is taxed on an income of 40 when his income was only 10. The final tax, therefore, largely becomes one on a*ccumulated capital* rather than on income.[27] The incentive for keeping investment rigid, therefore, becomes even greater.[28]

There are, of course, grave difficulties in any such tax on accrued capital gains, but, as we shall see, there are many insuperable obstacles to *any* attempt to impose uniform income taxes. Estimates of market value would pose the greatest problem. Appraisals are always simply conjectures, and there would be no way of knowing that the assessed value was the correct one.

Another insuperable difficulty arises from changes in the purchasing power of the monetary unit. If the purchasing power has fallen in half, then a change in capital value of an asset from 50 to 100 does not represent a real capital gain; it simply reflects the *maintenance of real capital* as nominal values double. Clearly, a constant nominal value of capital when other prices and values double would reflect a high capital *loss*—a halving of real capital value. To reflect gains or losses in income, then, a person's capital gain or loss would have to be corrected for changes in the purchasing power of money. Thus, a fall in purchasing power tends to result in the overstatement of business income and hence leads to a consumption of capital. But if a man's capital gains or losses must be corrected for changes in the purchasing power of money in order to state his true income for a certain period, what standards can be used for such a correction? For changes in purchasing power *cannot* be measured. Any "index" used would be purely arbitrary. Whichever method is adopted, therefore, uniformity in income taxation cannot be achieved, because an accurate measurement of income cannot be attained.[29]

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[27]For a discussion of taxation on accumulated capital, see below.

[28]*See* Due, *Government Finance*, p. 146.

[29]Another problem in levying a tax on accrued capital gains is that the income is not realized in money directly. Uniform taxation of income in kind, as well as of psychic income, faces insuperable problems, as will be seen below. Just as there may be taxes on the imputed monetary equivalents

Thus, to the controversial question, "Are capital gains income?" the answer is emphatically yes, provided that (1) a correction is made for changes in the purchasing power of the monetary unit, and (2) the *accrued* rather than the realized capital gain is considered. In fact, whenever businesses are owned by stockholders (and bondholders), the gains on these stocks and bonds will provide a fuller guide to income earned than the actual net income of the firm. If it is desired to tax incomes uniformly, then taxes would have to be levied on the former *only*; to tax both would be to level a "double" tax on the same income.

Professor Groves, while agreeing that capital gains are income, lists several reasons for giving capital gains preferential treatment.[30] Almost all of them apply, however, to taxation on *realized*, rather than on *accrued*, capital gains. The only relevant case is the familiar one that "capital gains and losses are not regularly recurrent, as are most other incomes." But *no* income is "regularly recurrent." Profits and losses, of course, are volatile, being based on speculative entrepreneurship and adjustments to changing conditions. Yet no one contends that profits are not income. All other income is flexible as well. No one has a guaranteed income on the free market. Everyone's resources are subject to change as conditions and the data of the market change. That the division between income and capital gains is illusory is demonstrated by the confusion over the classification of authors' incomes. Is the income in one year resulting from five years' writing of a book "income" or an increase in the "capital worth" of the author? It should be evident that this entire distinction is valueless.[31]

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of income in kind, however, there may also be taxes on accrued capital gains.

[30]Harold M. Groves, *Financing Government* (New York: Henry Holt, 1939), p. 181.

[31]Irregular income poses the same problem as irregular realized capital gain. The difficulty can be met in both cases by the suggested solution of averaging income over several years and paying taxes annually on the average.

Capital gains *are* profits. And the *real* value of aggregate capital gains in society will equal total aggregate profits. A profit increases the capital worth of the owner, whereas a loss decreases it. Moreover, there are no other sources from which real capital gains can come. What of the savings of individuals? Individual savings, to the extent that they do not add to cash balances, go into investments. These purchases of capital lead to capital gains for stockholders. Aggregate savings lead to aggregate capital gains. But it is also true that profits can exist in the aggregate only when there is aggregate net saving in the economy. Thus, *aggregate pure profits*, *aggregate capital gains*, and *aggregate net savings* all go hand in hand in the economy. Net dissavings lead to aggregate pure losses and aggregate capital losses.

To sum up, *if* it is desired to tax uniformly (this goal will be analyzed critically below), the correct procedure would be to consider capital gains as equivalent to income *when corrected* for changes in the purchasing power of the monetary unit, and to consider capital losses as negative income. Some critics charge that it would be discriminatory to correct capital for changes in prices without doing the same for income, but this objection misses the point. If the desire is to tax *income* rather than accumulated capital, it is necessary to correct for changes in the purchasing power of money. For example, capital rather than pure income is being taxed during an inflation.

(5) *Is a Tax on Consumption Possible?*

We have seen that attempts to tax consumption via sales and excise taxes are vain and that they inexorably result in a tax on incomes. Irving Fisher has suggested an ingenious plan for a *consumption tax*—a direct tax on the individual akin to the income tax, requiring annual returns, etc. The base for the individual's tax, however, would be his income, minus net additions to his capital or cash balance, plus net subtractions from that capital for the period—i.e., his consumption spending. The individual's consumption spending would then be taxed in the same way as his income is now.[32] We have seen the fallacy in the Fisher argument that only a tax on consumption would be a true income tax and that the ordinary income tax constitutes a double tax on savings. This argument places greater weight on savings than the market does, since the market knows all about the fructifying power of saving and allocates its expenditures accordingly. The problem we have to face here is this: Would such a tax as Fisher proposes actually have the intended effect—would it tax consumption only?

Let us consider a Mr. Jones, with a yearly income of 100 gold ounces. During the year, he spends 90 percent, or 90 ounces, on consumption and saves 10 percent, or 10 ounces. If the government imposes a 20-percent income tax upon him, he must pay 20 ounces at the end of the year. Assuming that his time-preference schedule remains the same (and setting aside the fact that there will be an increased proportion spent on consumption because an individual with fewer money assets has a higher time-preference *rate*), the ratio of his consumption to investment will still be 90:10. Jones will now spend 72 ounces on consumption and eight on investment.

Now, suppose that *instead* of an income tax, the government levies a 20-percent annual tax on consumption. Fisher maintained that such a tax would be levied only on consumption. But this is incorrect, since savings-investment is based solely on the possibility of future consumption. Since future consumption will also be taxed, in equilibrium, at the same rate as present consumption, it is evident that saving does not receive any special encouragement.[33] Even if it were desirable for the government to encourage saving at the expense of consumption, taxing consumption would not do so. Since future and

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[32]Fisher and Fisher, *Constructive Income Taxation*, *passim*.

[33]Neither does *hoarding* receive any special encouragement, since hoarding must finally eventuate in consumption. It is true that keeping cash balances itself yields a benefit, but the *basis* for such balances is always the prospect of future consumption.

present consumption will be taxed equally, there will be no shift in favor of savings. In fact, there will be a shift *in favor of consumption* to the extent that a diminished amount of money causes an increase in the rate of preference for present goods. Setting aside this shift, his loss of funds will cause him to reallocate and reduce his savings as well as his consumption. Any payment of funds to the government necessarily reduces the net income remaining to him, and, since his time preference remains the same, he reduces his savings *and* his consumption proportionately.

It will help to see how this works arithmetically. We may use the following simple equation to sum up Jones' position:

(1) Net Income = Gross Income – Tax
(2) Consumption = .90 Net Income
(3) Tax = .20 Consumption

With Gross Income equal to 100, and solving for these three equations, we get this result: Net Income = 85, Tax = 15, Consumption = 76.

We may now sum up in the following tabulation what happened to Jones under an income tax and under a consumption tax:

| Event | Gross Income | Tax | Net Income | Consumption | Savings Investment |
|---|---|---|---|---|---|
| 20% Income Tax | 100 | 20 | 80 | 72 | 8 |
| 20% Consumption Tax | 100 | 15 | 85 | 76 | 9 |

We thus see this important truth: A consumption tax is *always* shifted so as to become an income tax, though at a lower rate. In fact, the 20-percent consumption tax becomes equivalent to a 15-percent income tax. This is a very important argument against the plan. Fisher's attempt to tax consumption alone must fail; the tax is shifted by the individual until it becomes an income tax, albeit at a lower rate than the equivalent income tax.

Thus, the rather startling conclusion is reached in our analysis that *there can be no tax on consumption alone*; all consumption taxes resolve themselves in one way or another into taxes on incomes. Of course, as is true of the direct consumption tax, the effect of the rate is *discounted*. And here perhaps lies a clue to the relative predilection that free-market economists have shown toward consumption taxes. Their charm, in the final analysis, consists in the discounting—in the fact that the same rate in a consumption tax has the effect of a *lower* rate of income tax. The tax burden on society and the market is lower.[34] This reduction of the tax burden may be a very commendable objective, but it should be stated as such, and it should be realized that the problem lies not so much in the *type* of tax levied as in the over-all burden of taxes on individuals in the society.

We must now modify our conclusions by admitting the case of *dishoarding* or *dissaving*, which we had ruled out of the discussion. To the extent that dishoarding occurs, *consumption is tapped* rather than income, for the dissaver consumes out of previously accumulated wealth, and not out of current income. The Fisher tax would thus tap spending out of accumulated wealth, which would remain untaxed by ordinary income taxation.

### *4. The Incidence and Effects of Taxation*

#### Part II: Taxes on Accumulated Capital

In a sense, *all* taxes are taxes on capital. In order to pay a tax, a man must save the money. This is a universal rule. If the saving

[34]In the same way, the charm of the sales tax lies in the fact that it cannot be progressive, thus reducing the burden of income taxation on the upper groups.

took place in advance, then the tax reduces the capital invested in the society. If the saving did not take place in advance, then we may say that the tax reduced *potential* saving. Potential saving is hardly the same as accumulated capital, however, and we may therefore consider a tax on current income as separate from a tax on capital. Even if the individual were forced to save to pay the tax, the saving is current just as the income is current, and therefore we may make the distinction between taxes on *current* saving and current incomes, and taxes on *accumulated* capital from past periods. In fact, since there can be no consumption taxes, except where there is dissaving, almost all taxes resolve themselves into income taxes *or* taxes on accumulated capital. We have already analyzed the effect of an income tax. We come now to taxes on accumulated capital.

Here we encounter a genuine case of "double taxation." When *current* savings are taxed, the charge of double taxation is a dubious one, since people are allocating their newly produced current income. Accumulated capital, on the contrary, is our heritage from the past; it is the accumulation of tools and equipment and resources from which our present and future standard of living derive. To tax this capital is to reduce the stock of capital, especially to discourage replacements as well as new accumulations, and to impoverish society in the future. It may well happen that time preferences on the market will dictate voluntary capital consumption. In that case, people will deliberately choose to impoverish themselves in the future so as to live better in the present. But when the government compels such a result, the distortion of market choices is particularly severe. For the standard of living of everyone in the society will be absolutely lowered, and this *includes* perhaps some of the tax consumers—the government officials and the other recipients of tax privilege. Instead of living off present productive income, the government and its favorites are now dipping into the accumulated capital of society, thereby killing the goose that lays the golden egg.

Taxation of capital, therefore, differs considerably from income taxation; here the *type* matters as well as the level. A 20-percent tax on accumulated capital will have a far more devastating, distorting, and impoverishing effect than a 20-percent tax on income.

### A. Taxation on Gratuitous Transfers: Bequests and Gifts

The receipt of gifts has often been considered simple income. It should be obvious, however, that the recipient produced nothing in exchange for the money received; in fact, it is not an income from current production at all, but a transfer of ownership of accumulated capital. Any tax on the receipt of gifts, then, is a tax on capital. This is particularly true of *inheritances*, where the aggregation of capital is shifted to an heir, and the gift clearly does not come from current income. An *inheritance* tax, therefore, is a pure tax on capital. Its impact is particularly devastating because (*a*) large sums will be involved, since at some point within a few generations *every piece* of property must pass to heirs, and (*b*) the prospect of an inheritance tax destroys the incentive and the power to save and build up a family competence. The inheritance tax is perhaps the most devastating example of a pure tax on capital.

A tax on gifts and bequests has the further effect of penalizing charity and the preservation of family ties. It is ironic that some of those most ardent in advocating taxation of gifts and bequests are the first to assert that there would never be "enough" charity were the free market left to its own devices.

### B. Property Taxation

A property tax is a tax levied on the value of property and hence on accumulated capital. There are many problems peculiar to property taxation. In the first place, the tax depends on an *assessment* of the value of property, and the rate of tax is applied to this assessed value. But since an *actual* sale of property has usually not taken place, there is no way for assessments to be made accurately. Since all assessments are arbitrary, the road is open for favoritism, collusion, and bribery in making them.

Another weakness of current property taxation is that it taxes doubly both "real" and "intangible" property. The property tax *adds* "real" and "intangible" property assessments together; thus, the bondholders' equity in property is *added* to the amount of the debtors' liability. Property under debt is therefore doubly taxed as against other property. If A and B each own a piece of property worth $10,000, but C also holds a bond worth $6,000 on B's property, the latter is assessed at a total of *$16,000* and taxed accordingly.[35] Thus, the use of the credit system is penalized, and the rate of interest paid to creditors must be raised to allow for the extra penalty.

One peculiarity of the property tax is that it attaches to the property itself rather than to the *person* who owns it. As a result, the tax is shifted on the market in a special way known as *tax capitalization.* Suppose, for example, that the social time-preference rate, or pure rate of interest, is 5 percent. Five percent is earned on all investments in equilibrium, and the rate tends to 5 percent as equilibrium is reached. Suppose a property tax is levied on *one* particular property or set of properties, e.g., on a house worth $10,000. Before this tax was imposed, the owner earned $500 annually on the property. An annual tax of 1 percent is now levied, forcing the owner to pay $100 per year to the government. What will happen now? As it stands, the owner will earn $400 per year on his investment. The net return on the investment will now be 4 percent. Clearly, no one will continue to invest at 4 percent in this property when he can earn 5 percent elsewhere. What will happen? The owner will *not* be able to shift his tax forward by raising the rental value of the property. The property's earnings are determined by its discounted marginal value productivity, and the tax on the property does

[35] *See* Groves, *Financing Government*, p. 64.

not increase its merits or earning power. In fact, the reverse occurs: the tax lowers the capital value of the property to enable owners to earn a 5-percent return. The market drive toward uniformity of interest return pushes the capital value of the property down to enable a return on investment. The capital value of the property will fall to $8,333, so that future returns will be 5 percent.[36]

In the long run, this process of reducing capital value is imputed backward, falling mainly on the owners of ground land. Suppose a property tax is levied on a capital good or a set of capital goods. Income to a capital good is resolvable into wages, interest, profit, and rental to ground land. A lower capital value of capital goods would shift resources elsewhere; workers, confronted with lower wages in producing this particular good, would shift to a better-paying job; capitalists would invest

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[36]The final capital value is not $8,000, since the property tax is levied at 1 percent of the *final* value. The tax does not remain at 1 percent of the original capital value of $10,000. The capital value will fall to $8,333. Property tax payment will be $83, net annual return will be $417, and an annual *rate* of return of 5 percent on the capital of $8,333.

The algebraic formula for arriving at this result is as follows: If $C$ is the capital value to be determined, $i$ is the rate of interest, and $R$ the annual rent from the property, then, when no tax enters into the picture:

$$iC = R$$

When a property tax is levied, then the net return is the rent minus the annual tax liability, $T$, or:

$$iC = R - T$$

In this property tax, we postulate a fixed rate on the value of the property, so that:

$$iC = R - tC,$$

where $t$ equals the tax rate on the value of the property.

Transposing,

$C = R/i + t$; the new capital value equals the annual rent divided by the interest rate plus the tax rate. Consequently, the capital value is driven down below its original sum, the higher are (*a*) the interest rate and (*b*) the tax rate.

in a more remunerative field; and so forth. As a result, workers and entrepreneurs would largely be able to slough off the burden of the property tax, the former suffering to the extent that their original DMVP was higher here than in the next-highest-paying occupations. Consumers would, of course, suffer from a coerced misallocation of resources. The man bearing the major burden, then, is the owner of ground land; therefore, the process of tax capitalization applies most fully to a property tax upon ground land. The incidence falls on the owner of the "original" ground land, i.e., the owner at the time the tax is first imposed. For not only does the landlord pay the annual tax (a tax he cannot shift) so long as he is the owner, but he also suffers a loss in capital value. If Mr. Smith is the owner of the above property, not only does he pay $83 per year in taxes, but the capital value of his property also falls from $10,000 to $8,333. Smith openly absorbs the loss when he sells the property.

What, however, of the succeeding owners? They buy the property at $8,333 and earn a steady 5-percent interest, although they continue to pay $83 a year to the government. The expectation of the tax payment attached to the property, therefore, has been *capitalized* by the market and taken into account in arriving at its capital value. As a result, the future owners are able to shift the entire incidence of the property tax to the original owner; they do not really "pay" the tax in the sense that they bear its burden.

Tax capitalization is an instance of a process by which the market adjusts to burdens placed upon it. Those whom the government wanted to pay the burden can avoid doing so because of the market's resilience in adjusting to new impositions. The original owners of ground land, however, are especially burdened by a property tax.

Some writers argue that, where tax capitalization has taken place, it would be unjust for the government to lower or remove the tax because such an action would grant a "free gift" to the current owners of property, who will receive a counterbalancing increase in its capital value. This is a curious argument. It rests on a fallacious identification of the *removal of a burden* with a *subsidy*. The former, however, is a move toward free-market conditions, whereas the latter is a move *away* from such conditions. Furthermore, the property tax, while not burdening future owners, depresses the capital value of the property below what it would be on the free market, and therefore discourages the employment of resources in this property. Removal of the property tax would reallocate resources to the advantage of the consumers.

Tax capitalization and its incidence on owners of ground land occur only where the property tax is *partial* rather than universal—on some pieces of property rather than all. A truly general property tax will reduce the rate of income earned from all investments and thereby reduce the rate of interest instead of the capital value. In that case, the interest return of both the original owner and later owners is reduced equally, and there is no extra burden on the original owner.

A general, uniform property tax on all property values, then, will, like an income tax, reduce the interest return throughout the economy. This will penalize saving, thereby reducing capital investment below what it would have been and depressing real wage rates further below their free-market level.[37]

Finally, a property tax necessarily distorts the allocation of resources in production. It penalizes those lines of production in which capital equipment per sales dollar is large and causes resources to shift from these to less "capitalistic" fields. Thus, investment in higher-order productive processes is discouraged, and the standard of living lowered. Individuals will invest less in housing, which bears a relatively heavy property tax burden, and shift instead to less durable consumers' goods, thus distorting production and injuring consumer satisfaction. In practice, the property tax tends to be uneven from one line and location

[37]On tax-capitalization, *see* Seligman, *Shifting and Incidence of Taxation*, pp. 181–85, 261–64. *See also* Due, *Government Financing*, pp. 382–86.

to another. Of course, geographic differences in property taxation, in impelling resources to escape heavy tax rates,[38] will distort the location of production by driving it from those areas that would maximize consumer satisfaction.

### C. A Tax on Individual Wealth

Although a tax on individual wealth has not been tried in practice, it offers an interesting topic for analysis. Such a tax would be imposed on individuals instead of on their property and would levy a certain percentage of their total net wealth, excluding liabilities. In its directness, it would be similar to the income tax and to Fisher's proposed consumption tax. A tax of this kind would constitute a pure tax on capital, and would include in its grasp cash balances, which escape property taxation. It would avoid many difficulties of a property tax, such as double taxation of real and tangible property and the inclusion of debts as property. However, it would still face the impossibility of accurately assessing property values.

