; P.J.D. Wiles, "Changing Economic Thought in Poland," *Oxford Economic Papers*, June, 1957; Alec Nove, "The Politics of Economic Rationality," *Social Research*, Summer, 1958; and especially, Nove, "The Problem of 'Success Indicators' in Soviet Industry," *Economica*, February, 1958. See below on socialist planning in connection with growth and underdevelopment.

[71]A chief difference is that a formal Communist-style expropriation makes it far more difficult to *desocialize* later.

[72]The first one to point this out was Ludwig von Mises, in his *Human Action*, pp. 698–99. It is particularly interesting to find an empirical confirmation in Wiles, dealing with Communist planning:

> What actually happens is that "world prices," i.e., *capitalist world prices*, are used in all intra-[Soviet] bloc trade.

and errors of this partial socialist planning are negligible compared to what would be experienced under the *total* calculational chaos of a world socialist state.

Another neglected factor diminishing the extent of planning in socialist countries is "black market" activities, particularly in commodities (candy, cigarettes, drugs, stockings, etc.) that are easy to conceal. Even in bulkier commodities, falsification of records and extensive graft may bring some sort of limited market—a market violating all the socialist plans—into existence.[73]

Moreover, it should be noted that a centrally "planned" economy is a centrally *prohibited* economy. The concept of "social engineering" is a deceptive metaphor, since in the *social* realm, it is largely *people* who are being planned, rather than the inanimate machinery of engineering blueprints. And since every individual is by nature, if not always by law, a self-owner and self-starter—i.e., a self-energizer, this means that central orders, backed up, as they must be under socialism, by force and violence, effectively *prohibit* all the individuals from doing what they want most or what they believe themselves to be best

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> They are translated into rubles . . . and entered into bilateral clearing accounts. To the question, "What would you do if there were no capitalist world?" came only the answer "We'll cross that bridge when we come to it." In the case of electricity the bridge is already under their feet; there has been great difficulty in pricing it since there is no world market. (Wiles, "Changing Economic Thought in Poland," pp. 202–03)

On the difficulties encountered by the Soviet bloc in using world market prices, *see especially* Horst Mendershausen, "The Terms of Soviet-Satellite Trade: A Broadened Analysis," *Review of Economics and Statistics*, May, 1960, pp. 152–63.

[73]For an interesting account of the recent growth of organized private enterprises in Soviet Russia, illegal but protected by local graft, *see* Edward Crankshaw, "Breaking the Law in a Police State: Regimentation Can't Curb Russians' Anarchic Spirit," *New York Herald-Tribune*, August 17, 1960.

fitted to do. If the Central Planning Board, in short, orders X and Y to Pinsk to work as truck drivers, this means that X and Y are effectively and coercively *prohibited* from doing what they would have done voluntarily: perhaps X would have gone to Leningrad to be a longshoreman, and perhaps Y would have stayed around to tinker in his workshop and invent a new and highly useful device.

The latter point brings us to another grave defect of central planning: inventions, innovations, technological developments, by their very nature, by definition, cannot be predicted in advance and therefore cannot be centrally and bureaucratically *planned*. Not only does no one know *what* will be invented *when*; no one knows *who* will do the inventing. Clearly, a centrally prohibited economy, irrational and inefficient enough for *given* ends and given means and techniques at any point of time, is all the more incompetent if a flow of inventions and new development are desired in society. Bureaucracy, incompetent enough to plan a stationary system, is vastly more incompetent at planning a progressive one.[74,75]

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[74]Recent researches have shown the fallacy of the common view that modern inventions and applied technological developments can take place only in very large-scale, even centrally planned, laboratories. See particularly the brilliant work of John Jewkes, David Sawers, and Richard Stillerman, *The Sources of Invention* (London: Macmillan & Co., 1958). *Also see* John R. Baker, *Science and the Planned State* (New York: Macmillan & Co., 1945). For a useful summary of recent literature in this field, *see* Richard R. Nelson, "The Economics of Invention: A Survey of the Literature," *The Journal of Business*, April, 1959, pp. 101–27. Soviet science has, of course, been able to copy the technical achievements of the West; yet, on the inefficiencies of Soviet science, *see* Baker, *Science and the Planned State*, and Baker, *Science and the Sputniks* (London: Society for Freedom in Science, December, 1958). Of interest on the inherent inefficiencies of governmental military research is the Hoover Commission Task Force Report: Subcommittee of the Commission on Organization of the Executive Branch of Government, *Research Activities in the Department of Defense and Defense-Related Agencies* (Washington, D.C.: April,

