

TAXATION
and
CONFISCATION



THE FREEMAN

CLASSICS



Taxation and Confiscation

by
L. S. SARGENT

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Introduction

Taxes forcibly extract money from people and provide revenue for government. They reduce the levels of living of taxpayers and increase the spending potential of politicians and government officials. They raise a great many questions about the nature of government and its use of force in the extraction of revenue, and thereby come face to face with questions of equity and justice.

Most Americans rarely compare their tax liabilities with the benefits they expect to derive from government expenditures. When they reflect on costs and benefits, however, they may approve of certain taxes provided the public benefits offer a net gain to them. Retirees do not hesitate to vote for greater Social Security benefits and higher taxes as long as they can pocket the benefits and working people pay the taxes. Young parents generally favor higher school taxes as long as the levies are placed on the property of other taxpayers. Provided the primary burden rests on other people, especially on people with higher incomes and more wealth, it is deemed equitable and just. But to the victims who must carry the burden it is highly unfair. They are forever hoping and clamoring for a tax reform that will reduce their burden and place it on someone else. In this popular sense, every tax reform is an effort to alleviate the injustice perpetrated in the past. The Deficit Reduction Act of 1993 must be seen as just another such effort.

Political scientists may go beyond this simple version of popular justice, but often arrive at similar conclusions. They make a distinction between the tax burden on persons in different economic circumstances, subject to considerations of "vertical equity," and the burden on individuals in essentially the same economic circumstances, subject to "horizontal equity." Both considerations of equity play important roles in modern tax legislation and regulation.

Until the dawn of welfarism and transferism economists made no such distinction. They favored taxation that imposed its levies in accordance with benefits received. Government activity consisted primarily of defense and police protection of the basic human rights: life, liberty, and property. This activity was believed to be proportionate

to income, which justified proportionate taxation. The classical economists from Adam Smith to John Stuart Mill favored proportionate taxation as the most equitable distribution of tax burdens.

Under the influence of notions of economic exploitation and class conflict, many politicians and legislators early in this century began to question not only the very role of government but also the classical assumption of proportionate taxation. Favoring a more active role of government in economic life necessitating significantly higher revenue, they developed the doctrine of "ability to pay." Assuming rising ability to pay and diminishing sacrifice as incomes increase, they made "progression" the paramount principle of "vertical" equity.

In recent decades the ability-to-pay principle received further support from the socioeconomic doctrine of the desirability of economic equality. Social peace and harmony supposedly require a high degree of economic equality that can be attained through progressive taxation. Equity in taxation now means reduction of the disparities of income and wealth through tax progression; it is said to be served best by taxation that aims at the redistribution of income and wealth.

Political scientists also search for "horizontal equity" which, in their terminology, means equal treatment of all taxpayers in similar economic circumstances. Individuals with equal incomes or equal increases in the value of their assets are assumed to be equal and, therefore, are taxed equally. But consideration of similar economic circumstances immediately raises difficult questions about actual equality of equal incomes. How equal are bachelors and family fathers earning equal wages? Should allowance be made for taxpayer dependents? Should tax liabilities be differentiated on the basis of family responsibilities through a system of personal exemptions for the taxpayer and other members of his family? Or should such responsibilities be disregarded?

The search for "horizontal equity" also raises questions of differentiation on the basis of sources of income. How equal are taxpayers with equal incomes from four different sources—labor, investment, entrepreneurial activity, and political entitlement? Does any form of income deserve preferential treatment? At this point the equal treatment of all taxpayers usually breaks down. Powerful pressure groups manage to enact favorable provisions for labor income, which they call "earned income," and exemptions for entitlement income, or amounts set aside for retirement, and numerous other special benefits.

Considerations of "horizontal" equity may be given also to expenditures that are essential to earning income and for a wide variety of personal expenditures deemed desirable. Allowances may be made for some forms of saving, such as deposits in savings associations, for items of medical expenses, charitable contributions, interest on personal loans and mortgages, state and local taxes, casualty losses, child care of working parents, premiums for life, sickness, and accident insurance, and payments into annuity, pension, or other retirement plans.

All such deviations from equal treatment are rather controversial. Favoring certain earnings or outlays through preferential tax treatment, they create dissatisfaction among taxpayers who are the victims of discrimination. Their grievances provide the intellectual impetus and political energy for another tax reform.

Most tax experts are no economists. While they are searching for tax equity, as they perceive it, they tend to overlook the crucial fact that the overall tax burden is far too heavy. It consumes productive capital, lowers labor productivity, and hampers and exhausts economic activity. Many exemptions, deductions, and credits were designed to permit economic activity where there would be none under a full tax burden.

The 1993 Deficit Reduction Act confirms and accelerates the trend. The most significant economic development of the 1980s has been the massive consumption of productive capital by the federal government. In just twelve years it suffered budgetary deficits in excess of two trillion dollars; it tripled the federal debt and consumed the lion's share of the savings of the American people. It brought about a "decapitalization of industry" that is clearly visible not only in the rapid retreat of American heavy industry from world markets but also in the declining standards of living of many classes of American Society. In the name of tax equity the 1993 Act increases the tax burden on the backs of productive and affluent members of American Society. It raises the income tax to 36 percent for couples with incomes over \$140,000 and up to 39.6 percent for couples with incomes over \$250,000, and backdates the raise to January 1, 1993. The 1993 Act is the fifth law in twelve years that introduces major changes in the tax structure. Many economic consequences of the Act are clearly foreseeable; some are hidden in the haze of the future. No matter what they may be, we do know that there will be many future tax acts seeking to repair the iniquities of the past. In the meantime, the Deficit Reduc-

tion Act of 1993 will impose higher tax burdens on many taxpayers and boost federal spending. If there were a "Truth-in-Politics Act," as there is in lending, its sponsors would be subject to heavy fines and long imprisonment.

—HANS F. SENNHOLZ

I. IN SEARCH OF SOCIAL JUSTICE

The Elements of a Fair System of Taxation

by Ridgway K. Foley, Jr.

The current mania for tax limitation, tax reform, or tax protest provokes the more intense inquiry into the rationale and justification for any system of taxation and the proper structure of a fair conceptual framework for exercise of this state power. This essay presents a brief analysis of the issue and poses a simple solution much more in harmony with the idea of individual freedom than any existing dogma.

The Basis and Uses of Taxation

The ideological roots of taxation rest in the good earth of sovereignty, that compelling state power over the rights of individuals.¹ Traditionally, the three common attributes of sovereignty consisted of the power of police,² of taxation, and of eminent domain. From tribute paid involuntarily to the most evil or cunning or powerful by members of the tribe, to the king in his countinghouse, to the modern exchequer and internal revenue agents and audits, the theory of taxation has changed little: those in control of the apparatus of the state exact assets and value from serf or citizen in order to pay for governmental obligations and services.

It becomes possible to identify three uses of the sovereign power to tax: the raising of revenue, the looting of citizens, and the implementation of social policies. Reason would suggest that only the first rationale deserves support, although one could cogently urge that the appropriate analysis of that concept does indeed implement a social policy, the policy of non-intervention in voluntary human action.

Taxation of persons as a means of raising revenue probably pre-exists recorded history. Operating on the assumption that all mankind within a given perimeter benefit from the existence of the order of the state, princes and their modern counterparts have long demanded trib-

Mr. Foley practices law in Portland, Oregon. This article originally appeared in the September 1982 issue of *The Freeman*.

ute under force of law. Simply stated, taxation supports the state by supplying necessary revenue.

Like collecting revenue, the employment of taxation as a means of systematic looting and banditry antedates the dawn of history. Derived from the sinister side of the human actor, taxation can be enlisted as a handy label to obscure outright thievery. By its very nature, taxation requires coercion, not voluntary action, on the part of the subject; therefore, the master can appeal to law or theology or some other stratagem to justify his confiscation of the wealth created by another. History is replete with examples of the powerful and banal invoking "law" to line their pocketbooks and purses.

The practice of taxing to encourage or induce "social" policy appears of more recent origin, yet it is quite as wicked as the habits of the pickpockets of yore. The tactics are similar: those in power determine a "good" or "just" end and rob the productive to pay for that goal. For example, the populists in power may perceive that the wealthy individuals in society do not deserve all of the assets which they have secured through honest trade, therefore, by the means of progressive tax laws, the more wealth created and employed, the higher the tax payments levied, so as to achieve a leveling process and a misplaced, false egalitarianism. The entire modern program of entitlements owes its genesis and continued vitality to this very simple tactic once made famous by Robin Hood; the only difference resides in the fact that the modern counterpart of the Sherwood Forest rascal enjoys immunity from prosecution since he defines the issues and makes the rules.

The First Question: Is Taxation Proper in Any Form?

The rapidity of modern life encourages thinkers to leap to incomplete conclusions without plodding through the necessary intermediate steps. The initial question under the topic considered is not, what is a fair system of taxation? Rather, the fundamental inquiry must be, is any tax structure philosophically permissible as harmonious with the freedom philosophy? Only if the seminal inquiry is answered in the affirmative may we proceed to another question.

I have addressed this key question in general terms elsewhere³, it would not do to repeat the analysis at length here. For me, a justification for the existence and life of the state arises from a Rule of Necessity premised upon the incontestable nature of man. The socialist and

the anarchist fall into the same trap: they fail to observe that man is not capable of perfection; rather he is possessed of a wicked side and while able to improve he is never endowed with the inherent ability to achieve perfection.

The Rule of Necessity augurs that a free and orderly society must possess a state force to prevent internal and external fraud and aggression and a mandatory court of last resort to settle otherwise insoluble disputes. Without these limited state powers enforced by the monopoly of coercion, mankind would always be at the mercy of the strongest and most vicious members of the world. Beyond these necessary restraints, the state should not interfere with the market for creative human endeavor.

The anarchist argues that the need for personal protection and dispute resolution can be met by private defense agencies and private judicial arbitration. But what if someone refuses to play by the rules? What if an aggressor, convinced of the propriety of his position, employs force and wipes out your defense agency? What if a disputant refuses to come to arbitration or to abide by the arbitrator's decision? There must be some community-recognized and -supported court of last resort to protect rights and enforce judgments, else the world will quickly trundle into civil chaos, mountain feuds, and mob warfare, with no rules except "might makes right."