A tax on individual wealth could not be capitalized, since the tax would not be attached to a property, where it could be discounted by the market. Like an individual income tax, it could not be *shifted*, although it would have important *effects*. Since the tax would be paid out of regular income, it would have the effect of an income tax in reducing private funds and penalizing savings-investment; but it would also have the *further* effect of taxing accumulated capital.

How much accumulated capital would be taken by the tax depends on the concrete data and the valuations of the specific individuals. Let us postulate, for example, two individuals:

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[38]This distortion of location would result from all other forms of taxes as well. Thus, a higher income-tax rate in region A than in region B would induce workers to shift from A to B, in order to equalize net wage rates after taxes. The location of production is distorted as compared with the free market.

Smith and Robinson. Each has an accumulated wealth of $100,000. Smith, however, also earns $50,000 a year, and Robinson (because of retirement or other reasons) earns only $1,000 a year. Suppose the government levies a 10-percent annual tax on an individual's wealth. Smith might be able to pay the $10,000 a year out of his regular income, without reducing his accumulated wealth, although it seems clear that, since his tax liability is reduced thereby, he will want to reduce his wealth as much as possible. Robinson, on the other hand, *must* pay the tax by selling his assets, thereby reducing his accumulated wealth.

It is clear that the wealth tax levies a heavy penalty on accumulated wealth and that therefore the effect of the tax will be to slash accumulated capital. No quicker route could be found to promote capital consumption and general impoverishment than to penalize the accumulation of capital. Only our heritage of accumulated capital differentiates our civilization and living standards from those of primitive man, and a tax on wealth would speedily work to eliminate this difference. The fact that a wealth tax could not be capitalized means that the market could not, as in the case of the property tax, reduce and cushion its effect after the impact of the initial blow.

### *5. The Incidence and Effects of Taxation*

#### Part III: The Progressive Tax

Of all the patterns of tax distribution, the *progressive* tax has generated the most controversy. In the case of the progressive tax, the conservative economists who oppose it have taken the offensive, for even its advocates must grudgingly admit that the progressive tax lowers incentives and productivity. Hence, the most ardent champions of the progressive tax on "equity" grounds admit that the degree and intensity of progression must be limited by considerations of productivity. The major criticisms that have been leveled against progressive taxation are: (*a*) it reduces the savings of the community; (*b*) it reduces the incentive to work and earn; and (*c*) it constitutes "robbery of the rich by the poor."

To evaluate these criticisms, let us turn to an analysis of the effects of the progression principle. The progressive tax imposes a higher rate of taxation on a man earning more. In other words, it acts as a *penalty* on service to the consumer, on merit in the market. Incomes in the market are determined by service to the consumer in producing and allocating factors of production and vary directly according to the extent of such services. To impose penalties on the very people who have served the consumers most is to injure not only them, but the consumers as well. A progressive tax is therefore bound to cripple incentives, impair mobility of occupation, and greatly hamper the flexibility of the market in serving the consumers. It will consequently lower the *general* standard of living. The ultimate of progression—coercively equalized incomes—will, as we have seen, cause a reversion to barbarism. There is also no question that progressive income taxation will reduce incentives to save, because people will not earn the return on investment consonant with their time preferences; their earnings will be taxed away. Since people will earn far less than their time preferences would warrant, their savings will be depressed far below what they would be on the free market.

Thus, conservatives' charges that the progressive tax reduces incentives to work and save are correct and, in fact, are usually understated, because there is not sufficient realization that these effects stem *a priori* from the very nature of progression itself. It should not be forgotten, however, that *proportional* taxation will induce many of the same effects as, in fact, will any tax that goes beyond equality or the cost principle. For proportional taxation also penalizes the able and the saver. It is true that proportional taxation will not have many of the crippling effects of progression, such as the progressive hampering of effort from one income bracket to another. But proportional taxation also imposes heavier burdens as the income brackets rise, and these also hamper earning and saving.

A second argument against the progressive income tax, and one which is perhaps the most widely used, is that, by taxing the incomes of the wealthy, it reduces *savings* in particular, thus injuring society as a whole. This argument is predicated on the usually plausible assumption that the rich save more proportionately than the poor. Yet, as we have indicated above, this is an extremely weak argument, particularly for partisans of the free market. It is legitimate to criticize a measure for forcing deviations from free-market allocations to arbitrary ones; but it can hardly be legitimate simply to criticize a measure for reducing savings *per se*. For why does consumption possess less merit than saving? Allocation between them on the market is simply a matter of time preference. This means that *any* coerced deviation from the market ratio of saving to consumption imposes a loss in utility, and this is true *whichever* direction the deviation takes. A government measure that might induce more saving and less consumption is then no less subject to criticism than one that would lead to more consumption and less saving. To say differently is to criticize free-market choices and implicitly to advocate governmental measures to force more savings upon the public. If they were consistent, therefore, these conservative economists would have to advocate taxation of the poor to subsidize the rich, for in that case savings would presumably increase and consumption diminish.

The third objection is a political-ethical one—that "the poor rob the rich." The implication is that the poor man who pays 1 percent of his income in taxes is "robbing" the rich man who pays 80 percent. Without judging the merits or demerits of robbery, we may say that this is invalid. *Both* citizens are being robbed—by the State. That one is robbed in greater proportion does not eliminate the fact that both are being injured. It may be objected that the poor receive a net subsidy out of the tax proceeds because the government spends money to serve the poor. Yet this is not a valid argument. For the actual *act* of robbery is committed by the State, and not by the poor. Secondly, the State may spend its money, as we shall see below, on many different projects. It may consume products; it may subsidize some or all of the rich; it may subsidize some or all of the poor. The fact of progressive income taxation does not *itself* imply that "the poor" en masse will be subsidized. If *some* of the poor are subsidized, others may not be, and these latter will still be net taxpayers rather than tax-consumers and will be "robbed" along with the rich. The extent of this deprivation will be less for a poor taxpayer than for a rich one; and yet, since usually there are far more poor than rich, the poor en masse may very well bear the greatest burden of the tax "robbery." In contrast, the State bureaucracy, as we have seen, actually pays no taxes at all.[39]

This misconception of the incidence of "robbery," and the defective argument on savings, among other reasons, have led most conservative economists and writers to overemphasize greatly the importance of the *progressiveness* of taxation. Actually, the *level* of taxation is far more important than its progressiveness in determining the distance that a society has traveled from a free market. An example will clarify the relative importance of the two. Let us contrast two people and see how they fare under two different tax systems. Smith makes $1,000 a year, and Jones makes $20,000 a year. In Society A taxation is proportionate for all at 50 percent. In Society B taxation is very steeply progressive: rates are ½ percent for $1,000 income, 20 percent for $20,000 income. The following tabulation shows how much money each will pay in taxes in the different societies:

[39]On the extent to which the lower-income classes actually pay taxes in present-day America, *see* Gabriel Kolko, *Wealth and Power in America* (New York: Frederick A. Praeger, 1962), chap. 2.

| | *Society* A | B |
|---|---|---|
| Smith ($1,000) ....... | $ 500 | $ 5 |
| Jones ($20,000) ...... | $10,000 | $4,000 |

Now, we may ask both the rich and the poor taxpayers: *Under which system of taxation are you better off? Both* the rich man and the poor man will unhesitatingly pick Society B, where the rate structure is far more progressive, but where the level of taxation for every man is lower. Some may object that the total amount of tax levied is far greater in Society A. But this is precisely the point! The point is that what the rich man objects to is not the *progressiveness* of the rates, but the *high level* of the rates imposed upon him, and he will prefer progressiveness when rates are lower. This demonstrates that it is not the poor who "rob" the rich through the *progressive principle* of taxation; it is the State that "robs" both through all taxation. And it indicates that what the conservative economists are actually objecting to, whether they fully realize it or not, is not progression, but high levels of taxation, and that their real objection to progression is that it opens the sluice gates for *high levels* of taxation of the rich. Yet this prospect will not always be realized. For it is certainly possible and has often occurred that a rate structure is very progressive and yet lower all around, on the high brackets and on the low, than a less progressive structure. As a practical matter, however, progressiveness is necessary for high tax rates, because the multitude of lower-income citizens might revolt against very steep tax rates if they were imposed on all equally. On the other hand, many people may accept a high tax burden if they are secure in the knowledge or belief that the rich pay a still higher rate.[40]

We have seen that coerced egalitarianism will cause a reversion to barbarism and that steps in that direction will result in

[40]Cf., Bertrand de Jouvenel, *The Ethics of Redistribution* (Cambridge: Cambridge University Press, 1952).

dislocations of the market and a lowering of living standards. Many economists—notably the members of the "Chicago School"—believe that they champion the "free market," and yet they do not consider taxation as connected with the market or as an intervention in the market process. These writers strongly believe that, on the market, every individual should earn the profits and marginal value productivity that the consumers wish to pay, in order to achieve a satisfactory allocation of productive factors. Nevertheless, they see no inconsistency in then advocating drastic taxation and subsidies. They believe that these can alter the "distribution" of incomes without lowering the efficiency of productive allocations. In this way they rely on an equivalent of Keynesian "money illusion"—a *tax illusion*, a belief that individuals will arrange their activities according to their *gross* rather than *net* (after-tax) income. This is a palpable error. There is no reason why people should not be tax-conscious and allocate their resources and energies accordingly. Altering relative rewards by taxation will disrupt all the allocations of the market—the movement of labor, the alertness of entrepreneurship, etc. The market is a vast nexus, with all strands interconnected, and it must be analyzed as such. The prevailing fashion in economics of chopping up the market into isolated compartments—"the firm," a few "macroscopic" holistic aggregates, market exchanges, taxation, etc.—distorts the discussion of each one of these compartments and fails to present a true picture of the interrelations of the market.

### *6. The Incidence and Effects of Taxation*

#### Part IV: The "Single Tax" on Ground Rent

We have refuted elsewhere the various arguments that form part of the Henry Georgist edifice: the idea that "society" owns the land originally and that every new baby has a "right" to an aliquot part; the moral argument that an increase in the value of ground land is an "unearned increment" due to external causes; and the doctrine that "speculation" in sites wickedly withholds productive land from use. Here we shall analyze the famous Georgist proposal itself: the "single tax," or the 100-percent expropriation of ground rent.[41]

One of the first things to be said about the Georgist theory is that it calls attention to an important problem—the land question. Current economics tends to treat land as part of capital and to deny the existence of a separate land category at all. In such an environment, the Georgist thesis serves to call attention to a neglected problem, even though every one of its doctrines is fallacious.

Much of the discussion of ground-rent taxation has been confused by the undoubted stimulus to production that would result, not from this tax, but from the *elimination of all other forms of taxation.*

George waxed eloquent over the harmful effect taxation has upon production and exchange. However, these effects can as easily be removed by eliminating taxation altogether as by shifting all taxes onto ground rent.[42] In fact, it will here be

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[41]*See* Murray N. Rothbard, *The Single Tax: Economic and Moral Implications* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1957); also *idem*, *A Reply to Georgist Criticisms* (mimeographed MS., Foundation for Economic Education, 1957).

[42]George virtually admitted as much:

> To abolish the taxation which, acting and reacting now hampers every wheel of exchange and presses upon every form of industry, would be like removing an immense weight from a powerful spring. Imbued with fresh energy, production would start into new life, and trade would receive a stimulus which would be felt to the remotest arteries. The present method of taxation . . . operates upon energy, and industry, and skill, and thrift, like a fine upon those qualities. If I have worked harder and built myself a good house while you have been contented to live in a hovel, the tax-gatherer now comes annually to make me pay a penalty for my energy and my industry, by taxing me more than you. If I have saved while you wasted, I

demonstrated that taxation of ground rent also hampers and distorts production. Whatever beneficial effects the single tax might have on production would flow only from the elimination of other taxes, not from the imposition of this one. The two acts must be kept conceptually distinct.

A tax on ground rent would have the effect of a property tax as described above, i.e., it could not be shifted, and it would be "capitalized," with the initial burden falling on the original owner, and later owners escaping any burden because of the fall in the capital value of the ground land. The Georgists propose to place a 100-percent annual tax on ground rents alone.

One critical problem that the single tax could not meet is the difficulty of estimating ground rents. The essence of the single tax scheme is to tax ground rent only and to leave all capital goods free from tax. But it is impossible to make this division. Georgists have dismissed this difficulty as merely a practical one; but it is a theoretical flaw as well. As is true of any property tax, it is impossible accurately to assess value, because the property has not been actually sold on the market during the period.

Ground-land taxation faces a further problem that cannot be solved: how to distinguish quantitatively between that portion of the gross rent of a land area which goes to ground land and that portion which goes to interest and to wages. Since land in

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am mulct, while you are exempt. . . . We say we want capital, but if anyone accumulate it, or bring it among us, we charge him for it as though we were giving a privilege. . . . To abolish these taxes would be to lift the enormous weight of taxation from productive industry. . . . Instead of saying to the producer, as it does now, "The more you add to the general wealth, the more shall you be taxed!" the state would say to the producer, "Be as industrious, as thrifty, as enterprising as you choose, you shall have your full reward . . . you shall not be taxed for adding to the aggregate wealth." (Henry George, *Progress and Poverty* [New York: Modern Library, 1929], pp. 434–35) use is often amalgamated with capital investment and the two are bought and sold together, this distinction between them cannot be made.

But the Georgist theory faces even graver difficulties. For its proponents contend that the positive virtue of the tax consists in spurring production. They point out to hostile critics that the single tax (if it could be accurately levied) would not discourage capital improvements and maintenance of landed property; but then they proceed to argue that the single tax would *force* idle land into use. This is supposed to be one of the great merits of the tax. Yet if land is idle, it earns *no* gross rent whatever; if it earns no gross rent, then obviously it earns no net rent as ground land. Idle land earns no rent, and therefore earns no ground rent that could be taxed. It would bear no taxes under a *consistent* operation of the Georgist scheme! Since it would not be taxed, it could not be forced into use.

The only logical explanation for this error by the Georgists is that they concentrate on the fact that much idle land has a *capital value*, that it sells for a price on the market, even though it earns no rents in current use. From the fact that idle land has a capital value, the Georgists apparently deduce that it must have some sort of "true" annual ground rent. This assumption is incorrect, however, and rests on one of the weakest parts of the Georgists' system: its deficient attention to the role of time.[43] The fact that currently idle land has a capital value

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[43]George himself can hardly be blamed for the weak treatment of time, for he could draw only on the classical economic theories, which had the same defect. In fact, compared with the classical school, George made advances in many areas of economic theory. The Austrian School, with its definitive analysis of time, was barely beginning when George framed his theory. There is less excuse for George's modern followers, who have largely ignored all advances in economics since 1880. On George's contributions, *see* Leland B. Yeager, "The Methodology of George and Menger," *American Journal of Economics and Sociology*, April, 1954, pp. 233–39.

means simply that the market *expects* it to earn rent in the future. The capital value of ground land, as of anything else, is equal to and determined by the sum of expected future rents, discounted by the rate of interest. But these are not presently earned rents! Therefore, any taxation of idle land violates the Georgists' own principle of a single tax on ground rent; it goes beyond this limit to penalize land ownership further and to tax accumulated capital, which has to be drawn down in order to pay the tax.

Any *increas*e in the capital value of idle land, then, does not reflect a current rent; it merely reflects an upgrading of people's expectations about future rents. Suppose, for example, that future rents from an idle site are such that, if known to all, the present capital value of the site would be $10,000. Suppose further that these facts are not generally known and, therefore, that the ruling price is $8,000. Jones, being a farsighted entrepreneur, correctly judges the situation and purchases the site for $8,000. If everyone soon realizes what Jones has foreseen, the market price will now rise to $10,000. Jones' capital gain of $2,000 is the *profit* to his superior judgment, not earnings from current rate.

The Georgist bogey is idle land. The fact that land is idle, they assert, is caused by "land speculation," and to this land speculation they attribute almost all the ills of civilization, including business-cycle depressions. The Georgists do not realize that, since labor is scarce in relation to land, submarginal land *must* remain idle. The sight of idle land enrages the Georgist, who sees productive capacity being wasted and living standards reduced. Idle land should, however, be recognized as beneficial, for, if land were ever fully used this would mean that labor had become abundant in relation to land and that the world had at last entered on the terrible overpopulation stage in which some labor has to remain idle because no employment is available.

The present writer used to wonder about the curious Georgist preoccupation with idle, or "withheld," ground land as the cause of most economic ills until he found a clue in a revealing passage of a Georgist work:

> "Poor" Countries Do Not Lack Capital.
>
> Most of us have learned to believe that the people of India, China, Mexico, and other so-called backward nations are poor because they lack capital. Since, as we have seen, capital is nothing more than wealth, and wealth nothing more than human energy combined with land in one form or another, the absence of capital too often suggests that there is a shortage of land or of labor in backward countries like India and China. But that isn't true. For these "poor" countries have many times more land and labor than they use. . . . Undeniably, they have everything it takes—both land and labor—to produce as much capital as people anywhere.[44]

And so, since these poor countries have plenty of land and labor, it follows that landlords must be withholding land from use. Only this could explain the low living standards.

Here a crucial Georgist fallacy is exposed clearly: ignorance of the true role of *time* in production. It takes time to save and invest and build up capital goods, and these capital goods embody a shortening of the ultimate time period needed to acquire consumers' goods. India and China are short of capital because they are short of time. They start from a low level of capital, and therefore it would take them a long time to reach a high capital level through their own savings. Once again, the Georgist difficulty stems from the fact that their theory was formulated before the rise of "Austrian" economics and that the Georgists have never reevaluated their doctrine in the light of this development.[45]

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[44]Phil Grant, *The Wonderful Wealth Machine* (New York: Devin-Adair, 1953), pp 105–07.

[45]For a critique of George's peculiar theory of interest, *see* Eugen von Böhm-Bawerk, *Capital and Interest* (New York: Brentano's, 1922), pp. 413–20, especially p. 418 on the capitalization of idle land.

As we have indicated earlier, land speculation performs a useful social function. It puts land into the hands of the most knowledgeable and develops land at the rate desired by the consumers. And good sites will not be kept idle—thus incurring a loss of ground rent to the site owner—unless the owner expects a better use to be imminently available. The allocation of sites to their most value-productive uses, therefore, requires all the virtues of any type of entrepreneurship on the market.[46]

One of the most surprising deficiencies in the literature of economics is the lack of effective criticism of the Georgist theory. Economists have either temporized, misconceived the problem, or, in many cases, granted the economic merit of the theory but cavilled at its political implications or its practical difficulties. Such gentle treatment has contributed greatly to the persistent longevity of the Georgist movement. One reason for this weakness in the criticism of the doctrine is that most economists have conceded a crucial point of the Georgists, namely, that a tax on ground rent would not discourage production and would have no harmful or distorting economic effects. Granting the economic merits of the tax, criticism of it must fall back

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[46]See Frank Knight:

> Men do hold land "speculatively" for an expected increase in value. This is a social service, tending to put ownership in the hands of those who know best how to handle the land so that the value will increase. . . . They obviously do not need to keep it idle to get the increase, and do not, if there is a clear opening for remunerative use. . . . If land having value for use is not used by an owner, it is because of uncertainty as to how it should be used, and waiting for the situation to clear up or develop. An owner naturally does not wish to make a heavy investment in fitting a plot for use which does not promise amortization before some new situation may require a different plan. (Frank H. Knight, "The Fallacies in the 'Single Tax,'" *The Freeman*, August 10, 1953, pp. 810–11)

on other political or practical considerations. Many writers, while balking at the difficulties in the full single-tax program, have advocated the 100-percent taxation of future *increments* in ground rent. Georgists have properly treated such halfway measures with scorn. Once the opposition concedes the economic harmlessness of a ground-rent tax, its other doubts must seem relatively minor.