10. Growth, Affluence, and Government

A. The Problem of Growth

In recent years economists and journalists alike have been heavily emphasizing a new concept—"growth," and much economic writing is engaged in a "numbers game" on what percentage, or "rate of growth," "we" should have next year or in the next decade. The discussion is replete with comparisons of the higher rate of country X which "we" must hurriedly counter, etc. Amidst all the interest in growth, there are many grave problems which have hardly been touched upon. First and foremost is the simple query: "What is so good about growth?" The economists, discoursing scientifically about growth, have illegitimately smuggled an ethical judgment into their science—an ethical judgment that remains unanalyzed, as if it were self-evident. But why should growth be the highest value for which we can strive? What is the ethical justification? There is no doubt about the fact that growth, taken over as another dubious metaphor from biology, "sounds" good to most people, but this hardly constitutes an adequate ethical analysis. Many things are considered as good, but on the free market every man must choose between different quantities of them and the price for those forgone. Similarly, growth, as we shall presently see, must be balanced and weighed against competing values. Given due consideration, growth would be considered by few people as the *only* absolute value. If it were, why stop at 5 percent or 8 percent growth per year? Why not 50 percent?

1955). On atomic energy and government, *see*, in addition to Jewkes, Sawers, and Stillerman, Alfred Bornemann, "Atomic Energy and Enterprise Economics," *Land Economics*, August, 1954.

Virtually the central theme of Hayek's *Constitution of Liberty* is the importance of freedom for innovations and progress, in the widest sense.

[75]Two of the arguments for government activity most favored by economists are the "collective goods" and "external benefit" arguments. For a critique, see Appendix B below.

It is completely illegitimate for the economist *qua* economist simply to endorse growth. What he can do is to contrast what growth means in various social conditions. In a free market, for example, every person chooses how much future growth he wants as compared to *present consumption.* "Growth," i.e., a rise in future living standards, can be achieved, as we have implicitly made clear throughout this volume, only in a few definable ways. Either more and better resources can be found, or more and better people can be born, or technology improved, or the capital goods structure must be lengthened and capital multiplied. In practice, since resources need capital to find and develop them, since technological improvement can be applied to production only via capital investment, since entrepreneurial skills act only through investments, and since an increased labor supply is relatively independent of short-run economic considerations and can backfire in Malthusian fashion by lowering per capita output, the *only* viable way to growth is through increased saving and investment. On the free market, each individual decides how much he wants to save—to increase his future living standards —as against how much he wants to consume in the present. The net resultant of all these voluntary individual decisions is the nation's or world's rate of capital investment. The total is a reflection of the voluntary, free decisions of every consumer, of every person. The economist, therefore, has no business endorsing "growth" as an end; if he does so, he is injecting an unscientific, arbitrary value judgment, especially if he does not present an ethical theory in justification. He should simply say that, in a free market, everyone gets as much "growth" as he chooses to obtain; and that, furthermore, the people as a whole benefit greatly from the voluntary savings of others who do the saving and investing.

What happens if the government decides, either by subsidies or by direct government ownership, to try to spur the social rate of growth? Then, the economist should point out, the entire situation changes. No longer does each person elect to "grow" as he thinks best. Now, with compulsory saving and investing, investment can come only *at the expense* of the *forced* saving of some individuals. In short, if A, B, and C "grow" because their standard of living rises from compulsory investment, they do so at the expense of D, E, and F, the ones who were compelled to save. No longer can we say that the social standard of living, the standard of living of each active person, rises; under compulsory growth, some people—the coerced savers—clearly and demonstrably *lose*. *They* "grow" backward. Here is one reason why government intervention can *never* raise society's rate of "growth." For when individuals act freely on the market, every one of their actions benefits everyone, and so growth is truly "social," i.e., participated in by everyone in the society. But when government acts to force growth, it is only *some* who grow at the expense of the *retrogression* of others. The *Wertfrei* economist is therefore not permitted to say that "society" grows at all.

Growth, therefore, is demonstrably not the single absolute value for anyone. People on the market all weigh growth *against* present consumption, just as they weigh work against leisure, and all goods against one another. If we fully realize that there is no such existent entity as "society" apart from individuals, it becomes clear that "society" cannot grow at the expense of imposing losses on some or most of its members. Suppose, for example, that a community exists where the bulk of the population do not *want* to "grow"; they would rather not work very hard or save very much; instead they would loll under the trees, pick berries, and play games. To advocate the government's coming on the scene and forcing these people to work and save, in order to "grow" at some time in the future, means to advocate the compulsory lowering of the standard of living of the bulk of the populace in the present and near future. Any sort of achieved production, under this scheme, however great, would not be "growth" for society; instead it would be retrogression, not only for some but for most people. An economist, therefore, cannot *scientifically* advocate compulsory growth, for what he is really doing is attempting to impose his own ethical views (e.g., more hard work and saving is better than more leisure and berries) on the *other* members of society by force. These members greatly lose utility as a result.