Why Voluntary Taxation Is Not a Feasible Concept

The realm of tax policy has introduced a like idea which must be mentioned, analyzed, and discarded: the concept of voluntary taxation. Of course, "voluntary" taxation represents an impossibility, a contradiction in terms, because by accepted definition, taxation is never voluntary but always coercive (although members of society may acquiesce in the form of government and its application of coercive powers).

The doctrine of voluntary taxation proposes that public works projects be submitted to the vote of the electorate for approval; those casting a negative ballot may show that vote to the clerk and receive a certificate of exemption from taxation for the particular project should it pass.

Without discounting the procedural difficulties in administration of such an enterprise, voluntary taxation in this form suffers from a more serious defect: it tends to approve government intervention in

economic enterprises in which it has no business. If it is wrong for the state to build and maintain port facilities, airports, municipal auditoriums, domed stadiums, hydroelectric projects, and a host of other endeavors, then it remains wrong even if the dissenters are saved from taxation to support the businesses. Those activities beyond keeping the peace and settling wrangling can be done much more efficiently privately and with a higher moral tone and the voter should not be forced to lend tacit approval to government meddling where it doesn't belong.

Moreover, justice demands that all participants in society pay a fair share of the cost of maintaining order in that society. The exemption described heretofore disparages that principle by excluding the dissenter from the cost, albeit for a laudable purpose. If the function is properly one which the state should perform, all should pay equally; if the function resides beyond the limited powers of government, then none should be mulcted for that purpose and the matter—if worth doing at all—should be left to private entrepreneurs.

The Role of the Voluntarist

Properly viewed, then, government, the repository of organized coercion, possesses certain legitimate functions: keep the peace, prevent the application of force or fraud by one man against another, and provide a fair, common, and equal system for settling disputes and administering justice.

These functions require funding: judges and policemen must be paid a fair salary in order to induce competent people to serve, records must be maintained for public observation, the machinery of government must be housed in appropriate quarters, the necessary and proper implements for carrying on these obligations—firearms, paper, gavels—must be purchased.

~~Believers in freedom~~ Believers in freedom often suffer the accusation of negativism. True, the consistent voluntarist thinker seeks to reduce a government to its proper minimum. In searching for reductions, he must, of necessity, oppose spending of public moneys for improper and wasteful functions and ask that well-meaning programs be achieved by cooperative action, not coercive sanction. Nevertheless, the adherent of limited government need not always fit the mold of unswaying opposition, for he recognizes that true state responsibilities require government activ-

ity and, within the ambit of the legitimate conduct of government, he seeks ways to perform the job well. After all, for more than 6,000 years of recorded history, no state has approached perfection in performing the proper, i.e., legitimate, but limited functions of government.

The tax system represents one place which demands constructive affirmative action from the free individual in our society. Creativity and ingenuity proceed from adherence to fundamental principles; the voluntarist should possess those eternal values which enable him to construct a mode of taxation according to the rigors of a free society. Thus, like Diogenes' quest for an honest man, our search for a fair tax system (to support a legitimate, limited government only) goes forward.

Types of Taxation in the Present World

Modes of taxation proliferate, restrained only by the limits of human ingenuity or imagination. As we approach the waning years of the twentieth century, more than two centuries into our nation's history, the United States bears witness to a plethora of taxing devices. State and nation tax net income in progressive fashion. States collect fees, licenses, franchises, and permits. States levy sales and use taxes upon the purchases of some or all commodities. Congressmen clamor for a value-added tax so prevalent in Europe which imposes a national sales fee on each step of the production and distribution process in our complex world. Net estates of deceased citizens suffer the ignominy of another progressive assessment, usually by both the federal and (sometimes more than one) local government. Highway use taxes apply to gasoline consumption. Even gifts beyond a limited exemption are taxed on a progressive scale. Real property, assailed by a bewildering variety of measures, bears a disproportionate burden at the state and local level. Certain luxuries carry additional taxes. Customs duties on imports add to the cost. In some jurisdictions, personal property or goods held for sale are assessed once a year. A mere litany would unduly lengthen this treatise and boggle the mind to boot.

Disguised Forms of Taxes

Beyond these specific taxes lie the more invidious assessments imposed by the state—more invidious because they are not called by their

proper names. Social Security offers a prime example. Truly a tax, this exaction bears the label of an "insurance" payment, a misleading term since the law provides neither fund nor true voluntary insurance.⁴ Estimated income taxes and withholding payments likewise constitute disguised methods of increasing taxes: a citizen's income tax bill falls due 3 $\frac{1}{2}$ months following the close of his tax year yet, by these devices, the federal and local authorities deprive the taxpayer of the income he could have earned on his funds between the time he acquired them and the tax due date.

Surely, inflation constitutes the most invidious and unfair tax of all. We properly call inflation a tax because it results strictly from governmental meddling with the market system. Ancient monarchs clipped coins and practiced other petty debasements. Our government for many decades has ruled by deficit spending and, when the powers that be wish to fund their little schemes they debase the currency (no longer bound by the market laws associated with the gold standard) by churning out tons of paper dollars. The increase in the federal money supply causes the phenomenon we label "inflation" the more dollars in circulation relative to the value of created goods and services, the less each individual dollar is worth and the more dollars it takes to purchase a given good or service.⁵

Inflation operates as the cruelest tax of all because (1) it is not labeled as a tax, (2) it penalizes the thrifty, and (3) although occasioned by government policies, the politicians habitually blame other alleged causes and thus misdirect the anger and corrective powers of the citizens. One cannot imagine a more unjust situation than a hard-working laborer who, by thrift and foresight, saves up to \$50,000 during his working life, by forgoing luxury expenditures and restricting his consumption, in order to provide for his family when he is too old or too ill to work, only to discover that his hard-earned fund will only buy \$5,000 worth of goods. Yet that is precisely the result according to the decline in the dollar purchasing power since World War II.⁶ Outright thievery would seem less painful.

The Elusive "Fair Share"

Reflection suggests that a fair tax system might contain two basic ingredients: First, each citizen should pay his fair share of the costs of

government; second, the government should only tax real value, not fiat money inflation.

What constitutes fairness in taxation? In the first place, the proceeds should only be used to pay legitimate costs incurred by a limited government. In the second place, since every citizen receives theoretical benefits from the functions of the state, so every citizen should contribute on a relatively similar scale as his neighbor. A cardinal rule in taxation should require those persons who benefit from government activities to pay therefor.

Advocates of progressive taxation assert that "from each according to his ability to pay, to each according to his need." In other words, those who produce more value should pay progressively greater taxes.

This postulate rests on both spoken and silent fallacies. The creator-of-value benefits no more from the proper functions of the state than does the derelict; to each man, safety of person and ability to settle disputes without civil chaos represent ultimate values. Since the producer secures no greater benefits, justice does not demand larger payments. The "ability to pay" justification dwells, in final analysis, upon the "principle" that "might makes right," that it is just and proper to band together to take by force from one man that which he has produced and to give these ill-gotten gains to another individual without the voluntary action of the producer. Since the justification fails, the proposition should lose vitality.⁷

Likewise, exactions levied against certain kinds of property or purchases to the exclusion of others bear little fidelity to fairness. Thus a property tax levied against residential and commercial real property exclusive of that owned by the state and its minions falls too heavily upon one group of people to the exclusion of others in society. Those who do not own property pay a lesser share of the tax (through rent) particularly in an interventionist society where rent, wage, and price controls flourish. Luxury, sales, and use taxes fall more heavily upon users of the taxed goods (hence the term "regressive" usually applied pejoratively to these taxes).

Elements of Confusion

Since income, estate, gift, and inheritance taxes generally partake of the progressive feature, they suffer from the "ability to pay" malaise.

Moreover, these taxes also suffer from unequal application since semantic and definitional problems inherent in deciding what constitutes "income" (is a scholarship, fellowship, or prize "income?") or a "deduction" (should medical expense and other taxes be deducted?) or an "exemption" (should a person be entitled to a tax break because he contributes to the support of another person?).

In addition to rampant fundamental unfairness, modern tax systems suffer from gross inefficiency and waste of precious scarce resources. The amount of human energy—which could be creatively employed—wasted on regulating and complying with unreasonable and unnecessary rules and orders astounds even the casual observer. The various governmental units employ countless persons to write, interpret, and decipher the revenue regulations, regulations which are so vast that no living creature can understand them fully. Those same public agencies utilize even more coercers in the form of auditors and agents and the like, men and women bent on enforcement of needlessly complex laws.

The taxpayer, on the other hand, must spend large amounts of time and energy mastering the rules and regulations and complying with the regulatory process all at the expense of his creative endeavors, after all, human time and energy represents the most productive and precious of our scarce resources which should be husbanded for higher endeavors. Again, the beleaguered taxpayer must hire a veritable army of tax preparers, certified public accountants, tax specialists, attorneys, bookkeepers, clerks, and the like, just to satisfy the maze of rules and orders which pockmark the fair face of justice. Truly the cost of the present system, in economic terms of waste and inefficiency and in natural law terms of morality, represents too high a price to pay.

Indexing to a Constant Dollar: False Security

Measurements of income, assets, and expenditures in fiat currency produce several unenviable distortions in tax laws, leading to the suggestion by prominent authorities that the tax base—whatever the revenue program adopted—ought to be measured in constant dollars of uninflated value. In a modified form, for example, the Canadian Conservative Party proposed such an inflation discount in the 1972 elections and came within an eyelash of overturning the Liberal Trudeau government on this issue alone. Of course, the plan was hackneyed

beyond all recognition with the political shenanigans so common to politicians who neither know nor care about sound economic theory. Nevertheless, the harassed Canadian taxpayers responded so favorably to the inherent equity of the idea that the Liberal government adopted a modified version of the plan as an essential part of its program.

On the surface, such a plan appears to possess merit. As the eminent economist Henry Hazlitt has long advocated,⁸ capital gains should be taxed in *real dollars*, not inflated currency. For example, suppose I purchase 100 shares of ABC stock in 1940 at \$10 a share, establishing \$1,000 as my basis. I sell the stock in 1980 at a price of \$100 a share (sales price \$10,000). Under current legislation, I would be assessed a tax based on a long-term (more than one-year holding period) capital gain of \$9,000, although varying distortions in the law currently treat capital transactions somewhat favorably. *Yet my gain is illusory because 1982 dollars are worth less than 10 cents in 1940 dollars.*⁹ Mr. Hazlitt suggests that the government should tax only the real (uninflated) gain on the constant dollar value and thus discount my \$10,000 sales price to \$1,000 (value stated in 1940 dollars). Thus, in the example chosen, I have realized *no* real gain, not a \$9,000 inflation-wracked charade. Under this theory, if my sale discounted to constant dollars revealed a deficit position, I should be entitled to a tax loss for I have truly suffered a loss measured in real dollars, or dollars of constant value.