The crucial economic problem of the single tax, then, is this: Will a tax on ground rent have distortive and hampering effects? Is it true that the owner of ground land performs no productive service and, therefore, that a tax upon him does not hamper and distort production? Ground rent has been called "economic surplus," which would be taxed up to any amount with no side effects. Many economists have tacitly agreed with this conclusion and have agreed that a landowner can perform a productive service only as an improver, i.e., as a producer of capital goods on land.

Yet this central Georgist contention overlooks the realities. The owner of ground land performs a very important productive service. He brings sites into use and allocates them 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 goods, it is not just the physical good that is sold, but a whole bundle of services along with it—among which is the service of *transferring ownership* from seller to buyer. Ground land does not simply exist; it must be *served to* the user by the owner. (One man can perform both functions when the land is "vertically integrated.")[47]

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[47]"Land itself does not service civilized men any more than food itself does. Both are *served* to them." Spencer Heath, *How Come That We Finance World Communism?* (mimeographed MS., New York: Science of Society Foundation, 1953), p. 3. *See also* Heath, *Rejoinder to "Vituperation Well Answered" by Mason Gaffney* (New York: Science of Society Foundation, 1953).

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 insuring the most productive locations for each particular use.

The view that bringing sites into use and deciding on their location is not really "productive" is a vestige of the old classical view that a service which does not tangibly "create" something physical is not "really" productive.[48] Actually, this function is just as productive as any other, and a particularly vital function it is. To hamper and destroy this function would have grave effects on the economy.

Suppose that the government did in fact levy a 100-percent tax on ground rent. What would be the economic effects? The current owners of ground land would be expropriated, and the capital value of ground land would fall to zero. Since site owners could not obtain rents, the sites would become valueless on the market. From then on, sites would be *free*, and the site owner would have to pay his annual ground rent into the Treasury.

But since all ground rent is siphoned off to the government, *there is no reason for owners to charge any rent.* Ground rent will

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[48]*See* Spencer Heath, *Progress and Poverty Reviewed* (New York: The Freeman, 1952), pp. 7–10. Commenting on George, Heath states:

> But wherever the services of landowners 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 for their noncoercive 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. (*Ibid.*, pp. 9–10)

fall to zero as well, and rentals will thus be free. So, one economic effect of the single tax is that, far from supplying all the revenue of government, it would yield no revenue at all!

The single tax, then, makes sites *free* when they are actually not free and unlimited, but scarce. Any *good* is always scarce and therefore must always command a price in accordance with the demand for it and the supply available. The only "free goods" on the market are not *goods* at all, but abundant conditions of human welfare that are not the subject of human action.

The effect of this tax, then, is to fool the market into believing that sites are free when they are decidedly not. The result will be the same as any case of maximum price control. Instead of commanding a high price and therefore being allocated to the highest bidders, the most value-productive sites will be grabbed by first comers and wasted, since there will be no pressure for the best sites to go into their most efficient uses. People will rush in to demand and use the best sites, while no one will wish to use the less productive ones. On the free market, the less productive sites cost less to the tenant; if they cost no less than the best sites (i.e., if they are free), then no one will want to use them. Thus, in a city, the best, or most potentially value-productive, sites are in the "downtown" areas, and these consequently earn and charge higher rents than the less productive but still useful sites in the outlying areas. If the Henry George scheme went into effect, there would not only be complete misallocation of sites to less productive uses, but there would also be great overcrowding in the downtown areas, as well as underpopulation and underuse of the outlying areas. If Georgists believe that the single tax would end overcrowding of the downtown areas, they are gravely mistaken, for the reverse would occur.

Furthermore, suppose the government imposed a tax of *more* than 100 percent on ground rents, as the Georgists really envision, so as to force "idle" land into use. The result would be aggravated wasteful misapplication of labor and capital. Since labor is scarce relative to land, the compulsory use of idle land would wastefully misallocate labor and capital and force more work on poorer land, and therefore less on better land.

At any rate, the result of the single tax would be locational chaos, with waste and misallocation everywhere; overcrowding would prevail; and poorer sites would either be overused or underused and abandoned altogether. The general tendency would be toward underuse of the poorer sites because of the tax-induced rush to the better ones. As under conditions of price control, the use of the better sites would be decided by favoritism, queuing, etc., instead of economic ability. Since location enters into the production of *every* good, locational chaos would introduce an element of chaos into every area of production and perhaps ruin economic calculation as well, for an important element to be calculated—location—would be removed from the sphere of the market.

To this contention, the Georgists would reply that the owners would not be allowed to charge no rents, because the government's army of assessors would set the proper rents. But this would hardly alleviate the problem; in fact, it would aggravate matters in many ways. It might bring in revenue and check some of the excess demand of land users, but it would still provide no reason and no incentive for the land*owners* to perform their proper function of allocating land sites efficiently. In addition, if assessment is difficult and arbitrary at any time, how very much more chaotic would it be when the government must blindly estimate, in the absence of *any* rent market, the rent for every piece of ground land! This would be a hopeless and impossible task, and the resulting deviations from free-market rents would compound the chaos, with over- and underuse, and wrong locations. With no vestige of market left, not only would the landowners be deprived of any incentive for efficient allocation of sites; they would have no way of *finding* out whether their allocations were efficient or not.

Finally, this all-around fixing of rents by the government would be tantamount to virtual nationalization of the land, with all the enormous wastes and chaos that afflict any government ownership of business—all the greater in a business that would permeate every nook and cranny of the economy. The Georgists contend that they do not advocate the nationalization of land, since ownership would remain *de jure* in the hands of private individuals. The returns from this ownership, however, would all accrue to the State. George himself admitted that the single tax would "accomplish the same thing [as the land nationalization] in a simpler, easier, and quieter way."[49] George's method, however, would, as we have seen, be neither simple, easy, nor quiet. The single tax would leave *de jure* ownership in private hands while completely destroying its point, so that the single tax is hardly an improvement upon, or differs much from, outright nationalization.[50] Of course, as we shall see further below, the State has no incentive or means for efficient allocation either. At any rate, land sites, like any other resources, must be owned and controlled by someone, either a private owner or the government. Sites can be allocated either by voluntary contract or by governmental coercion, and the latter is what is attempted by the single tax or by land nationalization.[51,52]

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[49]George, *Progress and Poverty*, p. 404.

[50]See Knight:

> To collect such rent, the government would in practice have to compel the owner actually to use the land in the best way, hence to prescribe its use in some detail. Thus, we already see that the advantage of taxation over socialization of management has practically disappeared. (Knight, "The Fallacies in the 'Single Tax,'" p. 809)

[51]See Heath:

> Must we suppose that land . . . distributes itself? . . . It can be and often is distributed by the government of a prison camp or by the popularly elected denizens of a city hall. . . . Alternatively, in any free society its sites and resources must be and chiefly are distributed by the process of free contract in which . . . the title-holder is

The Georgists believe that ownership or control by the State means that "society" will own or command the land or its rent. But this is fallacious. Society or the public cannot own anything; only an individual or a set of individuals can do so. (This will be discussed below.) At any rate, in the Georgist scheme, it would not be society, but the State that would own the land. Caught in an inescapable dilemma are a group of antistatist Georgists, who wish to statize ground rent yet abolish taxation at the same time. Frank Chodorov, a leader of this group, could offer only the lame suggestion that ground land be municipalized rather than nationalized—to avoid the prospect that all of a nation's land might be owned by a central government monopoly. Yet the difference is one of degree, not of kind; the effects of government ownership and regional land monopoly still appear, albeit in a number of small regions instead of one big region.[53]

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> the only possible first party to the contract. From him flows his social service of distribution. The rent is his automatic recompense, set and limited in amount by the free market. (Heath, *How Come That We Finance World Communism?* p. 5)

*See also* Heath, *The Trojan Horse of "Land Reform"* (New York: n.d.), pp. 10–12, and Heath, *Citadel, Market and Altar* (Baltimore: Science of Society Foundation, 1957).

[52]Frank Knight says of the Georgist dream of every man's unconditional right of access to the soil, that (1) "everyone actually has this right, subject to competitive conditions, i.e., that he pay for it what it is worth," and that (2) the only viable alternative would be to "get permission from some political agent of government." For

> any attempt to give every person an unconditional right to access to the soil would establish anarchy, the war of all against all, and is of course not approximated by a confiscation and distribution of "rent" or its employment for "social ends." (Knight, "Fallacies in the 'Single Tax,'" p. 810)

[53]Frank Chodorov, *The Economics of Society, Government, and the State* (mimeographed MS., New York: Analysis Associates, 1946).

Every element in the Georgist system is thus seen to be fallacious. Yet the Georgist doctrines hold a considerable attraction even now, and, surprisingly, for many economists and social philosophers otherwise devoted to the free market. There is a good reason for this attraction, for the Georgists, though in a completely topsy-turvy manner, do call attention to a neglected problem: the land question. There *is* a land question, and no attempt to ignore it can meet the issue. Contrary to Georgist doctrine, however, the land problem does *not* stem from free-market ownership of ground land. It stems from failure to live up to a prime condition of free-market property rights, namely, that new, unowned land be first owned by its first user, and that from then on, it become the full private property of the first user or those who receive or buy the land from him. This is the free-market method; any other method of allocating new, unused land to ownership employs statist coercion.

Under a "*first-user*, *first-owner*" regime, the Georgists would be wrong in asserting that no labor had been mixed with nature-given land to justify private ownership of sites. For then, land could not be owned unless it were first used and could be originally appropriated for ownership only to the extent that it was so used. The "mixing" of labor with nature may take the form of draining, filling, clearing, paving, or otherwise preparing the site for use. Tilling the soil is only one possible type of use.[54] The use-claim to the land could be certified by courts if any dispute over its ownership arose.

Certainly the claim of the pioneer as first finder and first user is no more disputable than any other claim to a product of labor. Knight does not overdraw the picture when he charges that

[54]American homestead legislation, while attempting to establish a "first-user, first-owner" principle, erred in believing that a certain type of agriculture was the only legitimate use for land. Actually, any productive activity, including grazing or laying railroad tracks, qualifies as *use*.

> the allegation that our pioneers got the land for nothing, robbing future generations of their rightful heritage, should not have to be met by argument. The whole doctrine was invented by city men living in comfort, not by men in contact with the facts as owners or renters. . . . If society were later to confiscate the land value, allowing retention only of improvements or their value, it would ignore the costs in bitter sacrifice and would arbitrarily discriminate between one set of property owners and another set.[55]

Problems and difficulties arise whenever the "first-user, first-owner" principle is *not* met. In almost all countries, *governments* have laid claim to ownership of new, unused land. Governments could never own original land *on the free market.* This act of appropriation by the government already sows the seeds for distortion of market allocations when the land goes into use. Thus, suppose that the government disposes of its unused public lands by selling them at auction to the highest bidder. Since the government has no valid property claim to ownership, neither does the buyer from the government. If the buyer, as often happens, "owns" but does not use or settle the land, then he becomes a *land speculator* in a pejorative sense. For the true user, when he comes along, is forced either to rent or buy the land from this speculator, who does not have valid title to the area. He cannot have valid title because his title derives from the State, which also did not have valid title in the free-market sense. Therefore, *some* of the charges that the Georgists have leveled against land speculation are true, *not* because land speculation is bad *per se*, but because the speculator came to own the land, not by valid title, but via the government, which originally arrogated title to itself. So now the purchase price (or, alternatively, the rent) paid by the would-be user really does become the payment of a *tax* for permission to use the land. Governmental sale of unused land becomes similar to the old practice of *tax farming*, where

[55]Knight, "Fallacies in the 'Single Tax,'" pp. 809–10.

an individual would pay the State for the privilege of himself collecting taxes. The price of payment, if freely fluctuating, tends to be set at the value that this privilege confers.

Government sale of "its" unused land to speculators, therefore, restricts the use of new land, distorts the allocation of resources, and keeps land out of use that would be employed were it not for the "tax" penalty of paying a purchase price or rent to the speculator. Keeping land out of use raises the marginal value product and the rents of remaining land and lowers the marginal value product of labor, thereby lowering wage rates.

The affinity of rent and taxation is even closer in the case of "feudal" land grants. Let us postulate a typical case of feudal beginnings: a conquering tribe invades a territory of peasants and sets up a State to rule them. It *could* levy taxes and support its retinue out of the proceeds. But it could also do something else, and it is important to see that there is no essential difference between the two. It could parcel out all of the land as individual grants of "ownership" to each member of the conquering band. Then, instead of or in addition to one central taxing agency, there would be a series of regional *rent collecting* agencies. But the consequences would be exactly the same. This is clearly seen in Middle Eastern countries, where rulers have been considered to *own* their territories personally and have therefore collected taxes in the form of "rent" charged for that ownership.

The subtle gradations linking taxation and feudal rent have been lucidly portrayed by Franz Oppenheimer:

> The peasant surrenders a portion of the product of his labor, without any equivalent service in return. "In the beginning was the ground rent."
>
> The forms under which the ground rent is collected or consumed vary. In some cases, the lords, as a closed union or community, are settled in some fortified camp and consume as communists the tribute of

> their peasantry. . . . In some cases, each individual warrior-noble has a definite strip of land assigned to him: but generally the produce of this is still, as in Sparta, consumed in the "syssitia," by class associates and companions in arms. In some cases, the landed nobility scatters over the entire territory, each man housed with his following in his fortified castle, and consuming, each for himself, the produce of his dominion or lands. As yet, these nobles have not become landlords, in the sense that they administer their property. Each of them receives tribute from the labor of his dependents, whom he neither guides nor supervises. This is the type of medieval dominion in the lands of the Germanic nobility. Finally, the knight becomes the owner and administrator of the knight's fee.[56]

Of course, there are considerable differences between land speculation by the original buyer from the government and a feudal land grant. In the former case, the user eventually purchases the land from the original buyer, and, once he does so, the tax has been fully paid and disappears. From that point on, free-market allocations prevail. Once land gets into the hands of the user, he has, as it were, "bought out" the permission tax, and, from then on, everything proceeds on a free-market basis.[57] In contrast, the feudal lord passes the land on to his heirs. The true owners now have to pay rent where they did not have to pay

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[56]Oppenheimer, *The State*, pp. 83–84. On the breakup of feudal domains into separate substates, *see ibid.*, pp. 191–202.

[57]It must be repeated here that direct users would not be the only ones ever permitted to own land in the free market. The only stipulation is that use be the principle that *first* brings original, unused land *into ownership*. Once ownership accrues to a user, *then* the user can sell the land to a speculator, let it be idle again, etc., without distorting market allocations. The problem is the *original* establishment of valid titles to property. After valid titles are established, the owner can, of course, do what he likes with his property.

before. This rent-tax continues indefinitely. Because of the generally vast extent of the grant, as well as various prohibitory laws, it is most unusual for the feudal lord to be bought out by his tenant-subjects. When they do buy out their own plots, however, their land is from then on freed from the permission-tax incubus.

One charge often made against the market is that "all" property can be traced back to coercive depredations or State privilege, and therefore there is no need to respect current property rights. Waiving the question of the accuracy of the historical contention, we may state that historical tracings generally make little difference. Suppose, for example, that Jones steals money from Smith or that he acquires the money through State expropriation and subsidy. And suppose that there is no redress: Smith and his heirs die, and the money continues in Jones' family. In that case, the disappearance of Smith and his heirs means the dissolution of claims from the original titleholders *at that point*, on the "homestead" principle of property right from possession of unowned property. The money therefore accrues to the Jones family as their legitimate and absolute property.[58]

This process of converting force to service, however, does not work where rent paid for ground land is akin to regional taxation. The effects of speculation in original land disappear as the users purchase the land sites, but dissolution does not take place where feudal land grants are passed on, unbroken, over the generations. As Mises states:

> Nowhere and at no time has the large-scale ownership of land come into being through the working of economic forces in the market. It is the result of military and political effort. Founded by violence, it has been upheld by violence and by that alone. As soon as the latifundia are drawn into the sphere of market

[58]Note the assumption that Smith and his heirs die out or cannot be traced. If they can be, then the property rightly reverts to them in a free-market system.

> transactions they begin to crumble, until at last they disappear completely. Neither at their formation nor in their maintenance have economic causes operated. The great landed fortunes did not arise through the economic superiority of large-scale ownership, but through violent annexation outside the area of trade. . . . The non-economic origin of landed fortunes is clearly revealed by the fact that, as a rule, the expropriation by which they have been created in no way alters the manner of production. The old owner remains on the soil under a different legal title and continues to carry on production.[59]

## 7. *Canons of "Justice" in Taxation*

### A. The Just Tax and the Just Price

For centuries before the science of economics was developed, men searched for criteria of the "just price." Of all the innumerable, almost infinite possibilities among the myriads of prices daily determined, what pattern should be considered as "just"? Gradually it came to be realized that there is *no* quantitative criterion of justice that can be objectively determined. Suppose that the price of eggs is 50¢ per dozen, what is the "just price"? It is clear, even to those (like the present writer) who believe in the possibility of a rational ethics, that no possible ethical philosophy or science can yield a quantitative measure or criterion of justice. If Professor X says that the "just" price of eggs is 45¢, and Professor Y says it is 85¢, no philosophical principle can decide between them. Even the most fervent antiutilitarian will have to concede this point. The various contentions all become purely arbitrary whim.

Economics, by tracing the ordered pattern of the voluntary exchange process, has made it clear that the only possible

[59]Ludwig von Mises, *Socialism* (New Haven: Yale University Press, 1951), p. 375.

objective criterion for the just price is *the market price.* For the market price is, at every moment, determined by the voluntary, mutually agreed-upon actions of all the participants in the market. It is the objective resultant of every individual's subjective valuations and voluntary actions, and is therefore the only existent objective criterion for "quantitative justice" in pricing.

Practically nobody now searches explicitly for the "just price," and it is generally recognized that any ethical criticisms must be leveled qualitatively against the values of consumers, not against the quantitative price-structure that the market establishes on the basis of these values. The market price is the just price, given the pattern of consumer preferences. Furthermore, this just price is the concrete, *actual* market price, not equilibrium price, which can never be established in the real world, nor the "competitive price," which is an imaginary figment.

If the search for the just price has virtually ended in the pages of economic works, why does the quest for a "just tax" continue with unabated vigor? Why do economists, severely scientific in their volumes, suddenly become *ad hoc* ethicists when the question of taxation is raised? In no other area of his subject does the economist become more grandiosely ethical.

There is no objection at all to discussion of ethical concepts when they are needed, provided that the economist realizes always (*a*) that economics can establish *no* ethical principles by itself—that it can only furnish existential laws to the ethicist or citizen as data; and (*b*) that any importation of ethics must be grounded on a consistent, coherent set of ethical principles, and not simply be slipped in *ad hoc* in the spirit of "well, everyone must agree to this. . . ." Bland assumptions of universal agreement are one of the most irritating bad habits of the economist-turned-ethicist.

This book does not attempt to establish ethical principles. It does, however, refute ethical principles to the extent that they are insinuated, *ad hoc* and unanalyzed, into economic treatises.