Furthermore, it must be emphasized again that in cases of coerced saving the *saver* reaps none of the benefit of his sacrifice, which is instead reaped by government officials or other beneficiaries. This contrasts to the free market, where people save and invest precisely because *they* will reap some tangible and desired rewards.

In a regime of coerced growth, then, "society" cannot grow, and conditions are totally different from those of the free market. Indeed, what we have is a form of the "free rider" argument against the free market and for government; here the various "free riders" band together to force *other* people to be thrifty so that the former can benefit.[76]

Even if we set these problems aside, it is doubtful how much the coercing free riders can benefit from these measures. Many considerations treated above now come into play. In the first place, the growth and success of the compulsory free riders discourage production and shift more and more people and energy from production to the exploitation of production, i.e., to compulsory free riding. Secondly, we have seen that if government itself does the "investing" out of the confiscated savings of others, the result, for many reasons, is not genuine investment, but *waste assets*. The capital built out of coerced savings, then, instead of benefiting the consumers, is largely wasted and dissipated. Even if government uses the money to subsidize various private investments, the results are still grave; for these investments, being uneconomic in relation to genuine consumers' demand and profit-and-loss signals on the market, will constitute *mal*investment. Once the government removed its subsidies and let all capital compete equally in serving consumers, it is doubtful how much of this investment would survive.

[76]This is the first line of argument for government intervention analyzed in Appendix B below.

Although we have no intention of dealing here to any extent with an empirical problem like Soviet economic growth, we may illustrate our analysis by noting the hullabaloo that has been raised in recent years over the supposedly enormous rate of Soviet growth. Curiously, one finds that the "growth" seems to be taking place almost exclusively in capital goods, such as iron and steel, hydroelectric dams, etc., whereas little or none of this growth ever seems to filter down to the standard of living of the average Soviet consumer. The consumer's standard of living, however, is the be-all and end-all of the entire production process. *Production* makes no sense whatever except as a means to *consumption*. Investment in capital goods means nothing except as a *necessary way station to increased consumption*. When capital investment takes place in the free market, it deprives no one of consumption goods; for those save who voluntarily choose investment over some present consumption. No one is required to sacrifice present consumption who does not wish to do so. As a result, the standard of living of everyone rises continually and smoothly as investment increases. But a Soviet or other system of compulsory investment *lowers* the standard of living of almost everyone, certainly in the near future. And there is every indication that the "pie-in-the-sky" day when living standards finally rise almost never arrives. In short, government "investment," as we have noted above, turns out to be a peculiar form of wasteful "consumption" by government officials.[77]

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[77]In many cases, these "investments" are not simply bureaucratic errors; they pay welcome gains to government officials in "prestige." Every "underdeveloped" government seems to insist on its steel mill or its dam, for example, regardless whether it is economic or not (therefore usually *not*). As Professor Friedman astutely points out:

> The Pharaohs raised enormous sums of capital to build the Pyramids; this was capital formation on a grand scale; it certainly did not promote economic development in the fundamental sense of contributing to a self-sustaining

There is another consideration that reinforces our conclusion. Professor Lachmann has been diligently reminding us of what economists generally forget: that "capital" is not just a homogeneous blob that can be added to or subtracted from. Capital is an intricate, delicate, interweaving *structure* of capital goods. All of the delicate strands of this structure have to fit, and fit precisely, or else malinvestment occurs. The free market is almost an automatic mechanism for such fitting; and we have seen throughout this volume how the free market, with its price system and profit-and-loss criteria, adjusts the output and variety of the different strands of production, preventing any one from getting long out of alignment.[78] But under socialism or with massive government investment, there is no such mechanism for fitting and harmonizing. Deprived of a free price system and profit and-loss criteria, the government can only blunder along, blindly "investing" without being able to invest properly in the right fields, the right products, or the right places. A beautiful subway will be built, but no wheels will be available for the trains; a giant dam, but no copper for transmission lines, etc. These sudden surpluses and shortages, so characteristic of government planning, are the result of massive malinvestment by the government.[79]

> growth in the standard of life of the Egyptian masses. Modern Egypt has under government auspices built a steel mill; this involves capital formation; but it is a drain on the economic resources of Egypt . . . since the cost of making steel in Egypt is very much greater than the cost of buying it elsewhere; it is simply a modern equivalent of the Pyramids, except that maintenance expenses are higher. (Milton Friedman, "Foreign Economic Aid: Means and Objectives," *Yale Review*, Summer, 1958, p. 505)

[78]Cf. L.M. Lachmann, *Capital and Its Structure*. *Also see* P.T. Bauer and B.S. Yamey, *The Economics of Under-Developed Countries* (London: James Nisbet and Co., 1957), pp. 129 ff.