Other imbalances caused by inflation appear less readily but just as viciously. For example, the graduated income, gift, estate, and inheritance tax schemes promote what is euphemistically termed "bracket creep," creating an evil sibling to the distortion discussed by Mr. Hazlitt. As the nominal wages of a taxpayer increase, he moves to a higher bracket or tax rate on his base although inflation has robbed him of any *real* gain and, in many cases, has placed him in a deficit position. The result: higher fiat income, higher tax rates, less real spending power, and a windfall to the taxing authorities.

Recent Proposals to Achieve Fairness in Taxing

As a result of these patent inequities, proposals have appeared in the past decade to apply a constant dollar approach to all tax forms.¹⁰ For instance, the Oregon-based Research Committee Against Inflation proposed a net receipts tax on an indexed basis in the early 1970s. In

such a proposal, the tax rate should be levied upon receipts valued without the inflation factor so that the taxpayer pays his share of the cost of government based upon what he really earned and what his receipts or "income" (in the broad sense) really will buy in the marketplace. The proponents argued that it makes little sense, and certainly does not accord with common fairness, to tax a man on money substitutes in terms of money substitutes which have been debased by the taxing authorities.

Let us consider a common example. Our taxpayer earns \$15,000 in 1980 from all sources. That \$15,000 will buy equivalent goods and services in 1980 to those which could be purchased in 1940 for \$1,500. Now, does it harmonize with justice to levy any kind of tax on the \$15,000 income when it is really only worth \$1,500 in 1940 market power terms, particularly where the loss of purchasing power is solely attributable to the policies of the same body which now levies the tax? To state the question answers the inquiry.¹¹

Application of this novel idea educes at least three complex issues. The first issue: What base year or years to use from which to measure inflation, since, according to Dr. Pick, "We started to project the financial syphilis all over the world in 1776 when Ben Franklin began the Continental dollar which became worthless after four years."¹² In the examples, 1940 has been used as the base year because, according to Dr. Pick, that represented the last inflation-free year in this country.

Undoubtedly, other economists using other measuring devices could disagree with Dr. Pick and suggest their own base years, inflation-free years, and rates of inflation. One could make a strong case for using 1914 (before the twentieth century wars and after a long period of peace during which time a relatively free economy existed), 1933 (before the nation left the gold standard, which imposes certain natural law impediments restricting currency nonsense), 1957 (subsequent to the Korean war and during a time of relatively balanced budgets), or any one of a number of other key years.

A Shifting 10-Year Average as a Basis for Taxation

Probably the fairest approach requires the use of a 10-year average which shifts the burden forward each year. For example, the inflation discount could be determined by using the federal government's own statistical studies for the years 1957-1966, *averaging* the inflation fac-

tor, and applying it to receipts during 1980. For 1981 receipts, the base-year average could be shifted forward to 1958–1967; for 1982, we could use 1959–1968; and so on.

The use of the shifting 10-year average strikes a relatively fair balance necessitated by the realities of the situation. No year forms a perfect measure, and no state-produced econometric tool offers an exact yardstick. Reaching too far back into antiquity may unfairly hamper the government because of intervening crises not truly the responsibility of the present men in power. Using a base period too close to the fact (Canada proposed 1970 as a base year for 1972) destroys the efficacy of the system which is designed to aid the taxpayer who has accumulated fiat currency.

A single year can disproportionately affect the currency because of world-wide fiscal, emotional, and natural disasters while a 10-year average should balance out the hills and valleys which beset any economic chart. The period 1957–1966 supplies a happy medium from which to start. Although budgets were never in balance at the outset, and the Vietnam war had not yet heated up, these inflationary factors proceeded apace as the period wore on; the real glut of currency production did not take place until the advent of the Nixon administration.

Measuring Capital Gains

The second issue concerns the interrelationship between assets purchased, held for a period of time, and sold, and other receipts. Capital assets, as explained, might be treated to a discount factor between the year of acquisition and the year of transfer. All other receipts could be discounted from the year of acquisition and the base-year period. Although gifts and inheritance could be treated similarly to capital assets, ease of application might require that they be considered as general receipts in the year of acquisition.

The third issue: what should be the first step in implementation of the constant dollar approach? Assuming that most legislators will decide that an indexed tax plan, as outlined in this paper, would not reflect their vested interests, the citizens can still take steps to effect some of these proposals. The obvious: elect better representatives. The less obvious: in states, enjoying a system of direct legislation, enact a measure to tax only real income by means of the initiative process. Once such a measure is enacted by the people, the government will

learn to live within its means. The state example or examples will demonstrate the soundness of fair and credible tax policies and, hopefully, will induce the federal government, through its elected representatives, to follow suit.

Despite the appeal and lucidity of a constant dollar approach, its defects impel that it be discarded in favor of a better plan. Human nature dictates that such a device tends to encrust inflation into the political system rather than defeat it, by ameliorating the patent evils of paper money. Like the insidious withholding tax, a constant dollar offset would render currency debasement relatively painless to all but the perceptive observer; thus, it would serve as an opiate to mask the real cancer of government run amok. In addition, there exists little chance that a fair constant dollar credit would be enacted and maintained by elected officials who benefit greatly from the social schemes induced and encouraged by inflated currency. Moreover, the system raises complexities which would defeat the desired end of eradicating obfuscation and creating a simple yet fair tax structure.

A Proposal: Proportional Gross Receipts Taxation

Review the elements necessary for a fair system of taxation. First, the law should raise the necessary revenue to fund only the legitimate purposes of government, the prevention of aggression and the settlement of insoluble disputes. It should not act as a tool for looting the citizenry nor should it constitute a device for implementing social policy such as the redistribution of income and the satiation of the ends of envy, greed, and covetousness under the façade of egalitarianism and entitlement. Second, it should operate to collect a fair and equal share of the legitimate costs of government from each benefiting citizen. Third, it should be simple to administer so as to save the time and energy now needlessly expended on compliance and enforcement.

Given the flawed nature of mankind, no perfect system emerges, yet one concept seems better qualified than all others to fulfill these appropriate ends: Each person should contribute a proportionate amount of his gross receipts each year from each and every source to defray the legitimate and limited functions of his government; the government should be circumscribed from acting beyond its limited authority and from spending or pledging funds in excess of its income. Mr. John Chamberlain has delineated the justification of a propor-

tional theory of income taxation, a rationale which can be carried to its logical conclusion by applying the sound idea of proportional taxation to gross receipts:

Under the proportional theory of tax equity, a rich man would pay more taxes than a poor man naturally. But every dollar of assessed property value, or of income, or of spending, would be taxed in equal amount, at flat percentage rates. Dollars would be treated equally, no matter who owned them, or spent them. Thus the citizens would be accorded the "equal protection of the laws"—and their "privileges and immunities" would be equal, as provided for in the United States Constitution. Any other way of treating taxation was regarded as discriminatory, or as putting penalties on ability, ambition, and success.¹³

Under the proportional gross receipts tax system, every person, corporation, foundation, or other entity (save for governmental units) would pay a flat percentage (e.g., one percent) of its annual gross receipt of funds from every source. There should be no exceptions, limitations, exclusions, deductions, credits, or exemptions, thereby greatly simplifying the whole tax preparation process. This system would produce sufficient revenue to support necessary governmental functions and would result in a great saving of creative energy now utilized in the regulatory and compliance process.

Comments on the Plan

Several aspects deserve comment, for the proposal does not lack flaws. First, why should all institutions be subject to tax? The answer: The tax will not be onerous because the rate will not be graduated; the burden of government should fall equally upon individuals *qua* individuals and upon individuals operating in concert as entities or aggregates because the latter enjoy the protections of a properly restricted government. There exists no good reason to exclude hospitals, foundations, churches, and the like from the payment of the cost necessary to solve disputes and to maintain order and safety; indeed, cogent arguments can be made that taxation will impel those institutions to operate on a more businesslike and sound basis.

Second, will the plan unduly restrict the state? I think not. While the actual income to the government from a one percent gross receipts tax is not clear,¹⁴ preliminary studies demonstrate that such a rate should be ample to carry out the proper functions of government. No moral reason exists to permit the state to live beyond its means and to mortgage the future of its citizens, nor to allow it to carry out functions which ought better be left to the private endeavors of the citizenry if indeed they are worth doing at all.

Third, what constitutes gross receipts, and why not apply the tax to net receipts only? Gross receipts envisions all income of every kind and nature accumulated during the tax year. Wages and salaries, inheritances, gifts, prizes, scholarships, transfer payments, to name a few items. Simplicity demands no exclusions; exemptions breed special interest legislation and inherent unfairness.

Fourth, is it fair to tax proportionately so that a man earning \$1,000,000 pays one percent or \$10,000 in tax while a welfare recipient receiving \$1,000 pays only \$10 to the state? Probably not, but the concept is ever so much better than what now exists that some slight deviation from philosophical precision might be acceptable. A case can be made that each person and entity in a territory gains an equal value from the protection of his person and the establishment of order so that each ought to pay a flat rate, e.g., \$100 a year, for government services.

The proportional gross receipts tax incorporates a progressive feature in that each person pays a flat percentage of his receipts, and the receipts by definition may vary. The Libertarian Party fell into an identical trap during the 1980 presidential campaign when it decried unfair taxation yet produced a plan which still incorporated some progressive features. In the end result, the proportional gross receipts tax is acceptable because the person or entity with greater receipts may have more at stake in material things and thus may require justice services more often or in greater intensity than one possessing lesser wealth.

Conclusion

No system designed by fallible individuals will produce perfection in this orderly world. However, much remains to be done in the restriction of the state to its proper functions and in the restraint upon

untrammelled taxing and inflating powers. Adoption of the proportional gross receipts tax will mark a long step toward sanity and morality in the concept of sovereignty.