An example is the common quest for "canons of justice" in taxation. The prime objection to these "canons" is that the writers have first to establish the justice of taxation itself. If this cannot be proven, and so far it has not been, then it is clearly idle to look for the "just tax." If taxation itself is unjust, then it is clear that no allocation of its burdens, however ingenious, can be declared just. This book sets forth no doctrines on the justice or injustice of taxation. But we do exhort economists either to forget about the problem of the "just tax" or, at least, to develop a comprehensive ethical system before they tackle this problem again.

Why do not economists abandon the search for the "just tax" as they abandoned the quest for the "just price"? One reason is that doing so may have unwelcome implications for them. The "just price" was abandoned in favor of the market price. Can the "just tax" be abandoned in favor of the market tax? Clearly not, for on the market there is no taxation, and therefore no tax can be established that will duplicate market patterns. As will be seen further below, there is no such thing as a "neutral tax"—a tax that will leave the market free and undisturbed—just as there is no such thing as neutral money. Economists and others may try to approximate neutrality, in the hopes of disturbing the market as little as possible, but they can never fully succeed.

### B. Costs of Collection, Convenience, and Certainty

Even the simplest maxims must not be taken for granted. Two centuries ago, Adam Smith laid down four canons of justice in taxation that economists have parroted ever since.[60] One of them deals with the distribution of the burden of taxation, and this will be treated in detail below. Perhaps the most "obvious" was Smith's injunction that costs of collection be kept to a "minimum" and that taxes be levied with this principle in mind.

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[60]Adam Smith, *The Wealth of Nations* (New York: Modern Library, 1937), pp. 777–79. *See also* Hunter and Allen, *Principles of Public Finance*, pp. 137–40.

An obvious and harmless maxim? Certainly not; this "canon of justice" is not obvious at all. For the bureaucrat employed in tax collection will tend to favor a tax with *high* administrative costs, thereby necessitating more extensive bureaucratic employment. Why should we call the bureaucrat obviously wrong? The answer is that he is not, and that to call him "wrong" it is necessary to engage in an ethical analysis that no economist has bothered to undertake.

A further point: if the tax is unjust on other grounds, it may be *more just* to *have* high administrative costs, for then there will be less chance that the tax will be fully collected. If it is easy to collect the tax, then the tax may do more damage to the economic system and cause more distortion of the market economy.

The same point might be made about another of Smith's canons: that a tax should be levied so that payment is convenient. Here again, this maxim seems obvious, and there is certainly much truth in it. But someone may urge that a tax should be made *inconvenient* to induce people to rebel and force a lowering of the level of taxation. Indeed, this used to be one of the prime arguments of "conservatives" for an income tax as opposed to an indirect tax. The validity of this argument is beside the point; the point is that it is *not* self-evidently wrong, and therefore this canon is no more simple and obvious than the others.

Smith's final canon of just taxation is that the tax be certain and not arbitrary, so that the taxpayer knows what he will pay. Here again, further analysis demonstrates that this is by no means obvious. Some may argue that *uncertainty* benefits the taxpayer, for it makes the requirement more flexible and permits bribery of the tax collector. This benefits the taxpayer to the extent that the price of the bribe is less than the tax that he would otherwise have to pay. Furthermore, there is no way of establishing long-range certainty, for the tax rates may be changed by the government at any time. In the long run, certainty of taxation is an impossible goal.

A similar argument may be levelled against the view that taxes "should" be difficult to evade. If a tax is onerous and unjust, *evasion* might be highly beneficial to the economy, and moral to boot.

Thus, none of these supposedly self-evident canons of taxation is a canon at all. From some ethical points of view they are correct, from others they are incorrect. Economics cannot decide between them.

## C. Distribution of the Tax Burden

Up to this point, we have been discussing taxation as it is levied on *any given* individual or firm. Now we must turn to another aspect: the *distribution* of the burden of taxes among the people in the economy. Most of the search for "justice" in taxation has involved the problem of the "just distribution" of this burden.

Various proposed canons of justice will be discussed in this section, followed by analysis of the economic *effects* of tax distribution.

### *(1) Uniformity of Treatment*

#### *(a) Equality before the law: tax exemption*

Uniformity of treatment has been upheld as an ideal by almost all writers. This ideal is supposed to be implicit in the concept of "equality before the law," which is best expressed in the phrase, "Like to be treated alike." To most economists this ideal has seemed self-evident, and the only problems considered have been the practical ones of defining exactly when one person is "like" someone else (problems that, we shall see below, are insuperable).

All these economists adopt the goal of uniformity regardless of what principle of "likeness" they may hold. Thus, the man who believes that everyone should be taxed in accordance with his "ability to pay" also believes that everyone with the same ability should be taxed equally; he who believes that each should be taxed proportionately to his income also holds that everyone with the same income should pay the same tax; etc. In this way, the ideal of uniformity pervades the literature on taxation.

Yet this canon is by no means obvious, for it seems clear that the justice of *equality of treatment* depends first of all on the *justice of the treatment itself.* Suppose, for example, that Jones, with his retinue, proposes to enslave a group of people. Are we to maintain that "justice" requires that each be enslaved *equally*? And suppose that someone has the good fortune to escape. Are we to condemn him for evading the equality of justice meted out to his fellows? It is obvious that equality of treatment is no canon of justice whatever. If a measure is unjust, then it is just that it have as *little* general effect as possible. Equality of *unjust* treatment can never be upheld as an ideal of justice. Therefore, he who maintains that a tax be imposed equally on all must first establish the justice of the tax itself.

Many writers denounce tax exemptions and levy their fire at the tax-exempt, particularly those instrumental in obtaining the exemptions for themselves. These writers include those advocates of the free market who treat a tax exemption as a special privilege and attack it as equivalent to a subsidy and therefore inconsistent with the free market. Yet an exemption from taxation or any other burden is *not* equivalent to a subsidy. There is a key difference. In the latter case a man is receiving a special grant of privilege wrested from his fellowmen; in the former he is *escaping* a burden imposed on other men. Whereas the one is done at the expense of his fellowmen, the other is not. For in the former case, the grantee is participating in the acquisition of loot; in the latter, he escapes payment of tribute to the looters. To blame him for escaping is equivalent to blaming the slave for fleeing his master. It is clear that if a certain burden is unjust, blame should be levied, *not* on the man who escapes the burden, but on the man or men who impose it in the first place. If a tax is in fact unjust, and some are exempt from it, the hue and cry should not be to *extend the tax to everyone*, but on the contrary to *extend the exemption to everyone.* The exemption itself cannot be considered unjust unless the tax or other burden is first established as *just*.

Thus, uniformity of treatment *per se* cannot be established as a canon of justice. A tax must first be proven just; if it is unjust, then uniformity is simply imposition of general injustice, and exemption is to be welcomed. Since the very fact of taxation is an interference with the free market, it is particularly incongruous and incorrect for advocates of a free market to advocate uniformity of taxation.

One of the major sources of confusion for economists and others who are in favor of the free market is that the free society has often been defined as a condition of "equality before the law," or as "special privilege for none." As a result, many have transferred these concepts to an attack on tax exemptions as a "special privilege" and a violation of the principle of "equality before the law." As for the latter concept, it is, again, hardly a criterion of justice, for this depends on the justice of the law or "treatment" itself. It is this alleged justice, rather than equality, which is the primary feature of the free market. In fact, the free society is far better described by some such phrase as "equality of rights to defend person and property" or "equality of liberty" rather than by the vague, misleading expression "equality before the law."[61]

In the literature on taxation there is much angry discussion about "loopholes," the inference being that any income or area exempt from taxation must be brought quickly under its sway. Any failure to "plug loopholes" is treated as immoral. But, as Mises incisively asked:

> What is a loophole? If the law does not punish a definite action or does not tax a definite thing, this is not

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[61]This discussion applies to Professor Hayek's adoption of the "rule of law" as the basic political criterion. F.A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960).

> a loophole. It is simply the law. . . . The income tax exemptions in our income tax are not loopholes. . . . Thanks to these loopholes this country is still a free country.[62]

*(b) The impossibility of uniformity*

Aside from these considerations, the ideal of uniformity is *impossible* to achieve. Let us confine our further discussion of uniformity to *income taxation*, for two reasons: (1) because the vast bulk of our taxation is income taxation; and (2) because, as we have seen, most other taxes boil down to income taxes anyway. A tax on consumption ends largely as a tax on income at a lower rate.

There are two basic reasons why uniformity of income taxation is an impossible goal. The first stems from the very nature of the State. We have seen, when discussing Calhoun's analysis, that the State *must* separate society into two classes, or castes: the *taxpaying caste* and the *tax-consuming caste*. The tax consumers consist of the full-time bureaucracy and politicians in power, as well as the groups which receive *net* subsidies, i.e., which receive more from the government than they pay to the government. These include the receivers of government contracts and of government expenditures on goods and services produced in the private sector. It is not always easy to detect the net subsidized in practice, but this caste can always be conceptually identified.

Thus, when the government levies a tax on private incomes, the money is shifted from private people to the government, and the government's money, whether expended for government consumption of goods and services, for salaries to bureaucrats, or as subsidies to privileged groups, returns to be spent in the economic system. It is clear that the tax-expenditure level

[62]Mises, in Aaron Director, ed., *Defense, Controls and Inflation* (Chicago: University of Chicago Press, 1952), pp. 115–16.

*must distort* the expenditure pattern of the market and shift productive resources away from the pattern desired by the producers and toward that desired by the privileged. This distortion takes place in proportion to the amount of taxation.

If, for example, the government taxes funds that would have been spent on automobiles and itself spends them on arms, the arms industry and, in the long run, the specific factors in the arms industry become net tax consumers, while a special loss is inflicted on the automobile industry and ultimately on the factors specific to that industry. It is because of these complex relationships that, as we have mentioned, the identification in practice of the net subsidized may be difficult.

One thing we know without difficulty, however. Bureaucrats are net tax consumers. As we pointed out above, bureaucrats *cannot pay taxes.* Hence, it is inherently impossible for bureaucrats to pay income taxes uniformly with everyone else. And therefore the ideal of uniform income taxation for all is an impossible goal. We repeat that the bureaucrat who receives $8,000 a year income and then hands $1,500 back to the government is engaging in a mere bookkeeping transaction of no economic importance (aside from the waste of paper and records involved). For he does not and cannot *pay* taxes; he simply receives $6,500 a year from the tax fund.

If it is impossible to tax income uniformly because of the nature of the tax process itself, the attempt to do so also confronts another insuperable difficulty, that of trying to arrive at a cogent definition of "income." Should taxable income include the imputed money value of services received in kind, such as farm produce grown on one's own farm? What about imputed rent from living in one's own house? Or the imputed services of a housewife? Regardless of which course is taken in any of these cases, a good argument can be made that the incomes included as taxable are not the correct ones. And if it is decided to impute the value of goods received in kind, the estimates must always be arbitrary, since the actual sales for money were not made.

A similar difficulty is raised by the question whether incomes should be averaged over several years. Businesses that suffer losses and reap profits are penalized as against those with steady incomes—unless, of course, the government subsidizes part of the loss. This may be corrected by permitting averaging of income over several years, but here again the problem is insoluble because there are only arbitrary ways of deciding the period of time to allow for averaging. If the income tax rate is "progressive," i.e., if the rate increases as earnings increase, then failure to permit averaging penalizes the man with an erratic income. But again, to permit averaging will destroy the ideal of uniform current tax rates; furthermore, varying the period of averaging will vary the results.

We have seen that, in order to tax income only, it is necessary to correct for changes in the purchasing power of money when taxing capital gains. But once again, any index or factor of correction is purely arbitrary, and uniformity cannot be achieved because of the impossibility of securing general agreement on a definition of income.

For all these reasons, the goal of uniformity of taxation is an impossible one. It is not simply difficult to achieve in practice; it is conceptually impossible and self-contradictory. Surely any ethical goal that is *conceptually impossible* of achievement is an absurd goal, and therefore any movements in the direction of the goal are absurd as well.[63] It is therefore legitimate, and even necessary, to engage in a logical (i.e., praxeological) critique of ethical goals and systems when they are relevant to economics.

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[63]To say that an ethical goal is *conceptually impossible* is completely different from saying that its achievement is "unrealistic" because few people uphold it. The latter is by no means an argument against an ethical principle.

Conceptual impossibility means that the goal could not be achieved *even if* everyone aimed at it. On the problem of "realism" in ethical goals, see the brilliant article by Clarence E. Philbrook, "'Realism' in Policy Espousal," *American Economic Review*, December, 1953, pp. 846–59.

Having analyzed the goal of uniformity of treatment, we turn now to the various principles that have been set forth to give content to the idea of uniformity, to answer the question: Uniform in respect to what? Should taxes be uniform as to "ability to pay," or "sacrifice," or "benefits received"? In other words, while most writers have rather unthinkingly granted that people in the same income bracket should pay the same tax, what principle should govern the distribution of income taxes *between* tax brackets? Should the man making $10,000 a year pay as much as, as much *proportionately* as, more than, more proportionately than, or less than, a man making $5,000 or $1,000 a year? In short, should people pay uniformly in accordance with their "ability to pay," or sacrifice made, or some other principle?

*(2) The "Ability-To-Pay" Principle*

*(a) The ambiguity of the concept*

This principle states that people should pay taxes in accordance with their "ability to pay." It is generally conceded that the concept of ability to pay is a highly ambiguous one and presents no sure guide for practical application.[64] Most economists have employed the principle to support a program of proportional or progressive income taxation, but this would hardly suffice. It seems clear, for example, that a person's accumulated wealth affects his ability to pay. A man earning $5,000 during a certain year probably has more ability to pay than a neighbor earning the same amount if he also has $50,000 in the bank while his neighbor has nothing. Yet a tax on accumulated capital would cause general impoverishment. No clear standard can be found to gauge "ability to pay." Both wealth and income would have to be considered, medical expenses would have to be deducted, etc. But there is no precise criterion to be invoked, and the decision is necessarily arbitrary. Thus, should all or some proportion of medical bills be deducted? What about the

[64]*See* Walter J. Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation* (Chicago: University of Chicago Press, 1963), pp. 64–68.

expenses of childrearing? Or food, clothing, and shelter as necessary to consumer "maintenance"? Professor Due attempts to find a criterion for ability in "economic well-being," but it should be clear that this concept, being even more subjective, is still more difficult to define.[65]

Adam Smith himself used the ability concept to support *proportional* income taxation (taxation at a constant percentage of income), but his argument is rather ambiguous and applies to the "benefit" principle as well as to "ability to pay."[66] Indeed, it is hard to see in precisely what sense ability to pay rises *in proportion* to income. Is a man earning $10,000 a year "equally able" to pay $2,000 as a man earning $1,000 to pay $200? Setting aside the basic qualifications of difference in wealth, medical expenses, etc., in what sense can "equal ability" be demonstrated? Attempting to define equal ability in such a way is a meaningless procedure.

McCulloch, in a famous passage, attacked progressiveness and defended proportionality of taxation:

> The moment you abandon . . . the cardinal principle of exacting from all individuals the same proportion of their income or their property, you are at sea without rudder or compass, and there is no amount of injustice or folly you may not commit.[67]

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[65]Due, *Government Finance*, pp. 121 ff.

[66]Said Smith:

> The subjects of every state ought to contribute toward the support of the government, as nearly as possible, in proportion of their respective abilities; that is, in proportion to the revenue which they respectively enjoy under protection of the state. The expense of government to the individuals of a great nation, is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute to their respective interests in the estate. (*Wealth of Nations*, p. 777)

[67]J.R. McCulloch, *A Treatise on the Principle and Practical Influence of Taxation and the Funding System* (London, 1845), p. 142.

Seemingly plausible, this thesis is by no means self-evident. In what way is *proportional* taxation any less arbitrary than any given pattern of *progressive* taxation, i.e., where the rate of tax increases with income? There must be some *principle* that can justify proportionality; if this principle does not exist, then proportionality is no less arbitrary than any other taxing pattern. Various principles have been offered and will be considered below, but the point is that proportionality *per se* is neither more nor less sound than any other taxation.

One school of thought attempts to find a justification for a progressive tax via an ability-to-pay principle. This is the "faculty" approach of E.R.A. Seligman. This doctrine holds that the more money a person has, the relatively easier it is for him to acquire more. His power of obtaining money is supposed to increase as he has more: "A rich man may be said to be subject . . . to a law of increasing returns."[68] Therefore, since his ability increases at a faster rate than his income, a progressive income tax is justified. This theory is simply invalid.[69] Money does not "make money"; if it did, then a few people would by now own all the world's wealth. To be earned money must continually be justifying itself in current service to consumers. Personal income, interest, profits, and rents are earned only in accordance with their *current*, not their past, services. The size of accumulated fortune is immaterial, and fortunes can be and are dissipated when their owners fail to reinvest them wisely in the service of consumers.

As Blum and Kalven point out, the Seligman thesis is utter nonsense when applied to personal services such as labor energy. It could only make sense when applied to income from property, i.e., investment in land or capital goods (or slaves, in

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[68]E.R.A. Seligman, *Progressive Taxation in Theory and Practice* (2nd ed.; (New York: Macmillan & Co., 1908), pp. 291–92.

[69]For an excellent critique of the Seligman theory, *see* Blum and Kalven, *Uneasy Case for Progressive Taxation*, pp. 64–66.

a slave economy). But the return on capital is always tending toward uniformity, and any departures from uniformity are due to especially wise and farseeing investments (profits) or especially wasteful investments (losses). The Seligman thesis would fallaciously imply that the rates of return increase in proportion to the amount invested.

Another theory holds that ability to pay is proportionate to the "producer's surplus" of an individual, i.e., his "economic rent," or the amount of his income above the payment necessary for him to continue production. The consequences of taxation of site rent were noted above. The "necessary payments" to labor are clearly impossible to establish; if someone is asked by the tax authorities what his "minimum" wage is, what will prevent him from saying that *any* amount below the present wage will cause him to retire or to shift to another job? Who can prove differently? Furthermore, even if it could be determined, this "surplus" is hardly an indicator of ability to pay. A movie star may have practically zero surplus, for some other studio may be willing to bid almost as much as he makes now for his services, while a disabled ditch-digger may have a much greater "surplus" because no one else may be willing to hire him. Generally, in an advanced economy there is little "surplus" of this type, for the competition of the market will push alternative jobs and uses near to the factor's discounted marginal value product in its present use. Hence, it would be impossible to tax any "surplus" over necessary payment from land or capital since none exists, and practically impossible to tax the "surplus" to labor since the existence of a sizable surplus is rare, impossible to determine, and, in any case, no criterion whatever of ability to pay.[70]

*(b) The justice of the standard*

The extremely popular ability-to-pay idea was sanctified by Adam Smith in his most important canon of taxation and has

[70]*See ibid.*, pp. 67–68.

been accepted blindly ever since. While much criticism has been levelled at its inherent vagueness, hardly anyone has criticized the basic principle, despite the fact that no one has really grounded it in sound argument. Smith himself gave no reasoning to support this alleged principle, and few others have done so since. Due, in his text on public finance, simply accepts it because most people believe in it, thereby ignoring the possibility of any logical analysis of ethical principles.[71]

The only substantial attempt to give some rational support to the "ability-to-pay principle" rests on a strained comparison of tax payments to voluntary gifts to charitable organizations. Thus Groves writes: "To hundreds of common enterprises (community chests, Red Cross, etc.) people are expected to contribute according to their means. Governments are one of these common enterprises fostered to serve the citizens as a group. . . ."[72] Seldom have more fallacies been packed into two sentences. In the first place, the government is not a common enterprise akin to the community chest. *No one can resign from it.* No one, on penalty of imprisonment, can come to the conclusion that this "charitable enterprise" is not doing its job properly and therefore stop his "contribution"; no one can simply lose interest and drop out. If, as will be seen further below, the State cannot be described as a business, engaged in selling services on the market, certainly it is ludicrous to equate it to a charitable organization. Government is the very negation of charity, for charity is uniquely an unbought gift, a freely flowing uncoerced act by the giver. The word "expected" in Groves' phrase is misleading. No one is forced to give to any charity in which he is not interested or which he believes is not doing its job properly.