[79]On the subject of compulsory saving and government investment, see the noteworthy article of P.T. Bauer, "The Political Economy of

The current controversy over growth, is, in a sense, the result of a critical error made by "right-wing" economists in their continuing debate with their "left-wing" opponents. Instead of emphasizing freedom and free choice as their highest *political* end, the rightist economists have stressed the importance of freedom *as a utilitarian means* of encouraging saving, investment, and therefore, economic growth. We have seen above that conservative opponents of the progressive income tax have often fallen into the trap of treating saving and investment as somehow a greater and higher good than consumption, and therefore of implicitly criticizing the free market's saving/consumption ratio. Here we have another example of the same lapse into an implicit, arbitrary criticism of the market. What the modern "leftist" proponents of compulsory growth have done is to use the venerable arguments of the conservatives as a boomerang against them, and to say, in effect, to their opponents: "Very well. You have been maintaining that saving and investment are of critical importance because they lead to growth and economic progress. Fine; but, as you yourselves implicitly grant, the free market's proportion of saving and investment is really too slow. Why then rely upon it? Why not speed up growth by using government to coerce even more saving and investment, to speed

Non-Development" in James W. Wiggins and Helmut Schoeck, eds., *Foreign Aid Re-examined* (Washington, D.C.: Public Affairs Press, 1958), pp. 129–38. Bauer writes:

> . . . if development has meaning as a desirable process, it must refer to an increase in *desired* output. Governmental collection and investment of saving effect production which is not subject to the test of voluntary purchase at market price. . . . Increased output through this method is at best an ambiguous indicator of economic improvement. . . . If the capital is not provided voluntarily, this suggests that the population prefers an alternative use of resources, whether current consumption or other forms of investment. (*Ibid*., pp. 133–34)

up capital further?" It is evident that conservatives cannot counter by reiterating their familiar arguments. The proper comment here is the analysis we have been expounding—in short: (*a*) By what right do you maintain that people *should* grow faster than they voluntarily wish to grow? (*b*) Compulsory growth will not benefit the whole of society as will freely chosen growth, and it is therefore not "social growth"; some will gain—and gain at some distant date—at the expense of the retrogression of others. (*c*) Government investment or subsidized investment is either malinvestment or not investment at all, but simply waste assets or "consumption" of waste for the prestige of government officials.

What, in point of fact, *is* economic "growth"? Any proper definition must surely encompass an increase of economic means available for the satisfaction of people's ends—in short, increased satisfactions of people's wants, or as P.T. Bauer has put it, "an increase in the range of effective alternatives open to people." On such a definition, it is clear that compulsory saving, with its imposed losses and restrictions on people's effective choices, cannot spur economic growth; and also that government "investment," with its neglect of voluntary private consumption as its goal, can hardly be said to add to people's alternatives. Quite the contrary.[80]

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[80]P.T. Bauer, *Economic Analysis and Policy in Underdeveloped Countries* (Durham, N.C.: Duke University Press, 1957), pp. 113 ff. On Soviet economic growth Bauer and Yamey make this salutary comment:

> The meaning of national income, industrial output and capital formation is also debatable in an economy when so large a part of output is not governed by consumers' choices in the market; the difficulties of interpretation are particularly obvious in connection with the huge capital expenditure undertaken by government without reference to the valuation of output by consumers. (Bauer and Yamey, *Economics of Under-Developed Countries*, p. 162)

Also see Friedman, "Foreign Economic Aid," p. 510.

Finally, the very term "growth" is an illegitimate import of a metaphor from biology into human action.[81] "Growth" and "rate of growth" connote some sort of automatic necessity or inevitability and have for many people a value-loaded connotation of something self-evidently desirable.[82]

Concomitantly with the hubbub about growth there has developed an enormous literature about the "economics of underdeveloped countries." We can here note only a few considerations. First, contrary to a widespread impression, "neoclassical" economics applies just as fully to underdeveloped as to any other countries. In fact, as P.T. Bauer has often stressed, the economic discipline is in some ways sharper in less developed countries because of the extra option that many people have of reverting from a monetary to a barter economy. An underdeveloped country can grow only in the same ways as a more advanced country: largely via capital investment. The economic laws which we have adumbrated throughout this volume are independent of the specific content of any community's or nation's economy, and therefore independent of its level of development. Secondly, underdeveloped countries are especially prone to the wasteful, dramatic, prestigious government "investment" in such projects as steel mills or dams, as contrasted with economic, but undramatic, private investment in improved agricultural tools.[83,84]

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[81]For a critique of various metaphors illegitimately and misleadingly imported from the natural sciences into economics, *see* Rothbard, "The Mantle of Science."