1 Radgway K. Foley, Jr., "The Source of Sovereignty," 32 *Freeman* 167-175 (March 1982)

2 Police power is discussed at length in, Radgway K. Foley, Jr., "Police Power: Sovereignty's Sledgehammer," 25 *Freeman* 677-687 (November 1975).

3 See, e.g., Radgway K. Foley, Jr., "Individual Liberty and the Rule of Law," *Freeman* 357-378 (June 1971) and 7 *Willamette Law Journal* 396-418 (December 1971), and "The Source of Sovereignty," *op cit* note 1

4 See Abraham Ellis, *The Social Security Fraud* (Arlington House, New Rochelle, New York, 1971), *passim*

5 Admittedly this conclusory statement does little justice to the subject of the root causes of inflation but it will suffice for the purposes of this article. The following works, among others, discuss the problems in great detail: Ludwig von Mises, *Human Action* (3rd revised edition, Henry Regnery Company, Chicago 1966), p. 780 *et seq.*; Murray N. Rothbard, *What Has Government Done to Our Money?*, 27 *et seq.*; Donald T. Hoppe, *How to Invest in Gold Stocks and Avoid the Pitfalls* (Arlington House, New Rochelle, New York, 1972), Part I

6 "Franz Pick's 'Crises Seminar' Gold and Silver and the Coming 'Upheaval'," *The Investing Professional* (June 1973) 56. Dr. Pick states that the last relatively inflation-free year was 1940 and the 1940 dollar is worth less than 10 cents today.

7 A well written article which discusses the problem of the progressive income tax in detail is John Chamberlain, "The Progressive Income Tax," IX *Essays on Liberty* 277-296 (1962)

8 See, e.g., Hazlett, Henry, "How to Achieve a Fair Tax Structure," *Human Events* (March 17, 1973), 9-10

9 See Note 6, *op cit*

10 Indeed, a modified indexing proposal appears in the Economic Recovery Tax Act of 1981 although, at this writing, the national politicians are reconsidering the wisdom of this norm

11 If anyone doubts that only the United States government can flood the marketplace with fiat currency, let him print his own dollars and try to use them. Rather severe penalties attach to such conduct

12 See Note 6, *op cit*. Actually, debasement and inflation far antedate the history of the United States. See, e.g., Hoppe, Note 5, *op cit*

13 Chamberlain, *op cit*, Note 7, page 281

14 Government records are not available to make the exact determinations necessary for a precise answer. State records have been studied in the years 1973-1976 which demonstrate that one percent may yield much more return than necessary to fund state functions in Oregon.

The General Welfare

by Clarence B. Carson

"I wish the Constitution was not so vague," one of my daughters said. My first reaction to that was to deny that the document is particularly vague or, for that matter, obscure. "Why," she persisted, "does it contain a clause on the general welfare?" Actually, her question was a good one, and it gave point to her observation on the vagueness of the Constitution, if, as I think, I know where she was coming from, as they say. She is a college sophomore and is taking courses in American history and government, among others. Undoubtedly, she had hoped to find that the Constitution would be a bulwark against the claims of the welfare state. Yet, after studying it in her classes, she has been struck by its ambiguity and what appears to be the slipperiness of its phrases. It is my hope that what follows may throw some light on the troublesome phrase, both for sophomores and the rest of us as well.

The phrase, "general welfare," occurs twice in the Constitution. It occurs first in the Preamble, which announces that one of the purposes of the Constitution is to "promote the general Welfare." Since this is a statement of purpose, not a grant of power, it need not detain us beyond noting that it is there. The other use of the phrase, however, is much more significant. It is contained in the first sentence of Article I, Section 8, which lists the powers of Congress. Equally important, it is used in connection with the grant of the power of taxation, which, then as now, was reckoned to be an essential power of government. The relevant clause reads, "The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States. . . ." Clearly, Congress is empowered to levy taxes to provide for the general welfare. Viewed from the present perspective, this gives

Dr. Carson has written and taught extensively, specializing in American intellectual history. He is the author of several books. Among them are *Organized Against Whom? The Labor Union in America* and the comprehensive *A Basic History of the United States*. This article is reprinted from *The Freeman*, August 1983.

color, at least, to the idea that the welfare state has some constitutional foundation.

But that is to look at the matter wrong-end-to. What counts, in the first place, is what the words meant when they were used. "Welfare" is commonly used today to refer to or denote government programs to provide for the poor, the disabled, those without work, and those reckoned to be without sufficient means to provide for their basic wants. It is so used in such phrases as, welfare state, welfare programs, welfare worker, and welfare recipient. Until quite recently it was used in that way in the name of a cabinet rank department, namely, the Department of Health, Education and Welfare. This usage, however, was unknown to the makers of the Constitution. If they had intended to authorize what are nowadays called welfare programs, they would not have used the word "welfare" to express that intent. It is the other way around—welfare programs bear that name to give the color of constitutionality to them. But let that wait for a bit.

What Americans began calling welfare programs in the late 1930s, or thereabouts, the Founders would have known by the name of "poor relief," so far as they were familiar with it at all. In England, tax-supported relief of the poor was required under the poor laws, more specifically, the Elizabethan Poor Law, during the American colonial period. Poor laws were passed in the wake of the Reformation, the suppression of monasteries, and the confiscation of church lands. The destitute had received aid before that time from organizations within the church, but when much of the wealth of the church was taken away, the state took over last resort poor relief. Actually, Parliament simply required that local communities tax for and provide such relief.

A similar system took shape in the American colonies. In New England, relief for the poor was a charge upon the villages and towns, paid for from locally levied tax monies. Where the Anglican Church was established, poor relief was a duty of the parishes, and parishioners were taxed to pay for it.

Poor relief was hardly a sumptuous affair in the colonies, or, for that matter, in nineteenth-century America. Unless the person were totally incapacitated, more attention was given to reforming the poor, i.e., getting them to become productive and self-supporting, than helping them to fare well. For example, "The vestries in Virginia disposed of the able-bodied poor, destitute orphans, and the illegitimate children of indentured servants by binding them to masters as apprentices

or servants."¹ Workhouses were set up in some places for those who had no visible means of support. In New England, "The town provided materials and tools with which the inmates were required to earn a living."² The incapacitated were sometimes provided almshouses, or otherwise given some minimal aid.

No one at the time of the writing of the Constitution would have associated the life of the poor dependent upon public relief with the word welfare. "Welfare," in common usage for centuries, stems from the roots "well" and "fare," and means basically, according to my dictionary, a "state of faring well; well-being." Synonyms are: "prosperity, success, happiness, weal." No sensible person would have confused poor relief with prosperity, success, or even faring well. Indeed, it was in every respect the opposite.

So far as my researches have revealed, the word, "welfare," began to take on a new connotation around the beginning of the twentieth-century. The phrase, "welfare-manager," appeared in print in England in 1904. Some factories, it seems, were employing people to assist workers in improving their well-being. Thus, the *London Daily Express* declared in 1916 that "Welfare work tends to improve the condition of life for women and girls employed in factories."³ However, the word still had no clear connection with relief for the poor.

That connection was made in the United States in the course of the routinization, regularization, and bureaucratization of government aid programs in the 1930s. The key piece of legislation for making this change was the Social Security Act, passed in 1935. There is reason to believe that the adoption of the word "welfare" in place of relief was a more or less deliberate action. It served a highly important political and constitutional purpose. Much of the early New Deal legislation was tied up in court tests by 1934. As it turned out, the central pieces of New Deal legislation were nullified in the next year or so. New Dealers were casting about frantically for ways to overcome the constitutional impasse.

Secretary of Labor Frances Perkins remarked to Supreme Court Justice Harlan Stone in 1934, that she was worried that the Social Security system they were devising might not pass the constitutionality test. "The taxing power of the Federal Government, my dear," Stone replied; "the taxing power is sufficient for everything you want and need." This pointed clearly toward the general welfare phrase in the clause of the Constitution authorizing taxation. In the same year Pro-

fessor E. S. Corwin, a recognized constitutional authority, maintained that the taxing and spending authority of Congress was unchecked by the Constitution. Another law professor declared, after the Supreme Court nullified crucial portions of the NRA: "The waters dammed by judicial restriction on the commerce power may break out in unwelcome fields of taxing and spending. What seems a great victory against national regulation may prove to be a Pyrrhic one."⁴

Indeed, it did. The Social Security Act leaned heavily upon the general welfare phrase in the Constitution. It opens with the claim that it is "An Act to provide for the *general welfare* by establishing a system of Federal old-age benefits, and by enabling the several States to make more adequate provision for aged persons, blind persons, dependent and crippled children, maternal and child welfare, public health, and the administration of their unemployment compensation laws. . . ."⁵

Social Security Involves a Bundle of Programs

Since many people may not think of Social Security as a welfare measure, it may be well to emphasize that, however old-age benefits—the phrase then used to describe Social Security payments to the retired—should be classified, there was a bundle of programs provided in the act which formed the core of the welfare programs. The bundle included such things as pensions to those who had not contributed to Social Security and aid to dependent children, among others.

Moreover, these programs were administered in the states by what generally became known as welfare departments in the 1940s and 1950s. Frequently, they were formally titled Department of Public Welfare (DPW), and those who administered the programs were referred to as welfare workers. In 1953, an assortment of these programs were moved into the new cabinet ranked Department of Health, Education and *Welfare*. In this fashion, the shift from referring to these programs as poor relief to public welfare was completed, and the claim that such government activities were sanctioned by the reference in the Constitution to general welfare was linguistically ratified after the fact.

The main point, of course, is that the Founders could not have intended to include what they knew as poor relief in their reference to the general welfare. Poor relief was the last resort of local governments to provide minimal means for survival; it was at the opposite end of

the scale from faring well. Beyond that, the evidence presented here points toward the conclusion that as late as the early 1930s it took a great deal of straining to make the beginnings of an identification between relief and welfare.

But there is much more involved in this claim that the federal government is constitutionally authorized to provide for the general welfare than such programs as have been identified, however spuriously, with welfare. The whole concatenation of redistributionist and interventionist programs which comprise the welfare state find their main justification under it. Thus, we are brought back to the consideration of the claim regardless of what meanings may be attached to the word welfare.