The contrast is even clearer in a phrase of Hunter and Allen's:

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[71]Due, *Government Finance*, p. 122.

[72]Groves, *Financing Government*, p. 36.

> Contributions to support the church or the community chest are expected, not on the basis of benefits which individual members receive from the organization, but upon the basis of their ability to contribute.[73]

But this is praxeologically invalid. The reason that anyone contributes voluntarily to a charity is precisely the *benefit* that he obtains from it. Yet *benefit* can be considered only in a subjective sense. It can never be measured. The fact of subjective gain, or benefit, from an act is deducible from the fact that it was performed. Each person making an exchange is deduced to have benefited (at least *ex ante*). *Similarly*, a person who makes a unilateral *gift* is deduced to have benefited (*ex ante*) from making the gift. If he did not benefit, he would not have made the gift. This is another indication that praxeology does not assume the existence of an "economic man," for the benefit from an action may come either from a good or a service directly received in exchange, or simply from the knowledge that someone else will benefit from a gift. Gifts to charitable institutions, therefore, are made precisely on the basis of benefit to the giver, not on the basis of his "ability to pay."

Furthermore, if we compare taxation with the market, we find no basis for adopting the "ability-to-pay" principle. On the contrary, the market price (generally considered the just price) is almost always uniform or tending toward uniformity. Market prices tend to obey the rule of one price throughout the entire market. Everyone pays an equal price for a good regardless of how much money he has or his "ability to pay." Indeed, if the "ability-to-pay" principle pervaded the market, there would be no point in acquiring wealth, for everyone would have to pay more for a product in proportion to the money in his possession. Money incomes would be approximately equalized, and, in fact, there would be no point at all to acquiring money, since the

[73]Hunter and Allen, *Principles of Public Finance*, pp. 190–91.

purchasing power of a unit of money would never be definite but would drop, for any man, in proportion to the quantity of money he earns. A person with less money would simply find the purchasing power of a unit of his money rising accordingly. Therefore, unless trickery and black marketeering could evade the regulations, establishing the "ability-to-pay" principle for prices would wreck the market altogether. The wrecking of the market and the monetary economy would plunge society back to primitive living standards and, of course, eliminate a large part of the current world population, which is permitted to earn a subsistence living or higher by virtue of the existence of the modern, developed market.

It should be clear, moreover, that establishing equal incomes and wealth for all (e.g., by taxing all those over a certain standard of income and wealth, and subsidizing all those below that standard) would have the same effect, since there would be no point to anyone's working for money. Those who enjoy performing labor will do so only "at play," i.e., without obtaining a monetary return. Enforced equality of income and wealth, therefore, would return the economy to barbarism.

If taxes were to be patterned after market pricing, then, taxes would be levied *equally* (*not* proportionately) on everyone. As will be seen below, equal taxation differs in critical respects from market pricing but is a far closer approximation to it than is "ability-to-pay" taxation.

Finally, the "ability-to-pay" principle means precisely that the *able* are penalized, i.e., those most able in serving the wants of their fellow men. Penalizing ability in production and service diminishes the supply of the service—and in proportion to the extent of that ability. The result will be impoverishment, not only of the able, but of the rest of society, which benefits from their services.

The "ability-to-pay" principle, in short, cannot be simply assumed; if it is employed, it must be justified by logical argument, and this economists have yet to provide. Rather than being an evident rule of justice, the "ability-to-pay" principle resembles more the highwayman's principle of taking where the taking is good.[74]

*(3) Sacrifice Theory*

Another attempted criterion of just taxation was the subject of a flourishing literature for many decades, although it is now decidedly going out of fashion. The many variants of the "sacrifice" approach are akin to a subjective version of the "ability-to-pay" principle. They all rest on three general premises: (*a*) that the utility of a unit of money to an individual diminishes as his stock of money increases; (*b*) that these utilities can be compared interpersonally and thus can be summed up, subtracted, etc.; and (*c*) that everyone has the same utility-of-money schedule. The first premise is valid (but only in an *ordinal* sense), but the second and third are nonsensical. The marginal utility of money does diminish, but it is impossible to compare one person's utilities with another, let alone believe that everyone's valuations are identical. Utilities are not quantities, but subjective orders of preference. Any principle for distributing the tax burden that rests on such assumptions must therefore be declared fallacious. Happily, this truth is now generally established in the economic literature.[75]

Utility and "sacrifice" theory has generally been used to justify progressive taxation, although sometimes proportional taxation has been upheld on this ground. Briefly, a dollar is alleged to "mean less" or be worth less in utility to a "rich man" than to a "poor man" ("rich" or "poor" in income or wealth?), and

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[74]*See* Chodorov, *Out of Step*, p. 237. *See also* Chodorov, *From Solomon's Yoke to the Income Tax* (Hinsdale, Ill.: Henry Regnery, 1947), p. 11.

[75]The acceptance of this critique dates from Robbins' writings of the mid-1930's. *See* Lionel Robbins, "Interpersonal Comparisons of Utility," *Economic Journal*, December, 1938, pp. 635–41; and Robbins, *An Essay on the Nature and Significance of Economic Science* (2nd ed.; London: Macmillan & Co., 1935), pp. 138–41. Robbins was, at that time, a decidedly "Misesian" economist.

therefore payment of a dollar by a rich man imposes less of a subjective sacrifice on him than on a poor man. Hence, the rich man should be taxed at a higher rate. Many "ability-to-pay" theories are really inverted sacrifice theories, since they are couched in the form of *ability to make sacrifices*.

Since the nub of the sacrifice theory—interpersonal comparisons of utility—is now generally discarded, we shall not spend much time discussing the sacrifice doctrine in detail.[76] However, several aspects of this theory are of interest. The sacrifice theory divides into two main branches: (1) the *equal-sacrifice* principle and (2) the *minimum-sacrifice* principle. The former states that every man should sacrifice equally in paying taxes; the latter, that society as a whole should sacrifice the least amount. Both versions abandon completely the idea of government as a supplier of benefits and treat government and taxation as simply a burden, a sacrifice that must be borne in the best way we know how. Here we have a curious principle of justice indeed—based on adjustment to hurt. We are faced again with that *pons asinorum* that defeats all attempts to establish canons of justice for taxation—the problem of the justice of taxation *itself*. The proponent of the sacrifice theory, in realistically abandoning unproved assumptions of benefit from taxation, must face and then founder on the question: If taxation is pure hurt, why endure it *at all*?

The *equal-sacrifice* theory asks that equal hurt be imposed on all. As a criterion of justice, this is as untenable as asking for equal slavery. One interesting aspect of the equal-sacrifice theory, however, is that it does not necessarily imply progressive income taxation! For although it implies that the rich man should be taxed *more than* the poor man, it does not necessarily say that the former should be taxed *more than proportionately*. In fact, it does not even establish that all be taxed *proportionately*! In

[76]For a critique of sacrifice theory, *see* Blum and Kalven, *Uneasy Case for Progressive Taxation*, pp. 39–63.

short, the equal-sacrifice principle may demand that a man earning $10,000 be taxed more than a man earning $1,000, but not necessarily that he be taxed a greater percentage or even proportionately. Depending on the shapes of the various "utility curves," the equal-sacrifice principle may well call for *regressive taxation* under which a wealthier man would pay more in amount but less proportionately (e.g., the man earning $10,000 would pay $500, and the man earning $1,000 would pay $200). The more rapidly the utility of money declines, the more probably will the equal-sacrifice curve yield progressivity. A slowly declining utility-of-money schedule would call for regressive taxation. Argument about how rapidly various utility-of-money schedules decline is hopeless because, as we have seen, the entire theory is untenable. But the point is that even on its own grounds, the equal-sacrifice theory can justify neither progressive nor proportionate taxation.[77]

The minimum-sacrifice theory has often been confused with the equal-sacrifice theory. Both rest on the same set of false assumptions, but the minimum-sacrifice theory counsels very drastic progressive taxation. Suppose, for example, that there are two men in a community, Jones making $50,000, and Smith making $30,000. The principle of minimum social sacrifice, resting on the three assumptions described above, declares: $1.00 taken from Jones imposes less of a sacrifice than $1.00 taken from Smith; hence, if the government needs $1.00, it takes it from Jones. But suppose the government needs $2.00; the second dollar will impose less of a sacrifice on Jones than the first dollar taken from Smith, for Jones still has more money left than Smith and therefore sacrifices less. This continues as long as Jones has more money remaining than Smith. Should the government need $20,000 in taxes, the minimum-sacrifice principle counsels taking the entire $20,000 from Jones and zero

[77]For an attempt to establish proportional taxation on the basis of equal sacrifice, *see* Bradford B. Smith, *Liberty and Taxes* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, n.d.), pp. 10–12.

from Smith. In other words, it advocates taking all of the highest incomes in turn until governmental needs are fulfilled.[78]

The minimum-sacrifice principle depends heavily, as does the equal-sacrifice theory, on the untenable view that everyone's utility-of-money schedule is roughly identical. Both rest also on a further fallacy, which now must be refuted: that "sacrifice" is simply the obverse of the *utility of money*. For the subjective sacrifice in taxation may not be merely the opportunity cost forgone of the money paid; it may also be increased by *moral outrage* at the tax procedure. Thus, Jones may become so morally outraged at the above proceedings that his marginal subjective sacrifice quickly becomes very great, much "greater" than Smith's if we grant for a moment that the two can be compared. Once we see that subjective sacrifice is not necessarily tied to the utility of money, we may extend the principle further. Consider, for example, a philosophical anarchist who opposes all taxation fervently. Suppose that *his* subjective sacrifice in the payment of any tax is so great as to be almost infinite. In that case, the minimum-sacrifice principle would have to exempt the anarchist from taxation, while the equal-sacrifice principle could tax him only an infinitesimal amount. Practically, then, the sacrifice principle would have to exempt the anarchist from taxation. Furthermore, how can the government determine the subjective sacrifice of the individual? By asking him? In that case, how many people would refrain from proclaiming the enormity of their sacrifice and thus escape payment completely?

Similarly, if two individuals subjectively enjoyed their identical money incomes differently, the minimum-sacrifice principle would require that the happier man be taxed less because he

[78]Pushed to its logical conclusion in which the State is urged to establish "maximum social satisfaction"—the obverse of minimum social sacrifice—the principle counsels absolute compulsory egalitarianism, with everyone above a certain standard taxed in order to subsidize everyone else to come up to that standard. The consequence, as we have seen, would be a return to the conditions of barbarism.

makes a greater sacrifice in enjoyment from an equal tax. Who will suggest heavier taxation on the unhappy or the ascetic? And who would then refrain from loudly proclaiming the enormous enjoyment *he* derives from his income?

It is curious that the minimum-sacrifice principle counsels the obverse of the ability-to-pay theory, which, particularly in its "state of well-being" variant, advocates a special *tax on happiness* and a lower tax on *un*happiness. If the latter principle prevailed, people would rush to proclaim their *unhappiness* and deep-seated asceticism.

It is clear that the proponents of the ability-to-pay and sacrifice theories have completely failed to establish them as criteria of just taxation. These theories also commit a further grave error. For the sacrifice theory explicitly, and the ability-to-pay theory implicitly, set up presumed criteria for action in terms of sacrifice and burden.[79] The State is assumed to be a burden on society, and the question becomes one of justly distributing this burden. But man is constantly striving to sacrifice as little as he can for the benefits he receives from his actions. Yet here is a theory that talks only in terms of sacrifice and burden, and calls for a certain distribution *without demonstrating to the taxpayers that they are benefiting more than they are giving up.* Since the theorists do not so demonstrate, they can make their appeal only in terms of sacrifice—a procedure that is praxeologically invalid. Since men always try to find net benefits in a course of action, it follows that a discussion in terms of sacrifice or burden cannot establish a rational criterion for human action. To be praxeologically valid, a criterion must demonstrate net benefit. It is true, of course, that the proponents of the sacrifice theory are far more realistic than the proponents of the benefit theory (which we shall discuss below), in considering the State a net

[79]The ability-to-pay principle is unclear on this point. Some proponents base their argument implicitly on sacrifice; others, on the necessity for payment for "untraceable" benefits.

burden on society rather than a net benefit; but this hardly demonstrates the *justice* of the sacrifice principle of taxation. Quite the contrary.

### *(4) The Benefit Principle*

The benefit principle differs radically from the two preceding criteria of taxation. For the sacrifice and ability-to-pay principles depart completely from the principles of action and the accepted criteria of justice on the market. On the market people act freely in those ways which they believe will confer net benefits upon them. The result of these actions is the monetary exchange system, with its inexorable tendency toward uniform pricing and the allocation of productive factors to satisfy the most urgent demands of all the consumers. Yet the criteria used in judging taxation differ completely from those which apply to all other actions on the market. Suddenly free choice and uniform pricing are forgotten, and the discussion is all in terms of sacrifice, burden, etc. If taxation is only a burden, it is no wonder that coercion must be exercised to maintain it. The benefit principle, on the other hand, is an attempt to establish taxation on a similar basis as market pricing; that is, the *tax is to be levied in accordance with the benefit received by the individual.* It is an attempt to achieve the goal of a *neutral tax*, one that would leave the economic system approximately as it is on the free market. It is an attempt to achieve praxeological soundness by establishing a criterion of payment on the basis of benefit rather than sacrifice.

The great gulf between the benefit and other principles was originally unrecognized, because of Adam Smith's confusion between ability to pay and benefit. In the quotation cited above, Smith inferred that everyone benefits from the State in proportion to his income and that this income establishes his ability to pay. Therefore, a tax on his ability to pay will simply be a *quid pro quo* in exchange for benefits conferred by the State. Some writers have contended that people benefit from government in proportion to their income; others, that they benefit in *increased* proportion to their income, thus justifying a progressive income tax. Yet this entire application of the benefit theory is nonsensical. How do the rich reap a greater benefit proportionately, or even more than proportionately, from government than the poor? They could do so only if the government were *responsible* for these riches by a grant of special privilege, such as a subsidy, a monopoly grant, etc. Otherwise, how do the rich benefit? From "welfare" and other redistributive expenditures, which take from the rich and give to the bureaucrats and the poor? Certainly not. From police protection? But it is precisely the rich who could more afford to pay for their own protection and who therefore derive *less* benefit from it than the poor. The benefit theory holds that the rich benefit more from protection because their property is more valuable; but the *cost* of protection may have little relation to the value of the property. Since it costs less to police a bank vault containing $100 million than to guard 100 acres of land worth $10 per acre, the poor landowner receives a far greater benefit from the State's protection than the rich owner of personalty. Neither would it be relevant to say that A earns more money than B because A receives a greater benefit from "society" and should therefore pay more in taxes. In the first place, everyone participates in society. The fact that A earns more than B means precisely that A's services are *individually* worth more to his fellows. Therefore, since A and B benefit similarly from society's existence, the reverse argument is far more accurate: that the *differential* between them is due to A's individual superiority in productivity, and not at all to "society." Secondly, *society* is *not* at all the State, and the State's possible claim must be independently validated.

Hence, neither proportionate nor progressive income taxation can be sustained on benefit principles. In fact, the reverse is true. If everyone were to pay in accordance with benefit received, it is clear that (*a*) the recipients of "welfare" benefits would bear the full costs of these benefits: the poor would have to pay for their own doles (including, of course, the extra cost of paying the bureaucracy for making the transfers); (*b*) the buyers of any government service would be the only payers, so that government services could not be financed out of a general tax fund; and (*c*) for police protection, a rich man would pay *less* than a poor man, and less in absolute amounts. Furthermore, landowners would pay more than owners of intangible property, and the weak and infirm, who clearly benefit more from police protection than the strong, would have to pay higher taxes than the latter.

It becomes immediately clear why the benefit principle has been practically abandoned in recent years. For it is evident that if (*a*) welfare recipients and (*b*) receivers of other special privilege, such as monopoly grants, were to pay according to the benefit received, there would not be much point in either form of government expenditure. And if each were to pay an amount *equal* to the benefit he received rather than simply proportionately (and he would have to do so because there would be nowhere else for the State to turn for funds), then the recipient of the subsidy would not only earn nothing, but would have to pay the bureaucracy for the cost of handling and transfer. The establishment of the benefit principle would therefore result in a *laissez-faire* system, with government strictly limited to supplying defense service. And the taxation for this defense service would be levied more on the poor and the infirm than on the strong and the rich.

At first sight, the believer in the free market, the seeker after a neutral tax, is inclined to rejoice. It would seem that the benefit principle is the answer to his search. And this principle is indeed closer to market principles than the previous alleged canons. Yet, if we pursue the analysis more closely, it will be evident that the benefit principle is still far from market neutrality. On the market, people do not pay in accordance with individual benefit received; they pay a uniform price, one that just induces the marginal buyer to participate in the exchange. The more eager do not pay a higher price than the less eager; the chess addict and the indifferent player pay the same price for the same chess set, and the opera enthusiast and the novice pay the same price for the same ticket. The poor and the weak would be most eager for protection, but, in contrast to the benefit principle, they would not pay more on the *market*.

There are even graver defects in the benefit principle. For market exchanges (*a*) demonstrate benefit and (*b*) only establish the *fact* of benefit without measuring it. The only reason we know that A and B benefit from an exchange is that they voluntarily make the exchange. In this way, the market *demonstrates* benefit. But where taxes are levied, the payment is compulsory, and therefore benefit *can never be demonstrated*. As a matter of fact, the existence of coercion gives rise to the opposite presumption and implies that the tax is not a benefit, but a burden. If it really were a benefit, coercion would not be necessary.

Secondly, the benefit from exchange can never be measured or compared interpersonally. The "consumers' surplus" derived from exchange is purely subjective, nonmeasurable, and noncomparable scientifically. Therefore, we never know what these benefits are, and hence there can be no way of allocating the taxes in accordance with them.

Thirdly, on the market everyone enjoys a net benefit from an exchange. A person's benefit is not equal to his cost, but greater. Therefore, taxing away his alleged benefit would completely violate market principles.

Finally, if each person were taxed according to the benefit he receives from government, it is obvious that, since the bureaucracy receive all their income from this source, they would, like other recipients of subsidy and privilege, be obliged *to return their whole salary to the government.* The bureaucracy would have to serve without pay.

We have seen that the benefit principle would dispense with all subsidy expenditures of whatever type. Government services would have to be sold directly to buyers; but in that case, there would be no room for government ownership, for the characteristic of a government enterprise is that it is launched from tax funds. Police and judicial services are often declared by the proponents of the benefit principle to be inherently general and unspecialized, so that they would need to be purchased out of the common tax fund rather than by individual users. However, as we have seen, this assumption is incorrect; these services can be sold on the market like any others. Thus, even in the absence of all other deficiencies of the benefit principle, it would still establish no warrant for taxation at all, for all services *could* be sold on the market directly to beneficiaries.

It is evident that while the benefit principle attempts to meet the market criterion of limiting payment solely to beneficiaries, it must be adjudged a failure; it cannot serve as a criterion for a neutral tax or any other type of taxation.