[82]The presumably excessive growth of cancerous cells, for example, is generally overlooked.

[83]The prolific writings of Professor Bauer are a particularly fruitful source of analysis of the problems of the underdeveloped countries. In addition to the references above, *see* especially Bauer's excellent *United States Aid and Indian Economic Development* (Washington, D.C.: American Enterprise Association, November, 1959); his *West African Trade* (Cambridge: Cambridge University Press, 1954); "Lewis' *Theory of Economic Growth*," *American Economic Review*, September, 1956, pp. 632–41; "A

Thirdly, the term "underdeveloped" is definitely value-loaded to imply that certain countries are "too little" developed below some sort of imposed standard. As Wiggins and Schoeck point out, "undeveloped" would be a more objective term.[85]

Reply," *Journal of Political Economy*, October, 1956, pp. 435–41; and P.T. Bauer and B.S. Yamey, "The Economics of Marketing Reform," *Journal of Political Economy*, June, 1954, pp. 210–34.

The following quotation from Bauer's study on India is instructive for its analysis of central planning as well as development:

> As a corollary of reserving a large (and increasing) sector of the economy for the government, private enterprise and investment, both Indian and foreign, are banned from a wide range of industrial and commercial activity. These restrictions and barriers affect not only private Indian investment, but also the entry of foreign capital, enterprise and skill, which inevitably retards economic development. Such measures are thus paradoxical in view of the alleged emphasis on economic advance. (Bauer, *United States Aid*, p. 43)

Bauer's chief defect is a tendency to underweigh the role of capital in economic development.

[84]It is fascinating to discover, in 1925–26, before Soviet Russia became committed to full socialism and coerced industrialization, Soviet leaders and economists attacking central planning and forced industry and calling for economic reliance on private peasantry. After 1926, however, the Soviet planned economy deliberately planned *uneconomically* for forced heavy industry in order to establish an autarkic socialism. *See* Edward H. Carr, *Socialism In One Country, 1921–1926* (New York: Macmillan & Co., 1958), I, 259 f., 316, 351, 503–13. On the Hungarian experience, *see* Ray, "Industrial Planning in Hungary," pp. 134 ff.

[85]Wiggins and Schoeck, *Scientism and Values*, p. v. This symposium has many illuminating articles on the whole problem of underdevelopment. In addition to the Bauer article cited above, see especially the contributions of Rippy, Groseclose, Stokes, Schoeck, Haberler and Wiggins. Also see the critique of the concept of underdevelopment in Jacob Viner, *International Trade and Economic Development* (Glencoe, Ill.: Free Press, 1952), pp. 120 ff.

Because of its spectacular burst of popularity, something must here be said of the recent "stages of economic growth" doctrine of Professor Rostow. Highly recommended as "the answer to Marx" (as if Marx had never been "answered" before), Rostow divines five stages of economic growth through which each modern nation passes; these center around the "take-off" and include "preconditions" of take-off, drive from take-off to "maturity," and, as the final stage, "high mass-consumption."[86] In addition to committing the common fallacy of assuming some sort of automatic rate of "growth," Rostow adds many others of his own, among which are the following: (*a*) the resumption of the futile modern search for nonexistent "laws of history"; (*b*) the discovery of such "laws" by way of that hoary fallacy of late nineteenth-century German thought, "stages of history," with each arbitrary stage somehow destined to evolve automatically into the next; (*c*) the undue stress—here, as in other ways, closer to Marx than most critics realize—on sheer *technology* as the *fons et origo* of economic development; (*d*) the deliberate mixing of government and private firms as equally capable of "entrepreneurship"; and (*e*) reliance on the fallacious concept of "social overhead capital," which must be mainly supplied by the government before "take-off" is achieved. Actually, as we have seen, there are not different stages of economy, each subject to its own laws, but one single economics which applies to any level of development and explains any degree of "growth." Rostow's final stage of "high mass consumption" is particularly open to question. What was more characteristic of the early, "take-off" stage of the Industrial Revolution in Britain than precisely the shift of production toward mass consumption of cheap, factory-made textile goods? Mass consumption was a feature of the Industrial Revolution from the beginning; it is

[86]W.W. Rostow, *The Stages of Economic Growth* (Cambridge: Cambridge University Press, 1960). Perhaps some of the popularity may be due to the term "take-off," which is certainly in tune with our aeronautical and space-minded age.