The crucial question then becomes whether or not there is a grant of power in the Constitution to provide for the general welfare. There are at least two approaches that can be taken to answering this question. One is to try to discern the meaning of the phrase "general welfare" in the clause in which it occurs. The other is to see the clause within the context of the whole Constitution.

The Taxing Power

First, then, let us look at the clause again, which reads: "The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States . . ." One thing is certain: Congress is authorized to levy taxes. Is it authorized to do anything else? My view is that it is not. What follows the word "Excises" is restrictive rather than being a grant of powers, restrictive of the taxing power. The operative words, in my reading of the relevant parts, would be that taxes are to be levied to "provide for the *common* Defence and *general Welfare of the United States*."

What was being guarded against by these restrictions was the levying of taxes on the whole people to pay for some benefit to some locale, state, or region of the country. For example, by this reading, taxes could not be properly levied to pay for an undertaking such as the Tennessee Valley Authority. There was a definite interest in the Constitutional Convention to restrict such practices. At one point, Benjamin Franklin proposed that the general government be given "a power to provide for cutting canals where deemed necessary." Roger

Sherman objected. "The expense in such cases will fall on the United States, and the benefit accrue to the places where the canals may be cut."⁶ Franklin's motion was defeated by a vote of 8 states to 3.

But let me hasten to add that there is no way to make certain that my interpretation of the words as being restrictive is correct simply by reading the clause and selecting emphases within it. Furthermore, even if it were restrictive to the *general* welfare, there might still remain a potentially broad power to provide for the general welfare. After all, in ordinary usage the granting of the power to pay for something tacitly authorizes the buying of it. For example, if I tell my daughter that she may write checks to pay for her college expenses, it is a logical inference that I am authorizing such expenses. The same might be expected to apply to statements in the Constitution. To see that they do not, it is necessary to place the clause thus far examined in the context of the whole Constitution. Phrases and clauses that may appear to be vague and general when considered in isolation take on much more precision when viewed from the angle of the whole.

A Limited Government

The Constitution of the United States is no ordinary set of statements or document. It is, if not unique, a very special case among documents. It describes the form for and grants power to a limited government. There are no omnibus grants of power in the Constitution; every power granted is limited in one or more and usually several ways (though not necessarily in the clause that grants it). It does not grant the powers of government generally to the United States government.

What makes the Constitution almost unique is that the government it authorizes has only such powers as are granted to it. Thus, what can be inferred from ordinary speech or, for that matter, the general run of legal documents, is no guide in construing the provisions of the Constitution. It is concerned with granting and limiting power in an arrangement for which there are few, if any, parallels in ordinary life situations.

It is contrary to the whole tenor of the Constitution that the power to provide for the general welfare should have been granted in the sentence authorizing taxation. The men who drew the Constitution did not assume that by granting the power to tax in order to pay debts

that they had authorized indebtedness. On the contrary, the very next sentence authorizes Congress "To borrow Money on the credit of the United States." Nor did they assume that by authorizing taxation to pay for the common defense that they had granted the power to bring into being a military establishment. On the contrary, again, there is a list of powers to accomplish this purpose granted to Congress:

- To define and punish Piracies and Felonies committed on the high Seas and Offences against the Law of Nations;
- To declare War, grant letters of Marque and Reprisal, and make Rules concerning Captures on Land and Water,
- To raise and support Armies
- To provide and maintain a Navy,
- To make Rules for the Government and Regulation of the land and naval Forces.

If the power to provide for the common defense had been granted in the taxing power, each of these powers would have been implied by it. Such an enumeration of powers would have been redundant. Redundancies are commonplace, of course, in ordinary legal documents nowadays, but the Constitution is remarkably free of them. It is spare, lean, and once stated, repetition of a position is avoided.

Indeed, the powers which the Founders reckoned necessary to the general welfare of the United States are enumerated along with those mentioned above. Among them are the power of Congress to enact uniform laws on bankruptcies, to coin money, to fix standards of weights and measures, to establish post offices and post roads, to give authors and inventors exclusive right for a time to their writings and discoveries, and the like. Undoubtedly, they considered all the powers granted useful or necessary to the general welfare, including the powers of taxation and those for a military establishment. But my point is that the powers granted were enumerated, and those not so enumerated were reserved to the states or to the people.

That did not keep some from claiming or asserting that some object they wanted to achieve by government was provided for in the phrases of the taxation clause, even in the early years of the Republic. The issue came up for President Madison in 1817, when he was presented with a bill for making internal improvements such as roads and canals. He vetoed it on constitutional grounds.

Madison's Interpretation of Enumerated Powers

Madison said, in part, "The legislative powers vested in Congress are specified and enumerated in the eighth section of the first article of the Constitution, and it does not appear that the power proposed to be exercised by the bill is among the enumerated powers. . . ." Regarding the general welfare phrase specifically, he said: "To refer the power in question to the clause 'to provide for the common defense and general welfare' would be contrary to the established and consistent rules of interpretation, as rendering the special and careful enumeration of powers which follow the clause nugatory and improper. Such a view of the Constitution would have the effect of giving to Congress a general power of legislation instead of the defined and limited one hitherto understood to belong to them. . . ."⁷

President Monroe echoed Madison's views, and added some of his own, in vetoing a bill for maintaining the Cumberland Road in 1822. He denied that Congress had the power to do this. "If the power exist," he said, "it must be either because it has been specifically granted to the United States or that it is incidental to some power which has been granted. If we examine the specific grants of power we do not find it among them, nor is it incidental to any power which has been specifically granted." Among those from which he could not trace the power he declared, was the clause "to pay the debts and provide for the common defense and general welfare."⁸ In an addendum to his veto message, he included this thought: "Have Congress a right to raise and appropriate the money to any and to every purpose according to their will and pleasure? They certainly have not. The Government of the United States is a limited Government, instituted for great national purposes, and for those only."⁹

In sum, then, it is most unlikely that the makers of the Constitution would have chosen the phrase "general welfare" to authorize the federal government to provide what they understood to be poor relief. It would have violated both their understanding of the meaning of words and the common practice as to what level of government should provide the relief. On the contrary, it appears that relief came to be called welfare to give it a semblance of constitutionality. Indeed, close analysis within the sentence and the context of the Constitution points to the conclusion that the reference "to provide for the general wel-

fare" was the restriction of the taxing power rather than a separate grant of power.

In short, no powers were enumerated granting authority to the federal government either to enact relief measures or to erect what has come to be called a welfare state. Nor is the language of the Constitution especially vague or carelessly general when it is viewed within the context of the whole document. It only appears to be so when wrenched out of context and construed to cover purposes not intended.

1. Curtis P. Nettels, *The Roots of American Civilization* (New York: Appleton Century Crofts, 1963), p. 463

2. *Ibid.*, p. 462

3. This information comes from the *Oxford English Dictionary*.

4. See Arthur M. Schlesinger, Jr., *The Politics of Upheaval* (Boston: Houghton Mifflin, 1960), pp. 398-99

5. Henry S. Commager, *Documents of American History*, vol. II (New York: Appleton Century Crofts, 1962), p. 326. Italics added.

6. Charles C. Tansill, ed., *Formation of the Union of the American States* (Washington, D.C.: Government Printing Office, 1927), p. 724

7. James D. Richardson, ed., *A Compilation of the Messages and Papers of the Presidents*, vol. II (New York: Bureau of National Literature, 1897), pp. 569-70

8. *Ibid.*, p. 712

9. *Ibid.*, p. 736

Some Thoughts on Taxation

by George C. Leef

With the exception of the weather, probably no subject is more complained about than taxation. Almost everyone feels that our tax system treats him unfairly, for one reason or another. The poor say that wealthy persons and businesses should pay more than they do, and the latter argue that the taxes they already pay are economically counterproductive. Politicians are forever promising tax "reforms" and legislative bodies debate the desirability of an endless variety of deductions, credits, exemptions, and rates. The overall tax scheme which results is not predicated upon any principle, but rather is capricious, based only upon the respective success of each interest group in influencing the political process.

This, I submit, is an undesirable state of affairs. In pace with the rise of mass democracy, our tax system has become an institution for plunder, prodigality, and the gratification of envy. Many a shrewd politician has taken the easy road to power of promising the voters governmental services or subsidies paid for in the main by somebody else. The one discernible principle of our tax system, that of "progressivity," is inherently unjust, as it compels some to subsidize others' use of governmental services.

What we have is the ugly spectacle of a societal gang war, each group attempting to manipulate government so as to enrich itself at the expense of the others. This is possible—indeed, inevitable—because our tax system is not rooted in principles of justice (as are, e.g., our property and tort law). But it need not be so. There is, I believe, one principle, and only one principle, upon which taxation could be based which avoids injustice to any citizen. It is the same principle which underlies all market transactions: You pay for what you get.

Mr. Leef is an Adjunct Scholar with the Mackinac Center for Public Policy, Midland, Michigan. This article is reprinted from the September 1978 issue of *The Freeman*.

The Rights of Man

The view one takes of man's rights will inform his judgment on the moral defensibility of a system of taxation. I do not propose here to argue at length for the position I take, as that has been ably done elsewhere.¹

Individuals have rights. Locke distilled the fundamental rights to these: life, liberty, and property. Each person has a right to be the master of his life, the only life he has. It may not be taken from him, and neither may it be made the tool of others. That property which justly comes into his possession is his to do with as he pleases—consume it, save it, exchange it, or give it away. The dominion of an individual over property excludes any rightful claim to that property by another. As Professor Nozick writes, "The particular rights over things fill the space of rights, leaving no room for general rights to be in a certain material condition."² This concept of man's rights is deeply embedded in our religious heritage, and was embodied in the earliest forms of the common law.³

Let us agree that man has a right to enjoy the fruits of his labor. Can there co-exist with this right such alleged rights as the "right to decent housing" or the "right to an education"? The answer is no. As soon as an agent of compulsion, usually the state, takes any part of the fruit of one's labor from him in order to give effect to these other so-called rights, the primary right is violated. Then we can no longer say that man has a right to enjoy the fruits of his labor, but only that man is permitted to enjoy that which the state does not demand be put to purposes of its choosing. The degree of the taking does not matter. The right is violated whenever an owner is compelled to part with any portion of his property against his wishes.