### *(5) The Equal Tax and the Cost Principle*

Equality of taxation has far more to commend it than any of the above principles, none of which can be used as a canon of taxation. "Equality of taxation" means just that—a uniform tax on every member of the society. This is also called a head tax, capitation tax, or poll tax. (The latter term, however, is best used to describe a uniform tax on voting, which is what the poll tax has become in various American states.) Each person would pay the same tax annually to the government. The equal tax would be particularly appropriate in a democracy, with its emphasis on equality before the law, equal rights, and absence of discrimination and special privilege. It would embody the principle: "One vote, one tax." It would appropriately apply only to the protection services of the government, for the government is committed to defending everyone equally. Therefore, it may seem just for each person to be taxed equally in return. The principle of equality would rule out, as would the benefit principle, all government actions except defense, for all other expenditures would set up a special privilege or subsidy of some kind. Finally, the equal tax would be far more nearly neutral than any of the other taxes considered, for it would attempt to establish an equal "price" for equal services rendered.

One school of thought challenges this contention and asserts that a *proportional* tax would be more nearly neutral than an equal tax. The proponents of this theory point out that an equal tax alters the market's pattern of distribution of income. Thus, if A earns 1,000 gold ounces per year, B earns 200 ounces, and C earns 50 ounces, and each pays 10 ounces in taxes, then the *relative proportion* of net income remaining after taxes is altered, and altered in the direction of greater inequality. A proportionate tax of a fixed percentage on all three would leave the distribution of income constant and would therefore be neutral relative to the market.

This thesis misconceives the whole problem of neutrality in taxation. The object of the quest is *not* to leave the income distribution the same as if a tax had not been imposed. The object is *to affect the income "distribution" and all other aspects of the economy in the same way as if the tax were really a free-market price.* And this is a very different criterion. No market price leaves relative income "distribution" the same as before. If the market really behaved in this way, there would be no advantage in earning money, for people would have to pay proportionately higher prices for goods in accordance with the level of their earnings. The market tends toward uniformity of pricing and hence toward equal pricing for equal service. Equal taxation, therefore, would be far more nearly neutral and would constitute a closer approach to a market system.

The equal-tax criterion, however, has many grave defects, even as an approach toward a neutral tax. In the first place, the market criterion of equal price for equal service faces the problem: What is an "equal service"? The service of police protection is of far greater magnitude in an urban crime area than it is in some sleepy backwater. That service is worth far more in the crime center, and therefore the price paid will tend to be greater in a crime-ridden area than in a peaceful area. It is very likely that, in the purely free market, police and judicial services would be sold like insurance, with each member paying regular premiums in return for a call on the benefits of protection when needed. It is obvious that a more risky individual (such as one living in a crime area) would tend to pay a higher premium than individuals in another area. To be neutral, then, a tax would have to vary in accordance with costs and not be uniform.[80] Equal taxation would distort the allocation of social resources in defense. The tax would be below the market price in the crime areas and above the market price in the peaceful areas, and there would therefore be a shortage of police protection in the dangerous areas and a surplus of protection in the others.

Another grave flaw of the equal-tax principle is the same that we noted in the more general principle of uniformity: no bureaucrat can pay taxes. An "equal tax" on a bureaucrat or politician is an impossibility, because he is one of the tax consumers rather than taxpayers. Even when all other subsidies are eliminated, the government employee remains a permanent obstacle in the path of equal tax. As we have seen, the bureaucrat's "tax payment" is simply a meaningless bookkeeping device.

These flaws in the equal tax cause us to turn to the last remaining tax canon: *the cost principle*. The cost principle would apply as we have just discussed it, with the government setting the tax in accordance with costs, like the premiums charged by an insurance company.[81] The cost principle would constitute

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[80]This does not concede 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 people will pay for their products is enough to cover their costs, which are determined throughout the market. In equilibrium, costs and prices will all be equal. Since a tax is levied on general funds and therefore cannot be equivalent to market pricing, the only way to approximate market pricing is to set the tax according to costs, since costs at least reflect market pricing of the nonspecific factors.

[81]Blum and Kalven mention the cost principle but casually dismiss it as being practically identical with the benefit principle:

> Sometimes the theory is stated in terms of the *cost* of the government services performed for each citizen rather than in terms of the *benefits* received from such services.

the closest approach possible to neutrality of taxation. Yet even the cost principle has fatal flaws that finally eliminate it from consideration. In the first place, although the costs of nonspecific factors could be estimated from market knowledge, the costs of specific factors could not be determined by the State. The impossibility of calculating specific costs stems from the fact that products of tax-supported firms have no real market price, and so specific costs are unknown. As a result, the cost principle cannot be accurately put into effect. The cost principle is further vitiated by the fact that a compulsory monopoly—such as State protection—will invariably have higher costs and sell lower-quality service than freely competitive defense firms on the market. As a result, costs will be much higher than on the market, and, again, the cost principle offers no guide to a neutral tax.

A final flaw is common to both the equality and the cost theories of taxation. In neither case is *benefit demonstrated* as accruing to the taxpayer. Although the taxpayer is blithely *assumed* to be benefiting from the service just as he does on the market, we have seen that such an assumption cannot be made—that the use of coercion presumes quite the contrary for many taxpayers. The market requires a uniform price, or the exact covering of costs, only because the purchaser voluntarily buys the product in the expectation of being benefited. The State, on the other hand, would force people to pay the tax even if they were not voluntarily willing to pay the cost of this or any other defense

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> This refinement may avoid the need of measuring subjective benefits, but it does little else for the theory. (*Uneasy Case for Progressive Taxation*, p. 36 n)

Yet their major criticism of the benefit principle is precisely that it requires the impossible measurement of subjective benefit. The cost principle, along with the benefit principle, dispenses with all government expenditures except *laissez-faire* ones, since each recipient would be required to pay the full cost of the service. With respect to the *laissez-faire* service of protection, however, the cost principle is clearly far superior to the benefit principle.

system. Hence, the cost principle can never provide a route to the neutral tax.

### *(6) Taxation "For Revenue Only"*

A slogan popular among many "right-wing" economists is that taxation should be for "revenue only," and not for broad social purposes. On its face, this slogan is simply and palpably absurd, since all taxes are levied for revenue. What else can taxation be called but the appropriation of funds from private individuals by the State for its own purposes? Some writers therefore amend the slogan to say: Taxation should be limited to revenue essential for social services. But what are social services? To some people, every conceivable type of government expenditure appears as a "social service." If the State takes from A and gives to B, C may applaud the act as a "social service" because he dislikes something about the former and likes something about the latter. If, on the other hand, "social service" is limited by the "unanimity rule" to apply only to those activities that serve some individuals without making others pay, then the "taxation-for-revenue-only" formula is simply an ambiguous term for the benefit or the cost principles.

### *(7) The Neutral Tax: A Summary*

We have thus analyzed all the alleged canons of tax justice. Our conclusions are twofold: (1) that economics cannot assume any principle of just taxation, and that no one has successfully established any such principles; and (2) that the *neutral tax*, which seems to many a valid ideal, turns out to be conceptually impossible to achieve. Economists must therefore abandon their futile quest for the just, or the neutral, tax.

Some may ask: Why does anyone search for a neutral tax? Why consider neutrality an ideal? The answer is that all services, all activities, can be provided in two ways only: by freedom or by coercion. The former is the way of the market; the latter, of the State. If all services were organized on the market, the result would be a purely free-market system; if all were organized by the State, the result would be socialism (see below). Therefore, all who are not full socialists must concede some area to market activity, and, once they do so, they must justify their departures from freedom on the basis of some principle or other. In a society where most activities are organized on the market, advocates of *State* activity must justify departures from what they themselves concede to the market sphere. Hence, the use of neutrality is a benchmark to answer the question: Why do you want the State to step in and alter market conditions in this case? If market prices are uniform, *why* should tax payments be otherwise?

But if neutral taxation is, at bottom, impossible, there are two logical courses left for advocates of the neutral tax: either abandon the goal of neutrality, or abandon taxation itself.

## D. Voluntary Contributions to Government

A few writers, disturbed by the compulsion necessary to the existence of taxation, have advocated that governments be financed, not by taxation, but by some form of voluntary contribution. Such voluntary contribution systems could take various forms. One was the method relied on by the old city-state of Hamburg and other communities—voluntary *gifts* to the government. President William F. Warren of Boston University, in his essay, "Tax Exemption the Road to Tax Abolition," described his experience in one of these communities:

> For five years it was the good fortune of the present writer to be domiciled in one of these communities. Incredible as it may seem to believers in the necessity of a legal enforcement of taxes by pains and penalties, he was for that period . . . his own assessor and his own tax-gatherer. In common with the other citizens, he was invited, without sworn statement or declaration, to make such contribution to the public charges as seemed to himself just and equal. That sum, uncounted by any official, unknown to any but himself, he was asked to drop with his own hand into a strong public chest; on doing which his name was

> checked off the list of contributors. . . . Every citizen felt a noble pride in such immunity from prying assessors and rude constables. Every annual call of the authorities on that community was honored to the full.[82]

The gift method, however, presents some serious difficulties. In particular, it continues that *disjunction between payment and receipt of service* which constitutes one of the great defects of a taxing system. Under taxation, payment is severed from receipt of service, in striking contrast to the market where payment and service are correlative. The voluntary gift method perpetuates this disjunction. As a result, A, B, and C continue to receive the government's defense service even if they paid nothing for it, and only D and E contributed. D's and E's contributions, furthermore, may be disproportionate. It is true that this is the system of voluntary charity on the market. But charity flows from

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[82]Dr. Warren's article appeared in the Boston University Year Book for 1876. The board of the Council of the University endorsed the essay in these words:

> In place of the further extent of taxation advocated by many, the essay proposes a far more imposing reform, the general abolition of all compulsory taxes. It is hoped that the comparative novelty of the proposition may not deter practical men from a thoughtful study of the paper. (*See* the *Boston University Year Book III* (1876), pp. 17–38)

Both quotations may be found in Sidney H. Morse, "Chips from My Studio," *The Radical Review*, May, 1877, pp. 190–92. *See also* Adam Smith, *Wealth of Nations*, pp. 801–03; Francis A. Walker, *Political Economy* (New York: Henry Holt, 1911), pp. 475–76. Smith, in one of his most sensible canons, declared:

> In a small republic, where the people have entire confidence in their magistrates and are convinced of the necessity of the tax for the support of the state, and believe that it will be faithfully applied to that purpose, such conscientious and voluntary payment may sometimes be expected. (Smith, *Wealth of Nations*, p. 802)

the more to the less wealthy and able; it does not constitute an efficient *method* for organizing the general sale of a service. Automobiles, clothes, etc., are sold on the market on a regular uniform-price basis and are not indiscriminately given to some on the basis of gifts received from others. Under the gift system people will tend to demand far more defense service from the government than they are willing to pay for; and the voluntary contributors, getting no direct reward for their money, will tend to reduce their payment. In short, where service (such as defense) flows to people regardless of payment, there will tend to be excessive demands for service, and an insufficient supply of funds to sustain it.

When the advocates of taxation, therefore, contend that a voluntary society could never efficiently finance defense service because people would evade payment, they are correct insofar as their strictures apply to the *gift* method of finance. The gift method, however, hardly exhausts the financing methods of the purely free market.

A step in the direction of greater efficiency would have the defense agency charging a set price instead of accepting haphazard amounts varying from the very small to the very large, but continuing to supply defense indiscriminately. Of course, the agency would not refuse gifts for general purposes or for granting a supply of defense service to poor people. But it would charge some minimum price commensurate with the cost of its service. One such method is a *voting tax*, now known as a poll tax.[83] A poll tax, or voting tax, is not really a "tax" at all; it is only a *price* charged for participating in the State organization.[84] Only those who voluntarily vote for State officials, i.e., who participate in the State machinery, are required to pay the tax. If all

[83]The current poll tax began simply as a head tax, but in practice it is enforced only as a requirement for *voting*. It has therefore become a voting tax.

[84]See below on fees charged for government service.

the State's revenues were derived from poll taxes, therefore, this would not be a system of taxation at all, but rather voluntary contributions in payment for the right to participate in the State's machinery. The voting tax would be an improvement over the gift method because it would charge a certain uniform or minimal amount.

To the proposal to finance all government revenues from poll taxes it has been objected that practically no one would vote under these conditions. This is perhaps an accurate prediction, but curiously the critics of the poll tax never pursue their analysis beyond this point. It is clear that this reveals something very important about the nature of the voting process. Voting is a highly marginal activity because (*a*) the voter obtains no direct benefits from his act of voting, and (*b*) his aliquot power over the final decision is so small that his abstention from voting would make no appreciable difference to the final outcome. In short, in contrast to all other choices a man may make, in political voting he has practically no power over the outcome, and the outcome would make little *direct* difference to him anyway. It is no wonder that well over half the eligible American voters persistently refuse to take part in the annual November balloting. This discussion also illuminates a puzzling phenomenon in American political life—the constant exhortation by politicians of all parties for people to vote: "We don't care *how* you vote, but *vote*!" is a standard political slogan.[85] On its face, it makes little sense, for one would think that at least one of the parties would see advantages in a small vote. But it does make a great deal of sense when we realize the enormous desire of politicians

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[85]Voting, like taxation, is another activity generally phrased in terms of "duty" rather than benefit. The call to "duty" is as praxeologically unsound as the call to sacrifice and generally amounts to the same thing. For both exhortations tacitly admit that the actor will derive little or no benefit from his action. Further, the invocation of duty or sacrifice implies that *someone else* is going to receive the sacrifice or the payment of the "obligation"—and often that someone is the exhorter himself.

of *all* parties to make it appear that the people have given them a "mandate" in the election—that all the democratic shibboleths about "representing the people," etc., are true.

The reason for the relative triviality of voting is, once again, the disjunction between voting and payment, on the one hand, and benefit on the other. The poll tax gives rise to the same problem. The voter, with or without paying a poll tax, receives no more benefit in protection than the nonvoter. Consequently, people will refuse to vote in droves under a single poll-tax scheme, and everyone will demand the use of the artificially free defense resources.

Both the *gift* and the *voting-tax* methods of voluntary financing of government, therefore, must be discarded as inefficient. A third method has been proposed, which we can best call by the paradoxical name *voluntary taxation*. The plan envisioned is as follows: Every land area would, as now, be governed by one monopolistic State. The State's officials would be chosen by democratic voting, as at present. The State would set a uniform price, or perhaps a set of cost prices, for protective services, and it would be left to each individual to make a voluntary choice whether to pay or not to pay the price. If he pays the price, he receives the benefit of governmental defense service; if he does not, he goes unprotected.[86] The leading "voluntary taxationists" have been Auberon Herbert, his associate, J. Greevz Fisher, and (sometimes) Gustave de Molinari. The same position is found

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[86]We are assuming that the government will confine its use of force to defense, i.e., will pursue a strictly *laissez-faire* policy. Theoretically, it is possible that a government may get all its revenue from voluntary contribution, and yet pursue a highly coercive, interventionist policy in other areas of the market. The possibility is so remote in practice, however, that we may disregard it here. It is highly unlikely that a government coercive in other ways would not take immediate steps to see that its *revenues* are assured by coercion. Its own revenue is always the State's prime concern. (Note the very heavy penalties for income-tax evasion and counterfeiting of government paper money.)

earlier, to a far less developed extent, in the early editions of Herbert Spencer's *Social Statics*, particularly his chapter on the "Right to Ignore the State," and in Thoreau's *Essay on Civil Disobedience*.[87]

The voluntary taxation method preserves a voluntary system, is (or appears to be) neutral *vis-à-vis* the market, and eliminates the payment-benefit disjunction. And yet this proposal has several important defects. Its most serious flaw is inconsistency. For the voluntary taxationists aim at establishing a system in which no one is coerced who is not himself an invader of the person or property of others. Hence their complete elimination of taxation. But, although they eliminate the compulsion to subscribe to the government defense monopoly, they yet retain that monopoly. They are therefore faced with the problem: Would they use force to compel people *not* to use a freely competing defense agency *within* the same geographic area? The voluntary taxationists have never attempted to answer this problem; they have rather stubbornly assumed that no one would set up a competing defense agency within a State's territorial limits. And yet, if people are free to pay or not to pay "taxes," it is obvious that some people will not simply refuse to pay for all protection. Dissatisfied with the quality of defense they receive from the government, or with the price they must pay, they will elect to form a competing defense agency or "government" within the area and subscribe to it. The voluntary taxation system is thus *impossible* of attainment because it would be in unstable equilibrium. If the government elected to outlaw all competing defense agencies, it would no longer function as the voluntary

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[87]Spencer, *Social Statics*; Herbert and Levy, *Taxation and Anarchism*; and Molinari, *Society of Tomorrow*. At other times, however, Molinari adopted the pure free-market position. Thus, see what may be the first developed outline of the purely libertarian system in Gustave de Molinari, "De la production de la sécurité," *Journal des Economistes*, February, 1849, pp. 277–90, and Molinari, "Onzième soirée" in *Les soirées de la rue Saint Lazare* (Paris, 1849).

society sought by its proponents. It would not force payment of taxes, but it would say to the citizens: "You are free to accept and pay for our protection or to abstain; but you are *not* free to purchase defense from a competing agency." This is not a free market; this is a *compulsory monopoly*, once again a grant of monopoly privilege by the State to itself. Such a monopoly would be far less efficient than a freely competitive system; hence, its costs would be higher, its service poorer. It would clearly *not* be neutral to the market.

On the other hand, if the government *did* permit free competition in defense service, there would soon no longer be a central government over the territory. Defense agencies, police and judicial, would compete with one another in the same uncoerced manner as the producers of any other service on the market. The prices would be lower, the service more efficient. And, for the first and only time, the defense system would then be *neutral* in relation to the market. *It would be neutral because it would be a part of the market itself!* Defense service would at last be made fully marketable. No longer would anyone be able to point to one particular building or set of buildings, one uniform or set of uniforms, as representing "our government."

While "the government" would cease to exist, the same cannot be said for a constitution or a rule of law, which, in fact, would take on in the free society a far more important function than at present. For the freely competing judicial agencies would have to be guided by a body of absolute law to enable them to *distinguish* objectively between defense and invasion. This law, embodying elaborations upon the basic injunction to defend person and property from acts of invasion, would be codified in the basic legal code. Failure to establish such a code of law would tend to break down the free market, for then defense against invasion could not be adequately achieved. On the other hand, those neo-Tolstoyan *nonresisters* who refuse to employ violence even for defense would not themselves be forced into any relationship with the defense agencies.

Thus, if a government based on voluntary taxation permits free competition, the result will be the purely free-market system outlined in chapter 1 above. The previous government would now simply be one competing defense agency among many on the market. It would, in fact, be competing at a severe disadvantage, having been established on the principle of "democratic voting." Looked at as a market phenomenon, "democratic voting" (one vote per person) is simply the method of the consumer "co-operative." Empirically, it has been demonstrated time and again that co-operatives cannot compete successfully against stock-owned companies, especially when both are equal before the law. There is no reason to believe that co-operatives for defense would be any more efficient. Hence, we may expect the old co-operative government to "wither away" through loss of customers on the market, while joint-stock (i.e., corporate) defense agencies would become the prevailing market form.[88]

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[88]These corporations would not, of course, need any charter from a government but would "charter" themselves in accordance with the ways in which their owners decided to pool their capital. They could announce their limited liability in advance, and then all their creditors would be put amply on guard.