not, contrary to a popular myth, some sort of new condition of the 1950's.[87,88]

B. Professor Galbraith and the Sin of Affluence

In the early part of the twentieth century, the main indictment of the capitalist system by its intellectual critics was the alleged pervasiveness of "monopoly." In the 1930's, mass

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[87]On the complex of fallacies involved in the search for "laws of history," *see* Ludwig von Mises, *Theory and History* (New Haven: Yale University Press, 1957); for a critique of earlier "stage theories" of economic history, *see* T.S. Ashton, "The Treatment of Capitalism by Historians" in F.A. Hayek, ed., *Capitalism and the Historians* (Chicago: University of Chicago Press, 1954), pp. 57–62. Some of the fallacies of the "social overhead" concept are refuted in Wilson Schmidt, "Social Overhead Mythology" in Wiggins and Schoeck, *Scientism and Values*, pp. 111–28, although Schmidt himself clings to several. On the superiority of private over government entrepreneurship and innovation, and in significance for development, *see* Yale Brozen, "Business Leadership and Technological Change," *American Journal of Economics and Sociology*, 1954, pp. 13–30; and Brozen, "Technological Change, Ideology and Productivity," *Political Science Quarterly*, December, 1955, pp. 522–42.

Another Rostow fallacy is the adoption of the late nineteenth-century German theory that a strong centralized state was a necessary precondition for the emergence of Western capitalism. For a partial critique, see Jelle C. Riemersma, "Economic Enterprise and Political Powers After the Reformation," *Economic Development and Cultural Change*, July, 1955, pp. 297–308.

Finally, for a keen and pioneering discussion of many aspects of coerced development, *see* S. Herbert Frankel, *The Economic Impact of Under-Developed Societies* (Oxford: Basil Blackwell, 1953). For a contrasting case study of the free-market road to development, *see* F.C. Benham, "The Growth of Manufacturing in Hong Kong," *International Affairs*, October, 1956, pp. 456–63.

[88]For a critique of Rostow, stressing his mechanistic view of history and a technological determinism that neglects the vital *ideas* creating technology and political institutions, *see* David McCord Wright, "True Growth Must Come Through Freedom," *Fortune*, December, 1959, pp. 137–38, 209–12.

unemployment and poverty ("one third of a nation") came to the fore. At the present time growing abundance and prosperity have greatly dimmed the poverty and unemployment theme, and the only serious "monopoly" seems to be that of labor unionism. Let it not be thought, however, that criticism of capitalism has died. Two seemingly contradictory charges are now rife: (*a*) that capitalism is not "growing" fast enough, and (*b*) that the trouble with capitalism is that it makes us too "affluent." Excess wealth has suddenly replaced poverty as the tragic flaw of capitalism.[89] At first sight, these latter charges appear contradictory, for capitalism is at one and the same time accused of producing too many goods, and yet of not increasing its production of goods fast enough. The contradiction seems especially glaring when the same critic presses both lines of attack, as is true of the leading critic of the sin of affluence, Professor Galbraith.[90] But, as the *Wall Street Journal* has aptly pointed out, this is not really a contradiction at all; for the excessive affluence is all in the "private sector," the goods enjoyed by the consumers; the deficiency, or "starvation," is in the "public sector," which needs further growth.[91]

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[89]This performance leads one to believe that Schumpeter was right when he declared:

> . . . capitalism stands its trial before judges who have the sentence of death in their pockets. They are going to pass it, whatever the defense they may hear; the only success victorious defense may produce is a change in the indictment. (Schumpeter, *Capitalism, Socialism and Democracy*, p. 144)

[90]John Kenneth Galbraith, *The Affluent Society* (Boston: Houghton Mifflin Co., 1958).

[91]"Fable for Our Times," *Wall Street Journal*, April 21, 1960, p. 12. Thus Galbraith, *ibid.*, deplores the government's failure to "invest more" in scientists and scientific research to promote our growth, while also attacking American affluence. It turns out, however, that Galbraith wants more of precisely that kind of research which can have no possible commercial application.

Although *The Affluent Society* is replete with fallacies, backed by dogmatic assertions and time-honored rhetorical devices in place of reasoned argument,[92] the book warrants some consideration here in view of its enormous popularity.

As in the case of most "economists" who attack economic science, Professor Galbraith is an historicist, who believes that economic theory, instead of being grounded on the eternal facts of human nature, is somehow relative to different historical epochs. "Conventional" economic theory, he asserts, was true for the eras before the present, which were times of "poverty"; now, however, we have vaulted from a centuries-long state of poverty into an age of "affluence," and for such an age, a completely new economic theory is needed. Galbraith also makes the philosophical error of believing that ideas are essentially "refuted by events"; on the contrary, in human action, as contrasted with the natural sciences, ideas can be refuted only by *other* ideas; events themselves are complex resultants which need to be interpreted by correct ideas.