The Nature of Taxation

Taxation is the price we pay for government services. Government takes (or keeps) from us an amount of property (money), calculated by various formulae, each year. During that year, government does certain things for (or to) its citizens. Each of these services has a cost per citizen, although some would be difficult to account for with certainty. Under our present tax system, however, there is no necessary

relationship between the size of one's tax bill and the cost of the government services he has used.

If you go to get a haircut, the price you pay reflects the costs of the barber's time, his tools, rent on the shop, and so forth. It is deemed just that the recipient of the haircut should pay for these costs incurred on his behalf. Compare this with our tax system. Taxes are computed on the basis of income, wealth, purchases, and other measures. There is no attempt whatever to charge the costs of government to those people for whom they were incurred. Unavoidably, some taxpayers must pay more than the value of the government services they received while others pay less (or not at all). This system is undesirable for a number of reasons having to do with efficient use of resources, but I wish to focus on the reasons why it is immoral.

Taxation and Morality

First, our tax system is immoral because it compels some individuals to purchase government services which they do not desire. For example, many Americans contribute involuntary support to public schools even though neither they nor any children of theirs make any use of these facilities. There are also many citizens who drive very little or not at all, yet have no choice but to help underwrite the costs of our highway network. And there are those who, although they do not care for such things, are patronizing the fine arts through governmental subsidies.⁴ In this, their rights are violated because they are deprived of the freedom to choose how they will dispose of their property.

Secondly, if taxation requires us to purchase services we do not want (or want less than other things we might have bought), a corollary is that we are compelled to subsidize services used by others, and this too is immoral. Payments for services we do not use, or use only to a small degree, usually go to reduce the amount that more extensive users need pay. For instance, those of us who make considerable use of public libraries are relieved of paying the full cost of our usage because of the tax dollars taken from occasional and nonusers which go to defray the expense. It is a violation of those rights which we posited above to compel someone to support another's desires or even needs, yet our tax system is a hopeless maze of involuntary subsidizations of some by others. The most obvious example of how the tax

system is used to compel one person to make purchases for another is the phenomenon of transfer payments. Here, there is no governmental service at all, merely the taking of money from one person thought not to need it, and giving it to someone else. Such acts of robbery by indirection can occur only because our tax system does not link payments to benefits received.

Neither of the above objections to the morality of our tax system depends upon the existence of a "progressive" rate structure. If the government merely figured its costs and divided them equally among all taxpayers, we would object for the reasons given above. Progressivity is a separate issue, and must be regarded as a third indictment against our tax system.

We have had it drummed into us for so long that taxation should be based upon "the ability to pay" that this axiom is hardly ever questioned. (We might call it the Willie Sutton principle of taxation—"Why do you rob banks?" "Because that's where the money is.") Yet, upon examination, it cannot stand under our view of the rights of individuals.

When we say that taxation should be based upon "ability to pay," we are saying that two persons who use the same governmental services, and in the same amount, should pay different amounts of tax if their incomes are different. To illustrate the point, imagine two potters who live next door to each other. They place identical demands on governmental services in 1977 (use of roads, schools, national defense, *etc.*) and both pay the same amount of tax because they sold the same number of pots. Then, in 1978, one of the potters gets ambitious and produces and sells 15 percent more pots than in the prior year. His neighbor produces the same number as he did in 1977. Their lives remain the same except that the ambitious potter now buys steak more frequently than hamburger and drives a new car instead of an old one. Oh yes, and he also has to pay the government more in taxes. But why should he have to? Why should he now have to pay, let us say, \$1.10 per unit of service while his neighbor still pays only \$1.00 per unit? There is no defensible ground for the discrimination. If the government was previously extracting a proper amount from our ambitious potter to cover the cost of the services he used, it now is taking too much; it is demanding more than the services are worth. That is unjust. I conclude that "progressivity" is a bad principle of taxation in that it charges different people different prices for the same service.

A Neutral Principle

We have seen that our present tax system is unjust in that it violates the rights of many citizens. What we desire is a tax system which will require the government to respect the rights of each, to remain neutral among taxpayers. I submit that such a system can be based upon this, and only this principle: The amount of tax one pays should equal the cost of providing the services he uses. In the market, there is only one price for a good or service, not a sliding scale based upon some notion of ability to pay, and no one is required to buy things he does not want. Government should be constrained to follow this principle in charging for its services.

How could this be put into practice? Wherever possible, government should finance its operations through user fees rather than taxes. A good, though not perfect example of what I have in mind is found in the U.S. Postal Service. (Of course, a large part of its budget comes from taxes and to that extent is immoral in compelling some people to subsidize others' use of the service, but we will ignore that. Ignore also the fact that there is no reason why the government should deliver the mail.) The price of a stamp is the same for each buyer, regardless of income. If you do not send any mail, you do not have to buy any stamps. Thus, this method of financing the service closely resembles a market transaction.

Other services could be treated similarly. Roads could be paid for through tolls and other forms of user fees, and schools (if we must have public education) could be paid for solely out of funds collected from those who use them. If put to the task, man's ingenuity would be able to devise means of accurately accounting for the costs of government-provided services and charging them back to those who caused them to be incurred.

There are, however, many elements of a government's budget which relate to administration and enforcement of the law rather than the provision of a service per se, and these create analytical difficulties. How, for instance, do we allocate to each citizen his just share of the cost of the Presidency, the Congress, or the Defense Department? Do we assume that everyone benefits equally from these expenditures and divide them accordingly? Or do we assume that persons with higher incomes or greater wealth benefit more from these expenditures, and therefore charge them more? To a considerable extent, these expendi-

tures relate to the protection of property, and the proper analysis would seem to focus on how the market would handle analogous services. Premiums for property insurance contracts are largely a function of the value of the property covered. Therefore, an allocation of costs based upon wealth might be optimal. I do not claim that no better formula is possible, but propose the wealth tax idea merely to demonstrate the nature of the analysis which should underlie our approach to the just allocation of tax burdens.

The largest item of governmental spending in this country would be dramatically affected by the adoption of this principle. The item is transfer payments; they would cease. To see why, look to the principle. You pay for what you get. To get a dollar from the government, you would have to pay a dollar, plus administrative overhead. Obviously, there is no point in doing that. Many will think it unspeakably cold-hearted to suggest that the government not give anything to the needy, but it must be answered that the best policy is to rely upon individual charity and never allow the idea that the level of one's income is a matter for political consideration to gain a foothold. Bastiat was certainly correct when he wrote in *The Law* that government should not be allowed to do any act which would be a crime if done by an individual citizen. We do not permit even the neediest to steal. Neither should we permit the government to play Robin Hood.

The Free Rider Argument

Some will object to my analysis on the ground that since most people benefit in some way from governmental expenditures, it is not unjust to require them to pay for these benefits. For example, it is said that everyone benefits from the system of public education in this country because better-educated people improve society as a whole. I contend, however, that the free rider argument does not justify compulsory tax support for services one does not use.

In the first place, it is just too easy to *assume* that everyone is better off as a result of the provision of some governmental service.⁵ Who among us is so all-knowing that he can make the judgment not only that everyone benefits from some service, but what the *extent* of that benefit is in each case? No one, I answer.

Secondly, we should be extremely hesitant to allow the making of unilateral contracts. Even if you clearly benefit from an expenditure

by someone else, we should prefer that you not be compelled to help defray the cost. Allowing others to direct in some measure how you spend your money by making you pay for "benefits" for which you have not contracted might very well deprive you of funds you need for things of greater value to you. It is true that an elderly couple might derive some benefit of public education, but requiring them to pay for that benefit for which they had not contracted deprives them of money needed to pay medical and utility bills. Everyone has his own hierarchy of values, and it is wrong for the government to demand that its hierarchy take precedence over the individual's.

Finally, people usually *do* pay for services rendered by others, albeit indirectly. Assume for a moment that public education does yield a benefit to all of society. *How* does each person benefit from this increase in erudition? Presumably, by the better products and ideas which educated people can produce. But unless one lives his life as a self-sufficient hermit, he will eventually pay for the educational component of the products he uses and ideas he absorbs, through the operation of the price system. Ph.D. chemists do not work for free—their salaries, part of which is a return on their educational investment—are reflected in the price of the things which their research makes possible. Thus, there is no free ride, and this objection fails.

Some Advantages

Not only is a system of taxation requiring citizens to pay taxes only to the extent of benefits received consonant with man's rights, but it is true that an elderly couple might yield us some significant tangible advantages as well.

One benefit would be that no longer could government use taxation as a tool for social engineering or economic tinkering. The dense pages of the Internal Revenue Code are full of deductions and credits for use of money which the state wishes to encourage.⁶ Since government is to be the servant of the populace and not its master, it is wrong for it to attempt to direct how we spend our money. Moreover, such interferences lead to inefficient use of resources. The deductibility of mortgage interest unjustifiably encourages home ownership; the deductibility of bond interest unjustifiably causes corporations to favor debt financing over equity. These interferences would be at an end if government had to link taxes to the provision of services, rather than

to income or some other irrelevant measure. For instance, "business expenses" (lunches, travel, entertainment, *etc.*) would be immaterial to a company's tax bill if it were taxed on the basis of the cost of governmental services it used; thus, there would be an incentive to economize on these currently deductible items.

Another benefit would be that it would tend to get government out of the business of providing services appropriately left to the market. If people had to pay the full cost of using government services, they would quickly see how inefficient government is, and would turn to (or demand to be allowed to turn to) alternatives.

Finally, and perhaps most importantly, taxation based on benefits received would eliminate the government's motive for inflating the currency. Inflation is governmental additions to the money supply. (Rising prices are a consequence.) Governments resort to inflation because they desire to spend money in excess of the amount they dare to collect in taxes. Now suppose that government were operated as a service company, requiring all who partook of its services to pay for what they had used. Inflation would be impossible because government would *have* to balance its expenditures and receipts. With each person paying only the cost of providing him with services, there would no longer be any need, or motive, for government to resort to money creation to balance its books.

Conclusion

Freedom would be greatly expanded in this country if government could not compel us, through the tax system, to devote our money to services we do not want, and to subsidize services used by others. These annoyances frequently are part of a deliberate plan to redistribute wealth, which is inherently immoral, but even in the absence of redistributionist schemes, a tax system which does not base the amount of tax one pays on his use of government services is unavoidably unfair to some citizens.