There is a strong *a priori* reason for believing that corporations will be superior to cooperatives in any given situation. For if each owner receives only one vote regardless of how much money he has invested in a project (and earnings are divided in the same way), there is no incentive to invest more than the next man; in fact, every incentive is the other way. This hampering of investment militates strongly against the cooperative form.

# 5

# BINARY INTERVENTION: GOVERNMENT EXPENDITURES[1]

WHEN WRITERS ON PUBLIC FINANCE and political economy reach the topic of "government expenditures," they have traditionally abandoned analysis and turned to simple institutional description of various types of governmental expenditure. In discussing taxation, they engage in serious analysis, faulty as some of it may be; but they have devoted little attention to a theoretical treatment of expenditure. Harriss, in fact, goes so far as to say that a theory of government expenditure is impossible or, at least, nonexistent.[2]

The bulk of discussion of expenditures is devoted to describing their great proliferation, absolute and relative, in the last decades, coupled with the assumption (implicit or explicit) that this growth has been necessary to "cope with the growing complexities of the economy." This slogan or similar ones have gained almost universal acceptance but have never been rationally supported. On its face, the statement is unproved and will remain so until proved.

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[1]The subject of government binary intervention in the form of credit expansion is covered in *Man, Economy, and State*, pp. 989–1024.

[2]Harriss, "The Public Finance" in Haley, ed., *Survey of Contemporary Economics*, II, 262.

Broadly, we may consider two categories of government expenditures: *transfer* and *resource-using*. Resource-using activities employ nonspecific resources that could have been used for other production; they withdraw factors of production from private uses to State-designated uses. Transfer activities may be defined as those which use no resources, i.e., which transfer money directly from Peter to Paul. These are the *pure* subsidy-granting activities.

Now, of course, there is considerable similarity between the two branches of government action. *Both* are transfer activities insofar as they pay the salaries of the bureaucracy engaged in these operations. Both *even* involve shifts of resources, since transfer activities shift nonspecific factors from free-market, voluntary activity to demands stemming from State-privileged groups. *Both* subsidize: the supply of governmental services, as well as the purchase of material by government enterprises, constitutes a subsidy. But the difference is important enough to preserve. For in one case, goods are used for and resources are devoted to State purposes as the State wills; in the other, the State subsidizes private individuals, who employ resources as they think best. Transfer payments are *pure* subsidies without prior diversion of resources.

We shall first analyze transfer payments as *pure* subsidies and then see how the analysis applies to the subsidizing aspects of resource-using activities.

### *1. Government Subsidies: Transfer Payments*

There are two and only two ways of acquiring wealth: the *economic means* (voluntary production and exchange) and the *political means* (confiscation by coercion). On the free market only the economic means can be used, and consequently everyone earns only what other individuals in society are willing to pay for his services. As long as this continues, there is no separate process called "distribution"; there are only production and exchange of goods. Let government subsidies enter the scene, however, and the situation changes. Now the political means to wealth becomes available. On the free market, wealth is only a resultant of the voluntary choices of all individuals and the extent to which men serve each other. But the possibility of government subsidy permits a change: it opens the way to an allocation of wealth in accordance with the ability of a person or group to gain control of the State apparatus.

Government subsidy *creates* a separate *distribution* process (not "redistribution," as some would be tempted to say). For the first time, earnings are severed from production and exchange and become separately determined. To the extent that this distribution occurs, therefore, the allocation of earnings is distorted away from efficient service to consumers. Therefore, we may say that *all* cases of subsidy coercively penalize the *efficient* for the benefit of the *inefficient*.

Subsidies consequently prolong the life of inefficient firms at the expense of efficient ones, distort the productive system, and hamper the mobility of factors from less to more value-productive locations. They injure the market greatly and prevent the full satisfaction of consumer wants. Suppose, for example, an entrepreneur is sustaining losses in some industry, or the owner of a factor is earning a very low sum there. On the market, the factor owner would shift to a more value-productive industry, where both the owner of the factor and the consumers would be better served. If the government subsidizes him where he is, however, the life of inefficient firms is prolonged, and factors are encouraged *not* to enter their most value-productive uses. The greater the extent of government subsidy in the economy, therefore, the more the market is prevented from working, and the more inefficient will the market be in catering to consumer wants. Hence, the greater the government subsidy, the lower will be the standard of living of everyone, of all the consumers.

On the free market, as we have seen, there is a harmony of interests, for everyone demonstrably gains in utility from market exchange. Where government intervenes, on the other hand, *caste conflict* is thereby created, *for one man benefits at the expense of another.* This is most clearly seen in the case of government transfer subsidies paid from tax or inflation funds—an obvious taking from Peter to give to Paul. Let the subsidy method become general, then, and everyone will rush to gain control of the government. Production will be more and more neglected, as people divert their energies to the political struggles, to the scramble for loot. It is obvious that production and general living standards are lowered in two ways: (1) by the diversion of energy from production to politics, and (2) by the fact that the government inevitably burdens the producers with the incubus of an inefficient, privileged group. The inefficient achieve a legal claim to ride herd on the efficient. This is all the more true since *those who succeed in any occupation will inevitably tend to be those who are best at it*. Those who succeed on the free market, in economic life, will therefore be those most adept at production and at serving their fellowmen; those who succeed in the political struggle will be those most adept at employing coercion and winning favors from wielders of coercion. Generally, different people will be adept at these different tasks, in accordance with universal specialization and the division of labor, and hence the shackling of one set of people will be done for the benefit of another set.

But perhaps it will be argued that the same people will be efficient at both activities and that, therefore, there will be no exploitation of one group at the expense of another. As we have said, this is hardly likely; if true, the subsidy system would die out, because it would be pointless for a group to pay the government to subsidize itself. But, further, the subsidy system would promote the predatory skills of these individuals and penalize their productive ones. In sum, governmental subsidy systems promote inefficiency in production and efficiency in coercion and subservience, while penalizing efficiency in production and inefficiency in predation. Those people who ethically favor voluntary production can gauge which system—the free market or subsidies—scores the higher economic marks, while those who favor conquest and confiscation must at least reckon with the overall loss of production that their policy brings about.

This analysis applies to all forms of government subsidies, including grants of monopolistic privilege to favored producers. A common example of direct transfer subsidies is governmental *poor relief*. State poor relief is clearly a subsidization of poverty. 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. Thus, State subsidization of poverty tends to increase poverty, which in turn increases the amount of subsidy paid and extracted from those who are not impoverished. 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 have more children than otherwise, since he is assured of a proportionate subsidy by the State. Consequently, the number of paupers tends to multiply still further. As Thomas Mackay aptly stated:

> . . . the cause of pauperism is relief. We shall not get rid of pauperism by extending the sphere of State relief. . . . On the contrary, its adoption would increase our pauperism, for, as is often said, we can have exactly as many paupers as the country chooses to pay for.[3]

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[3]Thomas Mackay, *Methods of Social Reform* (London: John Murray, 1896), p. 210. Recently, economists have begun to recognize that government relief encourages leisure, discourages work, and subsidizes poverty. *See* Yale Brozen, "Welfare Without the Welfare State," *The Freeman*, December, 1966, pp. 40–42; C.T. Brehm and T.R. Saving, "The Demand for General Assistance Payments," *American Economic Review*, December, 1964, pp. 1002–18; *idem*, "Reply," *American Economic Review*, June, 1967, pp. 585–88; and Henry Hazlitt, "Income Without Work," *The Freeman*, July, 1966, pp. 20–36.

Private charity to the poor, on the other hand, does not have the same effect, for the poor would not have a compulsory and unlimited claim on the rich. Instead, charity is a voluntary and flexible act of grace on the part of the giver.

The sincerity of government's desire to promote charity may be gauged by two perennial governmental drives: one, to suppress "charity rackets," and the other, to drive individual beggars off the streets because "the government makes plenty of provision for them."[4] The effect of both measures is to suppress voluntary individual gifts of charity and to force the public to route its giving into those channels approved by and tied in with government officialdom.

Similarly, *unemployment relief*, instead of helping to cure unemployment, as often imagined, actually subsidizes and intensifies it. We have seen that unemployment arises when laborers or unions set a minimum wage above what they can obtain on the free market. Tax aid helps them to keep this unrealistic minimum and hence prolongs the period in which they can continue to withhold their labor from the market.

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[4]From the following admiring anecdote of such a drive, the reader can gauge 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.
>
> "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)

### *2. Resource-Using Activities: Government Ownership versus Private Ownership*

The bulk of government activities use resources, redirecting factors of production to government-chosen ends. These activities generally involve the real or supposed supply of services by government to some or all of the populace. Government functions here as an owner and enterpriser.

Resource-using expenditures by government are often considered "investment," and this classification forms an essential part of the Keynesian doctrine. We have argued that, on the contrary, all of this expenditure must be considered *consumption*. Investment occurs where producers' goods are bought by entrepreneurs, not at all for their own use or satisfaction, but merely to reshape and resell them to others—ultimately to the consumers. But government redirects the resources of society to *its* ends, chosen by it and backed by the use of force. Hence, these purchases must be considered consumption expenditures, whatever their intention or physical result. They are a particularly wasteful form of "consumption," however, since they are generally not *regarded* as consumption expenditures by government officials.

Government enterprises may either provide "free" services or charge a price or fee to users. "Free" services are particularly characteristic of government. Police and military protection, fire fighting, education, 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 would not be a good and thus not an object of human action; it would exist in abundance for all. If a good does not exist plentifully 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 their voluntary purchases, but by a coerced levy on the taxpayers. A basic split is effected between payment for and receipt of service.

Many grave consequences follow from this split and from the "free" service. 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 such service available. Consequently, there will always be "shortages" of the free good, constant complaints of insufficiency, overcrowding, etc. To illustrate, we need only cite such common conditions as police shortages, particularly in crime-ridden districts, teacher and school shortages in the public school system, traffic jams on government-owned streets and highways, etc. In no area of the free market are there chronic complaints about shortages and insufficiencies. In all areas of private enterprise, firms try to coax and persuade consumers to buy more of their product. Where government owns, on the other hand, there are invariably calls on consumers for patience and sacrifice, and there are continual problems of shortages and deficiencies. It is doubtful if any private enterprise would ever do what the government of New York and other cities have done: exhort the 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 use less, while in private industry the (welcome) pressure is on entrepreneurs to supply more.[5]

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

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[5]*See* Murray N. Rothbard, "Government in Business," in *Essays on Liberty* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1958), IV, 186 ff.

Thus, 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 government, even if it wanted to, could allocate its services to the 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, and 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 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 official*, not the public, does the "consuming." If the government wishes to do what is best for the public, it is faced with an impossible task.

Government can either deliberately subsidize 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." This is 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 solution, however? It is often stated that a single government enterprise, operating within the sphere of a private market, buying from it, etc., 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 what the government's intentions.

What is this fatal flaw? It is the fact that government can obtain virtually unlimited resources by means of its coercive tax power. Private businesses must obtain their funds from investors. It is this allocation of funds by investors on the basis of time preference and foresight that 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 investors who are willing to risk investment of their saved funds in anticipation of profit. In short, payment and service are, once again, indissolubly linked on the market. Government, on the other hand, can get as much money as it likes. The free market provides a "mechanism" 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 such optimum use. Government, however, has no checkrein on itself, i.e., no requirement for meeting a profit-and-loss test of valued service to consumers, to enable it to obtain funds. Private enterprise can get funds only from satisfied, valuing customers and from investors guided by profits and losses. Government can get funds literally 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* 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 answer never offered on the free market? The reason is that money must be *withdrawn* from some other use in consumption or investment—and this withdrawal must be justified. This 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 the government, which has no rational way to decide *how much* money to spend, either in total, or in each specific line. The more money it spends, the more service it can supply—but where to stop?[6]

Proponents of government enterprise may retort that the government could 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 flaws in this theory. First, 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 skill, to really adjust to consumer demands. They do not risk loss of their money in the enterprise. Secondly, aside from the question of incentives, even the most eager managers *could not* function as a business. 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. An arbitrary element has been "built into" the very vitals of the enterprise. Further, any *future* expenditures may be made out of tax funds, and therefore the decisions of the managers will be subject to the same flaw. The ease of obtaining money will inherently distort the operations of the government enterprise. Moreover, suppose the government "invests" in an enterprise, E. Either the free market, left alone, would also have invested the same amount in the selfsame enterprise, or it would not. If

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

it would have, then the economy suffers at 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 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 inherent 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, if it wishes can drive 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 the 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 government enterprise opens, it generates fears in other industries that they will be next, and that they will be either 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.

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

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. Thus, it has little incentive to be efficient. 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.[7] 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—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.[8]

A further reason for governmental inefficiency has been touched on already: that the personnel have no incentive to be efficient. In fact, the skills they will develop will *not* be the economic skills of production, *but political* skills—how to fawn on political superiors, how demagogically to attract the electorate, how to wield force most effectively. These skills are very different from the productive ones, and therefore different people

[7]*See* the interesting pamphlet by Frank Chodorov, *The Myth of the Post Office*, reprinted in Chodorov, *One Is A Crowd* (New York: Devin Adair, 1952), pp. 132–52. On the 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, 1891), pp. 305–25.

[8]Only governments can make self-satisfied announcements of cuts in service to effect economies. In private business, economies must be made as a corollary of improvements in service. A recent example of governmental cuts is the decline in American postal deliveries—joined, of course, with request for higher rates. When France nationalized the important Western Railway system in 1908, freight was increasingly damaged, trains slowed down, and accidents grew to such an extent 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.

will rise to the top in the government from those who succeed in the market.[9,10]

It is particularly absurd to call for "business principles" where a government enterprise functions as a monopoly. Periodically, 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. In order to do so, the price must be raised high enough to achieve a monopoly price and thus cover the costs of 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 decrease them. An outstanding example has been the New York subway system in recent years, which has been raising its fares in a vain attempt to end its

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[9]Hayek showed us that the "worst get on top" in a collectivist regime. This is true for *any* government-run enterprise, however. For our purposes, we may excise the moral evaluation and say that, for any task, those who get on top will be those with the most skill in that particular task—a praxeological law. The difference is that the market promotes and rewards the skills of production and voluntary co-operation; government enterprise promotes the skills of mass coercion and bureaucratic submission. *See* F.A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944), pp. 134–52.

[10]On the market, workers get paid in accordance with their (discounted) marginal value product. But in a government enterprise, which can charge any price it pleases, there is *no* discernible value product, and workers are hired and paid according to the personal charm or political attractions that they have for their superiors. *See* Mises, *Bureaucracy*, p. 53.

deficit, only to see passenger volume fall so drastically that the deficit increased even further after a time.[11]

Many "criteria" have been offered by writers as guides for the pricing of government services. One criterion supports pricing according to "marginal cost." However, this is hardly a criterion at all and rests on classical economic fallacies of price determination by costs. For one thing, "marginal" varies according to the period of time surveyed. Furthermore, costs are not static, but flexible; they change according to selling prices and hence cannot be used as a guide to those prices. Moreover, prices equal average costs—or rather, average costs equal prices—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 a similar operation on the free market.

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 (*a*) the government will decrease production and living standards in the society by siphoning off potentially productive labor to the bureaucracy; (*b*) in using confiscated funds, the government will be able to pay more than the market rate for labor, and hence set up a clamor by government job seekers for an expansion of the unproductive bureaucratic machine; and (*c*) through high, tax-supported wages the government may well mislead workers and unions into believing that this reflects the market wage in private industry, thereby causing unwanted unemployment.

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

Moreover, government enterprise, basing itself on coercion over the consumer, can hardly fail to substitute its own values for those of its customers. Hence, artificially standardized services of poorer quality—fashioned to governmental taste and convenience—will hold sway, in contrast to those of the free market, where diversified services of high quality are supplied to fit the varied tastes of a multitude of individuals.[12]

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 in a rational manner. This is the reason why State socialism could not plan or allocate rationally either. In fact, even two or more stages could not be *completely* 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 unfolds. For *each* governmental firm introduces its own island of chaos into the economy; *there is no need to wait for 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 can be established on a "business basis" even if the desire were present. Thus, any government 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

[12]Governments, despite bickering before a decision, generally end up speaking with a single voice. This is true of the executive and judicial arms, which are organized like a military force, with command from the top down; and of the legislative arm, where the majority may impose its will.

the allocation of funds to ends other than those desired by the public; it also lowers the utility of everyone (including, perhaps, the utilities of government officials) by distorting the market and spreading calculational chaos. The greater the extent of government ownership, of course, the more pronounced will this impact become.

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 a different idea on the best form of service.

In recent years, government schools in America have furnished a striking example of such 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 government can resolve these conflicts. It can only impose the will of the majority (or a bureaucratic "interpretation" of it) by coercion and leave an often large minority 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, socialist 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 the vital nerve centers, the command posts of the society. It has acquired compulsory monopoly ownership over these command posts, and it has always tried to convince the populace that private ownership and enterprise in these fields is simply and *a priori* impossible. We have seen, on the contrary, that *every* service can be supplied on the free market.

The vital command posts invariably owned monopolistically by the State are: (1) police and military protection; (2) judicial protection; (3) monopoly of the mint (and monopoly of defining money); (4) rivers and coastal seas; (5) urban streets and highways, and land generally (unused land, in addition to the power of eminent domain); and (6) the post office. The defense function is the one reserved most jealously by the State. It is vital to the State's existence, for on its monopoly of force depends its ability to exact taxes from the citizens. If citizens were permitted privately owned courts and armies, then they would possess the means to defend themselves against invasive acts by the government as well as by private individuals. Control of the basic land resources—particularly transportation—is, of course, an excellent method of ensuring overall control. The post office has always been a very convenient tool for the inspection and prohibition of messages by heretics or enemies of the State. In recent years, the State has constantly sought to expand these outposts. Monopoly of the mint and of the definition of money (legal tender laws) has been used to achieve full control of the nation's monetary system. This was one of the State's most difficult tasks, since for centuries paper money was thoroughly distrusted by the people. Monopoly over the mint and the definition of monetary standards has led to the debasement of the coinage, a shift of monetary names from units of weight to meaningless terms, and the replacement of gold and silver by bank or government paper. At present, the State in nearly every country has achieved its major monetary goal: the ability to expand its revenue by inflating the currency at will. In the other areas—land and natural resources, transportation and communication—the State is more and more in control. Finally, another critical command post held, though not wholly monopolized by the State, is education. For government schooling permits influencing the youthful mind to accept the virtues of the government and of government intervention.[13] In many countries, the government does not have a compulsory monopoly of schooling, but it approaches this ideal by compelling attendance of all children at either a government school or a private school approved or accredited by government. Compulsory attendance herds into the schools those who do not desire schooling and thus drives too many children into education. Too few youngsters remain in such competing fields as leisure, home study, and business employment.[14]

One very curious governmental activity has grown enormously in the present century. Its great popularity is a notable indication of widespread popular ignorance of praxeological law. We are referring to what is called "social security" legislation. This system confiscates the income of the poorer wage earners and then presumes to invest the money more wisely than they could themselves, later paying out the money to them or their beneficiaries in their old age. Considered as "social insurance," this is a typical example of government enterprise: there is no relation between premiums and benefits, both changing yearly under the impact of political pressures. On the free market, anyone who wishes to invest in an insurance annuity or in stocks or real estate may do so. Compelling everyone to transfer his funds to the government forces him to lose utility.

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[13]Those defenders of the free market who attack socialistic teaching in the government schools are tilting at windmills. The very fact that a government school exists and is therefore presumed to be good, teaches its little charges the virtues of government ownership, regardless of what is formally taught in textbooks. And if government ownership is preferable in schooling, why not in other educational media, such as newspapers, or in other important areas of society?