One of Galbraith's gravest flaws is the arbitrariness of the categories, which pervade his work, of "poverty" and "affluence." Nowhere does he define what he means by these terms, and therefore nowhere does he lay down standards by which we can know, even in theory, when we have passed the magic borderland between "poverty" and "affluence" that requires an entirely new economic theory to come into being. The present

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[92]Galbraith's major rhetorical device may be called "the sustained sneer," which includes (*a*) presenting an opposing argument so sardonically as to make it seem patently absurd, with no need for reasoned refutation; (*b*) coining and reiterating Veblenesque names of disparagement, e.g., "the conventional wisdom"; and (*c*) ridiculing the opposition further by psychological *ad hominem* attacks, i.e., accusing opponents of having a psychological vested interest in their absurd doctrines—this mode of attack being now more fashionable than older accusations of economic venality. The "conventional wisdom" encompasses just about everything with which Galbraith disagrees.

book and most other economic works make it evident that economic science is *not* dependent on some arbitrary level of wealth; the basic praxeological laws are true of all men at all times, and the catallactic laws of the exchange economy are true whenever and wherever exchanges are made.

Galbraith makes much of his supposed discovery, suppressed by other economists, that the marginal utility of goods declines as one's income increases and that therefore a man's final $1,000 is not worth nearly as much to him as his first—the margin of subsistence. But this knowledge is familiar to most economists, and this book, for example, has included it. The marginal utility of goods certainly declines as our income rises; but the very fact that people continue to work for the final $1,000 and work for more money when the opportunity is available, demonstrates conclusively that the marginal utility of goods is still greater than the marginal disutility of leisure forgone. Galbraith's hidden fallacy is a *quantitative* assumption: from the mere fact that the marginal utility of goods *falls* as one's income and wealth rise, Galbraith has somehow concluded that it has *already* fallen to *virtually, or really, zero*. The fact of decline, however, tells us nothing whatever about the *degree* of this decline, which Galbraith arbitrarily assumes has been almost total. All economists, even the most "conventional," know that as incomes have risen in the modern world, workers have chosen to take more and more of that income in the form of leisure. And this should be proof enough that economists have long been familiar with the supposedly suppressed truth that the marginal utility of goods in general tends to decline as their supply increases. But, Galbraith retorts, economists admit that leisure is a consumers' good, but *not* that other goods decline in value as their supply increases. Yet this is surely an erroneous contention; what economists know is that, as civilization expands the supply of goods, the marginal utility of goods declines *and* the marginal utility of leisure forgone (the opportunity cost of labor) increases, so that more and more real income will be "taken" in the form of leisure. There is nothing at all startling, subversive, or revolutionary about this familiar fact.

According to Galbraith, economists willfully ignore the spectre of the satiation of wants. Yet they do so quite properly, because when wants—or rather, wants for exchangeable goods—are truly satiated, we shall all know it soon enough; for, at that point, everyone will cease working, will cease trying to transform land resources into final consumers' goods. There will be no need to continue producing, because all needs for consumers' goods will have been supplied—or at least all those which can be produced and exchanged. At this point, everyone will stop work, the market economy—indeed, *all economy*—will come to an end, means will no longer be scarce in relation to ends, and everyone will bask in paradise. I think it self-evident that this time has not yet arrived and shows no signs of arriving; if it some day should arrive, it will be greeted by economists, as by most other people, not with curses, but with rejoicing. Despite their venerable reputation as practitioners of a "dismal science," economists have no vested interests, psychological or otherwise, in scarcity.

But, in the meanwhile, this is still a world of scarcity; scarce means have to be applied to alternate ends; labor is still necessary. People still work for their final $1,000 of income and would be happy to accept another $1,000 should it be offered. We would venture another prediction: An informal poll taken among the people, asking whether they would accept, or know what to do with, an extra few thousand dollars of annual (real) income, would find almost no one who would refuse the offer because of excessive affluence or satiety—or for any other reason. Few would be at a loss about what to do with their increased wealth. Professor Galbraith, of course, has an answer to all this. These wants, he says, are not real or genuine ones; they have been "created" in the populace by advertisers, and their wicked clients, the producing businessmen. The very fact of production, through such advertising, "creates" the supposed wants that it supplies.