The only tax system which would require government to treat each citizen neutrally—not forcing anyone to act as a tool for someone else more favored by the government—is one which embraces the concept that one should pay only for the cost of those services he actually uses. It is wrong to force one person to purchase government services for another, just as it is wrong to force him to purchase anything else for

another. If a wealthy person is to pay more tax than a poor person, it should be because he causes the government to incur larger expenses on his behalf, and not simply because he has more money.

When people make purchases in the market, they expect to pay for what they get. They have no expectation that others will pay part or all of the cost for them. If it is just that each person pay the full cost of a haircut or movie ticket, then it is also just that he pay the full cost of those services which the government provides him. Others should not be expected to pay his way. Our present tax system is unjust in that it often compels one person to subsidize the government used by another. Government would have to remain neutral among its citizens if we taxed strictly on the basis of the benefits received by each person. Any other system becomes a breeding ground for injustice and social strife.

1 The reader may wish to consult in this regard F. A. Hayek, *The Constitution of Liberty*, especially chapter 2.

2 *Anarchy, State and Utopia*, p. 238. The author cannot recommend this brilliant work of political philosophy highly enough.

3 Interestingly, early Anglo-Saxon criminal law was actually tort law in nature. That is to say, the state demanded that restitution be made by criminals to those who had suffered at their hands, but itself exacted no punishment. One may wonder whether the contemporary state deprives the victims of crime of a property right when it incarcerates those who have committed offenses against their persons or property, thus making restitution difficult or impossible.

4 The National Endowment for the Arts recently awarded a \$6,000 grant to the producer of a film showing large rolls of crepe paper being tossed from an airplane and floating back to earth. This vicariously generous bit of artistic patronage earned Senator Proxmire's "Golden Fleece of the Month" award. See *National Review*, September 30, 1977, p. 1090. Many other fantastic boondoggles are recounted in Donald Lambro's *The Federal Rathole* (Arlington House, 1975).

5 Regarding the supposed benefit of public education, the reader should consider (or reconsider) E. G. West's article on "The Perils of Public Education" in the November 1977 *Freyman*, p. 681.

6. It has been persuasively demonstrated that federal tax policies are in large measure responsible for the plight of the large northern cities. The investment tax credit has encouraged firms to build new plants in uncrowded southern and western states, and their movement has been facilitated by the expansion of the interstate highway system, paid for in the main with tax dollars taken from the already developed areas in the Northeast and Midwest. See "How Federal Policies are Hurting the Cities," *Business Week*, December 19, 1977, p. 86.

Taxation Theory

by W. M. Curtiss

Tax experts long have theorized about the raising of money for various units and functions of government

Should taxes be for revenue only, or as a means of social control, or both?

Should taxes be levied on citizens equally, or should "ability to pay" be a major consideration?

Where practicable, should the "benefit principle" be followed? That is, if government performs a service for specific individuals and not for all, should those who directly benefit be charged for the service? For example, should highway users be required to pay for them through specific taxes on motor fuels and motor vehicles and direct tolls? And, if such taxes are intended for highway use, are safeguards against diversion desirable?

How pay for government schools at all levels? Studies show the tremendous economic advantages of high school and college education. Most parents urgently want education for their children. Should the cost of government schooling be charged on a "benefit" basis, either to the parents, or against the enhanced future earnings of the students?

Changed Circumstances

In the early days of our country, tariffs were an important source of revenue for the federal government. And there was much debate among tax theorists as to the revenue-raising versus the protectionist and discriminatory aspects of tariffs. But "tariffs for revenue only" becomes an academic issue when the national government requires one quarter or more of people's earnings.

Seeking the ideal taxation formula is of course praiseworthy, but

Dr. Curtiss (1904-1979) was a member of the senior staff at FEE from its beginnings in 1946 until 1973, serving as Executive Secretary and as Director of FEE Seminars. This article originally appeared in the November 1967 issue of *The Freeman*.

conditions of the search have changed! The taxation experts of 100 years ago were talking about nine cents out of each personal income dollar. Today, nearly 40 cents of every dollar of personal income goes to support national, state, and local units of government. This calls forth new theories of taxation. Collecting the billions of dollars now spent by various units of government is no longer a question of "soaking the rich" but of how to extract 40 cents of each personal income dollar without stirring up a taxpayer revolt.

Taxation has become a tool of monetary and fiscal management. The experts speak of "fine-tuning" the economy so that employment will be high and productivity will expand.

There doubtless are those who look upon taxation as a means of redistributing wealth, in the belief that some have too much income and some too little. The progressive income tax is an expression of this belief, as are current discussions of a guaranteed annual income for all.

So, in view of the growing tax burden and the increasing use of taxes as a tool for social and fiscal control, let us further review the new theories and modern problems of taxation.

Hidden Taxes

The tendency of taxpayers to revolt against high taxes causes tax collectors to try to hide the tax burden so that the taxpayer will hardly be aware of what is happening to him. If this process takes place at a time of rapid growth in the economy, levels of living may rise at the same time that taxes are increasing. Without an understanding of what might have been, people can truthfully proclaim: "We never had it so good!"

An effective method of hiding taxes is the withholding of federal, state, and local income taxes by employers from the wages of employees. Most workers are inclined to think only of their take-home pay and give little thought to the tax they are paying.

The Social Security tax not only is hidden through withholding, as is the income tax, but is otherwise disguised as well. If he thinks of it at all, the employee is likely to consider only his share of the tax, not realizing that the employer pays an equal amount in his behalf. Further, many who pay in the name of social security view it not as a tax but as saving for their old age.

A real estate tax is rarely thought of as a hidden tax, but when I

asked a neighbor how much his school taxes were, he replied: "I haven't the slightest idea; I pay them monthly along with my mortgage, interest, and insurance bill."

Perhaps the most cleverly hidden tax is inflation. When the national government fails to cover its expenditures through taxes, it must borrow the difference, either from individuals or the central bank. If the latter, a multiple of that debt is likely to be added to the money supply, which is inflation. Inflation usually is accompanied by rising prices and erosion of the purchasing power of the dollar. Since 1939, the dollar has lost about half of its purchasing power. This is a tax upon savings, as truly a tax as any of the many other ways of raising revenue. From a political standpoint it has the advantage of being hidden. Also, it is possible to make people believe that the cause of inflation is the raising of prices by greedy businessmen or of wages by labor unions.

Taxes are hidden in other ways, too. Many are incorporated in the prices of things we buy and we rarely realize that a tax has been added. Taxes on liquor, cigarettes, automobiles, and gasoline are examples.

Voluntary Taxes

With compulsory taxes absorbing so high a proportion of income, it may appear paradoxical to speak of voluntary taxes. But what is a government lottery, if not a voluntary tax? Certainly, a person may avoid the tax by not participating in the lottery.

The state of New York spends millions of dollars each year to try to prevent illegal gambling. One might conclude that the lawmakers believe gambling is an evil which should be suppressed. But no, we find the state permitting and even encouraging certain types of gambling. Bingo is permitted under certain conditions and betting at race-tracks where the state gets a heavy "cut" is encouraged.

And now, the statewide lottery to raise money for "education"! The state felt it needed more general revenue than it could raise through its many tax sources. So, why not try a "voluntary" tax like a lottery, and call it "education"? This might remove the onus for some who think gambling is a little bit evil and who do not realize that this is just another way of swelling the general revenues of the state.

Regardless of how one may appraise the moral aspects of gambling, there seems little doubt that a state lottery operates as a regres-

sive tax, taking heavily from the poor, even though voluntarily. Historically, governments that have resorted to lotteries have had in common a tendency toward decadence. The state lottery feeds the idea of "something-for-nothing" already far advanced in this country. From the standpoint of the lawmakers, it is a "last resort," desperation effort to fill the coffers of a profligate state.

Diverted Taxes and Highways to the Moon

Taxes sometimes are levied for an alleged purpose and diverted to another. The gasoline tax often brings this comment: "I wouldn't mind paying the gas tax if I could be sure the money was spent to improve highways."

The diversion of taxes collected from highway users has brought sufficient protest that 28 states have adopted anti-diversion amendments to their constitutions. But, in most instances, such anti-diversion measures have little effect on the overall pattern of government spending.

True, in some states, more revenue is raised from highway users than the total spent on highways. For example, in New Jersey where there was no state income tax, more than 40 percent of all state revenue in 1966 was from motor vehicle, fuel, and license taxes; and about 40 percent of that was used for non-highway purposes. In contrast, some states spend more on highways than they collect in highway taxes. For the country as a whole, disbursements for highways by all units of government are about equal to the receipts from highway taxes by all units of government.

One may be certain that tax income from lotteries in New York and New Hampshire will be watched like a hawk to see that it is not diverted from educational purposes. But this fear will be unfounded; the huge amounts budgeted for education will more than absorb all such lottery funds. Whether the lotteries will make available additional funds for education or simply release general funds for other purposes would be difficult to determine.

The point is that when 40 percent of personal income is taken for taxes, the diversion argument is hardly important. Ways will be sought to raise this money as painlessly as possible. Motorists apparently will tolerate a tax equal to half the price of their gasoline. Liquor and cigarette users will submit to a very heavy tax on those products, no

matter to what purpose such funds are diverted. How would government finance an excursion to the moon except by diversion?

Are Social Security funds diverted? It all depends upon one's point of view. In the early days, when Social Security taxes collected far exceeded benefit payments, was there diversion? If one assumes that Social Security taxes are intended for the general welfare, then there is, of course, no diversion. If future benefits are considered a contractual obligation, then past and current Social Security taxes fall far short of needs, and diversion is a term without meaning.

From an administrative standpoint, with governments involved in so many activities and at such tremendous cost, it becomes practically meaningless to try to earmark funds at their source for specific expenditures. The attempt is made in the Postal Service, but with what success? Deficit after deficit! People will say "Let those who want mail service pay for it," or "Let those who want to go to the moon pay for it," or "Let those who want to fight in Vietnam pay for it." But do they really mean they're ready to vote the government out of that particular business and leave it to competitive private enterprise?

In many instances, special taxing districts are set up to provide specific services such as schools, fire protection, police protection, water, or sewerage. Diversion of such special district taxes for other purposes is reduced to a minimum under such arrangements, though such districts often require extra funds from other tax sources.