[14]For a trenchant critique of compulsory attendance laws, *see* Goodman, *Compulsory Mis-Education and the Community of Scholars*.

Thus, even on its face, it is difficult to understand the great popularity of the social security system. But the true nature of the operation differs greatly from its official image. For the government does *not* invest the funds it takes in taxes; it simply spends them, giving itself bonds, which must be later cashed when the benefits fall due. How will the cash then be obtained? Only from further taxes or inflation. Thus, the public must pay twice for "social security." The social security program taxes twice for one payment; it is a device to permit palatable taxation of the lower-income groups by the government. And, as is true of all taxes, the proceeds go into governmental consumption.

In weighing the question of private or governmental ownership of any enterprise, then, one should keep in mind the following conclusions of our analysis: (1) every service can be supplied privately on the market; (2) private ownership will be more efficient in providing better quality of service at lower cost; (3) allocation of resources in a private enterprise will better satisfy consumer demands, while government enterprise will distort allocations and introduce islands of calculational chaos; (4) government ownership will repress private activity in noncompeting as well as competing firms; (5) private ownership insures the harmonious and co-operative satisfaction of desires, while government ownership creates caste conflict.[15]

### *3. Resource-Using Activities: Socialism*

Socialism—or collectivism—occurs when the State owns all the means of production. It is the compulsory abolition and

[15]Various other criteria advanced to decide between private and State action are fallacious. Thus, a common rule states that government should weigh "marginal social costs" against "marginal social benefits" in making a decision. But, aside from many other flaws, there is no such thing as "society" apart from constituent individuals, so that this criterion is meaningless. Cf. Martin Anderson, "Discussion," *American Economic Review*, May, 1967, pp. 105–07.

prohibition of private enterprise, and the monopolization of the entire productive sphere by the State. Socialism, therefore, extends the principle of compulsory governmental monopoly from a few isolated enterprises to the whole economic system. It is the violent abolition of the market.

If an economy is to exist at all, there must be production in order to satisfy the desires of the consuming individuals. How is this production to be organized? Who is to decide on the allocation of factors to all the various uses, or on the income each factor will receive in each use? There are two and only two ways that an 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 only the latter constitutes real organization and planning, whereas the way of the market is only confusion and chaos. The organization of the free market, however, is actually an amazing and flexible means of satisfying the wants of all individuals, and one far more efficient than State operation or intervention.

Up to this point, however, we have discussed only isolated government enterprises and various forms of government intervention in the market. We must now examine socialism—the system of pure government dictation—the polar opposite of the purely free market.

We have defined ownership as the exclusive control of a resource. It is clear, therefore, that a "planned economy" which leaves nominal ownership in the hands of the previous private owners, but which places the actual control and direction of resources in the hands of the State, is as much *socialism* as is the formal nationalization of property. The Nazi and Fascist regimes were as socialist as the Communist system that nationalizes all productive property.

Many people refuse to identify Nazism or Fascism as "socialism" because they confine the latter term to Marxist or neo-Marxist proletarianism or to various "social-democratic" proposals. But economics is not concerned with the color of the uniform or with the good or bad manners of the rulers. Nor does it care which groups or classes are running the State in various political regimes. Neither does it matter, for economics, whether the socialist regime chooses its rulers by elections or by *coups d'etat*. Economics is concerned only with the powers of ownership or control that the State exercises. All forms of State planning of the whole economy are types of socialism, notwithstanding the philosophical or esthetic viewpoints of the various socialist camps and regardless whether they are referred to as "rightists" or "leftists." Socialism may be monarchical; it may be proletarian; it may equalize fortunes; it may increase inequality. Its essence is always the same: total coercive State dictation over the economy.

The distance between the poles of the purely free market, on the one hand, and total collectivism on the other, is a continuum involving different "mixes" of the freedom principle and the coercive, hegemonic principle. Any increase of governmental ownership or control, therefore, is "socialistic," or "collectivistic," because it is a coercive intervention bringing the economy one step closer to complete socialism.

The extent of collectivism in the twentieth century is at once under- and overestimated. On the one hand, its development in such countries as the United States is greatly *under*estimated. Most observers neglect, for example, the importance of the expansion of *government lending*. The *lender* is also an entrepreneur and part owner, regardless of his legal status. Government loans to private enterprise, therefore, or guarantees of private loans, create many centers of government ownership. Furthermore, the total quantity of savings in the economy is not increased by government guarantees and loans, but its specific form is changed. The free market tends to allocate social savings to their most profitable and productive channels. Government loans and guarantees, by contrast, *divert* savings from more to less productive channels. They also prevent the success of the most efficient entrepreneurs and the weeding out of the inefficient (who would then become simply labor factors rather than entrepreneurs). In both these ways, therefore, government lending lowers the general standard of living—to say nothing of the loss of utility inflicted on the taxpayers, who must make these pledges good, or who supply the money to be loaned.

On the other hand, the extent of socialism in such countries as Soviet Russia is *over*rated. Those people who point to Russia as an example of "successful" planning by the government ignore the fact (aside from the planning difficulties constantly encountered) that Soviet Russia and other socialist countries cannot have full socialism because only *domestic* trade is socialized. The rest of the world still has a market of sorts. A socialist State, therefore, can still buy and sell on the world market and at least vaguely approximate the rational pricing of producers' goods by referring to the prices of factors set on the world market. Although the errors of even this partial socialist planning are impoverishing, they are insignificant compared to what would happen under the total calculational chaos of a *world* socialist State. One Big Cartel could not calculate and therefore could not be established on the free market. How much more does this apply to socialism, where the State imposes its overall monopoly by force, and where the inefficiencies of a single State's actions are multiplied a thousandfold.

One point should not be overlooked in the analysis of specific socialist regimes: the possibility of a "black" market, with resources passing illicitly into private hands.[16] Of course, the opportunity for black markets in large-sized goods is rather limited; there is more scope for such trade where commodities (like candy, cigarettes, drugs, and stockings) are easy to conceal. On

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[16]This differs completely from the artificial play-at-markets advocated by some writers as a method of permitting calculation under socialism. The "black market" is a real market, though very limited in scope.

the other hand, falsification of records by managers and the pervasive opportunity for bribery may be used to establish some form of limited market. There is reason to believe, for example, that extensive graft (*blat*) and black markets, i.e., the subversion of socialist planning, have been essential to the level of production which the Soviet system has been able to attain.

In recent years, the total failure of socialist planning to calculate for an industrial economy has been implicitly acknowledged by the Communist countries, which have been rapidly moving, especially in Eastern Europe, away from socialism and toward an ever freer market economy. This progress has been particularly remarkable in Yugoslavia, which is now marked by private as well as producers' co-operative ownership and by the absence of central planning, even of investments.[17]

### *4. The Myth of "Public" Ownership*

We all hear a great deal about "public" ownership. Whenever the government owns property, in fact, or operates an enterprise, it is referred to as "publicly owned." When natural resources are sold or given to private enterprise, we learn that the "public domain" has been "given away" to narrow private interests. The inference is that when the government owns anything, "we"—all members of the public—own equal shares of

[17]On the Yugoslav experience, *see* Rudolf Bicanic, "Economics of Socialism in a Developed Country," *Foreign Affairs*, July, 1966, pp. 632–50. *See also* Deborah D. Milenkovitch, "Which Direction for Yugoslavia's Economy?" *East Europe*, July, 1969, pp. 13–19. Yugoslav economists are even thinking in terms of developing a stock market and refer to this latent development as "socialist people's capitalism"! *See* the November 25, 1966, Research Report of *Radio Free Europe*. On the impossibility of economic calculation under socialism, *see* Mises, *Human Action*; F.A. Hayek, ed., *Collectivist Economic Planning* (New York: Augustus M. Kelley, 1967); and Trygve Hoff, *Economic Calculation in the Socialist Society* (London: William Hodge & Co., 1949).

that property. Contrast to this broad sweep the narrow, petty interests of mere "private" ownership.

We have seen that, since a socialist economic system could not calculate economically, a die-hard socialist must be prepared to witness the disappearance of a large part of the earth's population, with only primitive subsistence remaining for the survivors. Still, a man who identifies *government* with *public* ownership might be content to spread the area of government ownership despite the loss of efficiency or social utility it entails.

The identity itself, however, is completely fallacious. *Ownership* is the ultimate control and direction of a resource. The owner of a property is its ultimate director, regardless of legal fictions to the contrary. In the purely free society, resources so abundant as to serve as general conditions of human welfare would remain unowned. Scarce resources, on the other hand, would be owned on the following principles: self-ownership of each person by himself; self-ownership of a person's created or transformed property; first ownership of previously unowned land by its first user or transformer. Government ownership means simply that the ruling officialdom *owns* the property. The top officials are the ones who direct the use of the property, and they therefore do the *owning*. The "public" owns no part of the property. Any citizen who doubts this may try to appropriate for his own *individual* use his aliquot part of "public" property and then try to argue his case in court. It may be objected that individual stockholders of corporations cannot do this either, e.g., by the rules of the company, 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 stockholder can contract out of his company; he can *sell* his shares of General Motors' stock to someone else. The subject of a government *cannot* contract out of that government; he cannot sell his "shares" in the post office 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."[18]

Whatever the form of government, the rulers are the true owners of the property. However, in a democracy or, in the long run under any form of government, the rulers are transitory. They can always lose an election or be overthrown by a *coup d'etat*. Hence, no government official regards himself as more than a transitory owner. As a result, while a private owner, secure in his property and owning its capital value, plans the use of his resource over a long period of time, the government official must milk the property as quickly as he can, since he has no security of ownership. Further, even the entrenched civil servant must do the same, for no government official can sell the capitalized value of his property, as private owners can. In short, government officials own the *use* of resources, but not their capital value (except in the case of the "private property" of a hereditary monarch). When only the current use can be owned, but not the resource itself, there will quickly ensue uneconomic exhaustion of the resources, since it will be to no one's benefit to conserve it over a period of time and to every owner's advantage to use it up as quickly as possible. In the same way, government officials will consume their property as rapidly as possible.

It is curious that almost all writers parrot the notion that private owners, possessing time preference, must take the "short view," while only government officials can take the "long view" and allocate property to advance the "general welfare." The truth is exactly the reverse. The private individual, secure in his property and in his capital resource, can take the long view, for he wants to maintain the capital value of his resource. It is the

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[18]F.A. Harper, *Liberty, a Path to Its Recovery* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1949), pp. 106, 132. *See also* Paterson, *God of the Machine*, pp. 179 ff. Paterson has a stimulating discussion of the "two-dimensionality"—neglect of real conditions—in the theory of collective ownership.

government official who must take and run, who must plunder the property while he is still in command.[19]

### *5. Democracy*

Democracy is a process of choosing government rulers or policies and is therefore distinct from what we have been considering: the nature and consequences of various policies that a government may choose. A democracy can choose relatively *laissez-faire* or relatively interventionist programs, and the same is true for a dictator. And yet the problem of forming a government *cannot* be absolutely separated from the policy that government pursues, and so we shall discuss some of these connections here.

Democracy is a system of majority rule in which each citizen has one vote either in deciding the policies of the government or in electing the rulers, who will in turn decide policy. It is a system replete with inner contradictions.

In the first place, suppose that the majority overwhelmingly wishes to establish a popular dictator or the rule of a single party. The people wish to surrender all decision-making into his or its hands. Does the system of democracy permit itself to be voted democratically out of existence? Whichever way the democrat answers, he is caught in an inescapable contradiction. If the majority *can* vote into power a dictator who will end further elections, then democracy is really ending its own existence. From then on, there is no longer democracy, although there is continuing majority consent to the dictatorial party or

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[19]Those who object that private individuals are mortal, but that "governments are immortal," indulge in the fallacy of "conceptual realism" at its starkest. "Government" is not a real acting entity but is a real category of action adopted by actual individuals. It is a name for a type of action, the regularization of a type of interpersonal relation, and is not itself an acting being.

ruler. Democracy, in that case, becomes a *transition* to a nondemocratic form of government. On the other hand, if, as it is now fashionable to maintain, the majority of voters in a democracy are prohibited from doing one thing—ending the democratic elective process itself—then this is no longer democracy, because the majority of voters can no longer rule. The election process may be preserved, but how can it express that majority rule essential to democracy if the majority cannot end this process should it so desire? In short, democracy requires two conditions for its existence: majority rule over governors or policies, and periodic, equal voting. So if the majority wishes to end the voting process, democracy cannot be preserved regardless of which horn of the dilemma is chosen. The idea that the "majority must preserve the freedom of the minority to become the majority" is then seen, not as a preservation of democracy, but as simply an arbitrary value judgment on the part of the political scientist (or at least it remains arbitrary until justified by some cogent ethical theory).[20]

This dilemma occurs not only if the majority wishes to select a dictator, but *also* if it desires to establish the purely free society that we have outlined above. For that society has no overall monopoly-government organization, and the only place where equal voting would obtain would be in co-operatives, which have always been inefficient forms of organization. The only important form of voting, in that society, would be

[20]This idea that democracy must force the majority to permit the minority the freedom to become a majority, is an attempt by social democratic theorists to permit those results of democracy which they like (economic interventionism, socialism), while avoiding the results which they do not like (interference with "human rights," freedom of speech, etc.). They do this by trying to elevate their value judgments into an allegedly "scientific" definition of democracy. Aside from the self-contradiction, this limitation is itself not as rigorous as they believe. It would permit a democracy, for example, to slaughter Negroes or redheads, because there is no chance that such minority groups could become majorities. For more on "human" rights and property rights, see below.

that of shareholders in joint stock companies, whose votes would not be equal, but proportionate to their shares of ownership in the company assets. Each individual's vote, in that case, would be meaningfully tied to his share in the ownership of joint assets.[21] In such a purely free society there would be nothing for democratic electors to vote *about*. Here, too, democracy can be only a possible route *toward* a free society, rather than an attribute of it.

Neither is democracy conceivably workable under socialism. The ruling party, owning all means of production, will have the complete decision, for example, on how much funds to allocate to the opposition parties for propaganda, not to speak of its economic power over all the individual leaders and members of the opposition. With the ruling party deciding the income of every man and the allocation of all resources, it is inconceivable that any functioning political opposition could long persist under socialism.[22] The only opposition that could emerge would be

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[21]To Spencer Heath, this is the only genuine form of democracy:

> When persons contractually pool their separate titles to property by taking undivided interests in the whole, they elect servants—officers—and otherwise exercise their authority over their property by a process of voting, as partners, share owners or other beneficiaries. This is authentically democratic in that all the members exercise authority in proportion to their respective contributions. Coercion is not employed against any, and all persons are as free to withdraw their membership and property as they were to contribute it. (Heath, *Citadel, Market, and Altar*, p. 234)

[22]Even if, as is highly unlikely—especially in view of the fact that rulers under socialism are those most adept at wielding force—the socialist leaders were saintly men, wishing to give a political opposition every chance, and even if the opposition were unusually heroic and risked liquidation by emerging into the open, *how* would the rulers decide their allocations? Would they give funds and resources to *all* opposing parties? Or only to a pro-socialist opposition? How much would they allocate to each opposition party?

not opposing parties in an election, but different administrative cliques within the ruling party, as has been true in the Communist countries.

Thus, democracy is compatible neither with the purely free society nor with socialism. And yet we have seen in this work (and shall see further below) that only those two societies are stable, that all intermediary mixtures are in "unstable equilibrium" and always tending toward one or the other pole. This means that democracy, in essence, is itself an unstable and transitional form of government.

Democracy suffers from many more inherent contradictions as well. Thus, democratic voting may have either one of these two functions: to determine governmental policy or to select rulers. According to the former, what Schumpeter termed the "classical" theory of democracy, the majority will is supposed to rule on issues.[23] According to the latter theory, majority rule is supposed to be confined to choosing rulers, who in turn decide policy. While most political scientists support the latter version, democracy means the former version to most people, and we shall therefore discuss the classical theory first.

According to the "will of the people" theory, direct democracy—voting on each issue by all the citizens, as in New England town meetings—is the ideal political arrangement. Modern civilization and the complexities of society, however, are supposed to have outmoded direct democracy, so that we must settle for the less perfect "representative democracy" (in olden days often called a "republic"), where the people select representatives to give effect to their will on political issues. Logical problems arise almost immediately. One is that different forms of electoral arrangements, different delimitations of geographical districts, all equally arbitrary, will often greatly alter the picture of the "majority will." If a country is divided into districts for choosing representatives, then "gerrymandering" is

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[23] *See* Schumpeter, *Capitalism, Socialism and Democracy*, *passim*.

inherent in such a division: there is no satisfactory, rational way of demarking the divisions. The party in power at the time of division, or redivision, will inevitably alter the districts to produce a systematic bias in its favor; but no other way is inherently more rational or more truly evocative of majority will. Moreover, the very division of the earth's surface into countries is itself arbitrary. If a government covers a certain geographical area, does "democracy" mean that a majority group in a certain district should be permitted to secede and form its own government, or to join another country? Does democracy mean majority rule over a larger, or over a smaller, area? In short, *which* majority should prevail? The very concept of a national democracy is, in fact, self-contradictory. For if someone contends that the majority in Country X should govern that country, then it could be argued with equal validity that the majority of a certain district within Country X should be allowed to govern *itself* and secede from the larger country, and this subdividing process can logically proceed down to the village block, the apartment house, and, finally, each individual, thus marking the end of all democratic government through reduction to individual self-government. But if such a right of secession is denied, then the national democrat must concede that the more numerous population of other countries should have a right to outvote *his* country; and so he must proceed upwards to a world government run by a world majority rule. In short, the democrat who favors national government is self-contradictory; he must favor a world government or none at all.

Aside from this problem of the geographical boundary of the government or electoral district, the democracy that tries to elect representatives to effect the majority will runs into further problems. Certainly some form of proportional representation would be mandatory, to arrive at a kind of cross section of public opinion. Best would be a proportional representation scheme for the whole country—or world—so that the cross section is not distorted by geographic considerations. But here again, different forms of proportional representation will lead to very different results. The critics of proportional representation retort that a legislature elected on this principle would be unstable and that elections should result in a stable majority government. The reply to this is that, if we wish to represent the public, a cross section is required, and the instability of representation is only a function of the instability or diversity of public opinion itself. The "efficient government" argument can be pursued, therefore, only if we abandon the classical "majority-will" theory completely and adopt the second theory—that the only function of the majority is to choose rulers.

But even proportional representation would not be as good—according to the classical view of democracy—as direct democracy, and here we come to another important and neglected consideration: modern technology *does* make it possible to have direct democracy. Certainly, each man could easily vote on issues several times per week by recording his choice on a device attached to his television set. This would not be difficult to achieve. And yet, why has no one seriously suggested a return to direct democracy, now that it may be feasible? The people could elect representatives through proportional representation, solely as advisers, to submit bills to the people, but without having ultimate voting power themselves. The final vote would be that of the people themselves, all voting directly. In a sense, the entire voting public would be *the* legislature, and the representatives could act as committees to bring bills before this vast legislature. The person who favors the classical view of democracy must, therefore, either favor virtual eradication of the legislature (and, of course, of executive veto power) or abandon his theory.

The objection to direct democracy will undoubtedly be that the people are uninformed and therefore not capable of deciding on the complex issues that face the legislature. But, in that case, the democrat must completely abandon the classical theory that the majority should decide on *issues*, and adopt the modern doctrine that the function of democracy is majority