Galbraith's entire theory of excess affluence rests on this flimsy assertion that consumer wants are artificially created by business itself. It is an allegation backed only by repetitious assertion and by no evidence whatever—except perhaps for Galbraith's obvious personal dislike for detergents and tailfins. What is more, the attack on wicked advertising as creating wants and degrading the consumer is surely the most conventional of the conventional wisdom in the anticapitalist's arsenal.[93]

There are many fallacies in Galbraith's conventional attack on advertising. In the first place, it is not true that advertising "creates" wants or demands on the part of the consumers. It certainly tries to persuade consumers to buy the product; but it cannot *create* wants or demands, because each person must himself *adopt* the ideas and values on which he acts—whether these ideas or values are sound or unsound. Galbraith here assumes a naive form of determinism—of advertising upon the consumers, and, like all determinists, he leaves an implicit escape clause from the determination for people like himself, who are, unaccountably, *not* determined by advertising. If there

[93]In addition to wicked advertising, wants are also artificially created, according to Galbraith, by emulation of one's neighbor: "Keeping up with the Joneses." But, in the first place, what is *wrong* with such emulation, except an unsupported ethical judgment of Galbraith's? Galbraith pretends to ground his theory, not on his private ethical judgment, but on the alleged creation of wants by production itself. Yet simple emulation would not be a function of producers, but of consumers themselves—unless emulation, too, were inspired by advertising. But this reduces to the criticism of advertising discussed in the text. And secondly, where did the original *Jones* obtain his wants? Regardless of how many people have wants purely in emulation of others, *some* person or persons must have originally had these wants as genuine needs of their very own. Otherwise the argument is hopelessly circular. Once this is conceded, it is impossible for economics to decide to what extent each want is pervaded by emulation.

is determinism by advertising, how can some people be determined to rush out and buy the product, while Professor Galbraith is free to resist the advertisements with indignation and to write a book denouncing the advertising?[94]

Secondly, Galbraith gives us no standard to decide which wants are so "created" and which are legitimate. By his stress on poverty, one might think that all wants above the subsistence level are false wants created by advertising. Of course, he supplies no evidence for this view. But, as we shall see further below, this is hardly consistent with his views on public or governmentally induced wants.

Thirdly, Galbraith fails to distinguish between fulfilling a given want in a better way and inducing new wants. Unless we are to take the extreme and unsupported view that *all* wants above the subsistence line are "created," we must note the rather odd behavior attributed to businessmen by Galbraith's assumptions. Why *should* businessmen go to the expense, bother, and uncertainty of trying to create *new* wants, when they could far more easily look for better or cheaper ways of fulfilling wants that consumers *already* have? If consumers, for example, already have a discernible and discoverable want for a "no-rub cleanser," it is surely easier and less costly to produce and then advertise a no-rub cleanser than it would be to create some completely new want—say for *blue* cleansers in particular—and then work very hard and spend a great deal of money on advertising campaigns to try to convince people that they *need* blue cleansers because blue "is the color of the sky" or for some other artificial reason.[95] In short, the Galbraithian view of

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[94]For more on determinism and the sciences of human action, *see* Rothbard, "Mantle of Science," and Mises, *Theory and History*.

[95]Professor Abbott, in his important book on competition, quality of products, and the business system, put it this way:

> The producers will generally find it easier and less costly to gain sales by adapting the product as closely as possible

the business and marketing system makes little or no sense. Rather than go to the expensive, uncertain, and, at bottom, needless, task of trying to find a new want for consumers, business will tend to satisfy those wants that consumers already have, or that they are pretty sure consumers would have if the product were available. Advertising is then used as a means of (*a*) conveying information to the consumers that the product is now available and telling them what the product will do; and (*b*) specifically, trying to convince the consumers that this product *will* satisfy their given want—e.g., *will* be a no-rub cleanser.

Indeed, our view is the only one that makes sense of the increasingly large quantities of money spent by business on marketing research. Why bother investigating in detail *what* consumers really want, if all one need do is to *create* the wants for them by advertising? If, in fact, production *really* created its own demand through advertising, as Galbraith maintains, business would never again have to worry about losses or bankruptcy or a failure to sell automatically any good that it may arbitrarily choose to produce. Certainly there would be no need for marketing research or for any wondering about what consumers will buy. This image of the world is precisely the reverse of what is occurring. Indeed, precisely because people's standards of living are moving ever farther past the subsistence line, businessmen are worrying ever more intensely about what consumers want and what they will buy. It is because the range of goods available to the consumers is expanding so much beyond simple staples needed for subsistence, in quantity, quality, and breadth of product substitutes, that businessmen must compete as never before in paying court to the consumer, in trying to obtain his attention: in short, in advertising.

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to existing tastes and by directing advertising to those whose wants it is already well equipped to satisfy than by attempting to alter human beings to fit the product. (Abbott, *Quality and Competition*, p. 74)