Not many years ago, public elementary and secondary schools were financed almost entirely from local real estate taxes. But the trend has been increasingly toward state and federal aid for the financing of more and more elaborate schools and school programs.

Conclusion

So, we see that tax policy is more complicated than it once was. What one's theory of taxation finally amounts to is his theory of government, because taxing is an integral part of the governmental process. And there are really but two basic and fundamentally opposed theories of government. One theory, the one upon which the United States of America was launched, held that government ought to defend the peaceful individual and his property.

The alternative theory of government, increasingly popular among Americans, would plunder the property of individuals for the sup-

posed benefit of others. This is socialism. And the tax policy of socialism is to confiscate all private property.

The use of tax policy for social control—for leveling wealth—is not a new development. The U.S. official who said recently he would take property from those who had more than they need and give it to those who don't have enough was merely expressing the major tenet of socialism.

More important than taxation theories is the question of the proper function of government.¹ Rather than debate whether 10 percent should be added to income taxes or raised through further inflationary deficits, a more basic question should be raised: Will this money be used to finance a proper function of government?

Even though there will be minor differences in details, a clear understanding of the proper place of government in an advanced free and open society will largely eliminate the need for complicated taxation theory. With government reduced to reasonable size, the financing of it becomes relatively simple.

1 For a discussion of the proper function of government see *Government: An Ideal Concept*, by Leonard E. Read

The Forgotten Man (1968)

by William Henry Chamberlin

"Wealth comes only from production, and all that the wrangling grabbers, loafers, and jobbers get to deal with comes from somebody's toil and sacrifice. Who, then, is he who provides it all? The Forgotten Man . . . delving away in patient industry, supporting his family, casting his vote, supporting the church and the school—but he is the only one for whom there is no provision in the great scramble and the big divide. Such is the Forgotten Man. He works, he votes, generally he prays—but he always pays. All the burdens fall on him, or on her, for the Forgotten Man is not seldom a woman."

This 1883 declaration by economist and sociologist William Graham Sumner, a professor at Yale, is the first use of the expression, "Forgotten Man," which Franklin D. Roosevelt employed in a much more demagogic context fifty years later. What Sumner had to say on this subject looms larger as prophecy than as a description of the economist's own time. For in 1883 there was no federal income tax, the United States had not assumed military and economic burdens all around the world and Big Government, in the sinister modern sense, with its enormous demands on the resources of the taxpayers, did not exist.

If Sumner were alive, he would probably be the first to recognize that the plight of his Forgotten Man is far worse today than it was when he first used the expression. Here a little definition is in order. The Forgotten Man is the rare and discouraged breed of citizen who wants to pay his own way in the world, without benefit of any crutches in the way of government aid.

He receives no handouts, but is required to help finance innumerable handouts to others, at home and abroad. Rapacious tax collectors,

The late Mr. Chamberlin was a skilled observer and reporter of economic and political conditions at home and abroad. In addition to writing a number of books, he lectured widely and was a contributor to *The Wall Street Journal* and numerous magazines. This essay is reprinted from *The Freeman*, February, 1968.

federal, state, local, always have their hands in his pockets. He is saddled with an ever-increasing load of exactions, a load that, if present trends are not sharply reversed, will one day break his back, with incalculable consequences for American society and economy. He is a producer, not a consumer of so-called social security. The Forgotten Man does not riot or demonstrate or strike. As his principal exploiters are bureaucrats at various levels, armed with the authority of governmental power, he could not, unless he were willing to go to jail, employ the strike weapon so beloved of industrial workers organized in monopolistic unions, of teachers, "welfare" dispensers, even, incredible as it sounds, of "welfare" recipients.

Forget the Controls

The Forgotten Man only wishes that the state would forget him to the extent of permitting him to contract out of its cumbersome, incredibly mismanaged bureaucratic nightmare of "social security" and let him provide for his own rent, medical care, and retirement needs. But this is a vain desire, as the steady and growing compulsory deductions from his income prove. No matter how diligent he may be in his work or profession, tax laws, especially on the federal level, are calculated to frustrate his effort to build up a competence for his old age and his family. One need only think of the steeply graduated character of the federal income tax and of such inequities as the double taxation (as individual and as corporation income) of earnings from dividends. Many states, in their income taxation, have copied the method of steep graduation.

The witty and perceptive French economist Frederic Bastiat defined the state as "the great fiction, by which everyone hopes to live at the expense of everyone else." Today there might be a substitute definition: "an engine for pillaging the thrifty for the supposed benefit of the thriftless." And the worst, for the Forgotten Man, is probably still to come. The present raids on his pocketbook and gouges at his bank account, onerous though they are, would seem mild in retrospect if such schemes for dividing up the wealth as the guaranteed annual income, the so-called negative income tax, or the various proposals for paying tens of billions of "compensation" to a certain ethnic group in the population should go into effect.

Direct and Indirect Taxes

The Forgotten Man is caught between the hammer of inexorably rising taxation (with state and local grabs outpacing the federal) and the anvil of visible inflation. As a concrete example of the continuous encroachments of state and local tax authorities on the earnings and savings of citizens, consider the situation in the state where I live, the Commonwealth of Massachusetts, widely rechristened Taxachusetts by its disgruntled taxpayers.

Corruption, mismanagement, and extravagance are old characteristics of the state administration, especially under such notorious political bosses as the twice jailed James Michael Curley, amusingly portrayed as "Skeffington" in Edwin O'Connor's novel, *The Last Hurrah*. The regime of a more recent Governor, Foster Furcolo, produced a rich crop of scandals.

Matters seemed to take a turn for the better with the election of a businessman, John A. Volpe, as Governor. There was substantial support for Volpe among the harassed taxpayers when he pressed for the raising of additional funds through a sales tax, decidedly preferable, from the individual taxpayer's standpoint, to the introduction of a graduated income tax. Volpe fought off such proposals and was vindicated in a referendum and by a smashing majority when he ran last year for re-election.

Many of the people who supported Volpe on the referendum and at the polls believed that he would be satisfied with tapping one important new source of revenue. They were also attracted by the frequent assertion, during the campaign for the sales tax, that its enactment would make it possible to reduce the extremely high rates of personal property tax throughout the state ("Taxachusetts" is a leader among states in this form of exaction.)

On both counts they have been sorely disappointed. Volpe has proved himself only a politician, after all, with the politician's uncontrollable yen for spending taxpayers' money. Safely re-elected for a four-year term, he has come to the legislature with a request for about \$100 million dollars in additional revenue, to be financed through increases of the already high rates of state income tax. This burden is aggravated for anyone with investment savings because income from investment is taxed at about two and a half times the rate levied on salaries and wages.

Instead of the sales tax as an alternative to higher income taxes, Massachusetts taxpayers are hit fore and aft by increases in both. They have also been hit amidships. The promised reduction in the rate of property tax has proved a cruel hoax, at least in Cambridge, the town where I live, and in some other communities as well. A cabal in the Cambridge city council ousted an admirable city manager who had combined efficient administration with a stable tax rate and installed a successor who could not restrain his eagerness to pile up the burden on Cambridge homeowners. Whereas the former city manager had kept the tax rate unchanged without a share in the receipts of the sales tax, which had not gone into effect during his administration, his successor pushed through tax increases of 6 percent and 15 percent, while also enjoying the increment of a share in the proceeds of the sales tax.

So "Taxachusetts" runs true to form, and its unfortunate taxpayers and homeowners get three simultaneous solar plexus blows, through the sales tax, the increase in income tax (unless sufficient pressure can be brought on the legislature to vote this down), and through property taxes that have risen, not fallen, since the enactment of the state sales tax. It does not stand alone, the same pattern, with differing details, may be observed throughout the nation.

The Meek Inherit Burdens

Part of the blame for the steady chipping away and erosion of the taxpayers' income and standard of living rests with the undue meekness of the Forgotten Man. He is a law-abiding citizen and his impulse, on getting an increased bill from the tax collector, is to pay up without even marching to city hall and hanging the mayor and members of the council in effigy.

Indeed, it is a problem for a psychologist why organized union groups will sometimes commit every crime in the book, assault and battery, willful destruction of property, mayhem, even murder, in order to extort a higher income while the taxpayer meekly accepts dose after dose of diminished income. The latter is surely a more serious grievance and one wonders what explosion would follow if an employer proposed the same work at reduced wages. That is what the state, through one agency or another, is continually imposing on the

Forgotten Man, the taxpayer whom the politician despises as a cow to be milked dry, a sheep to be shorn.

How different was the reaction of early Americans to the imposition of what seem, in comparison with the present exactions, quite trivial taxes on tea and stamps! One of the grievances of the colonists against King George III is phrased as follows in the old-fashioned, grave, and dignified language of the Declaration of Independence: "He has erected a multitude of new Offices, and sent hither swarms of Officers to harass our People and eat out their substance."

There is enough lawless violence in the United States now, without recommending violent extralegal forms of protest to the oppressed, pillaged, and exploited taxpayers. Besides, the Forgotten Man, as described by Sumner, is a sober, responsible citizen with a high regard for public order. However, there are eminently legal forms of protest and resistance which have not been called into effect as often as they should have been.

"Don't Tread on Me"

One obvious reason why taxpayers are treated with contempt by free-spending politicians, eager to buy this or that bloc of votes at the price of other people's money, is that they are completely unorganized. A very healthy change would come over the picture if taxpayers in states and communities would organize and study with microscopic closeness the spending records of elected officials and legislators.

Then they could punish at the polls every executive, every administrator, every legislator on the federal, state, or local level who is identified with unnecessary high spending programs that involve higher taxes. Let them develop an elephant's memory and permanently blacklist every man and woman in public office who has been in the habit of raiding their pocketbooks with impunity. Let this strategy be applied consistently, ruthlessly, implacably, and the politician's instinct for self-preservation will come into operation and bring about a sudden saving vision of the virtues of public economy.

Unless the Forgotten Men who never get any government hand-outs but finance a good many to others, who are providers but not consumers of security, take some measures of financial self-defense and self-preservation, unless present trends toward reckless spending at federal, state, and local levels are checked, the taxpayer, more heavily

loaded than any camel in a caravan, will find that he has no more earnings, or savings, to be taxed away.

The Forgotten Man, who is so old-fashioned as to believe in the merit of thrift, is hard hit by inflation. During the nineteenth century the United States dollar, although it experienced ups and downs in purchasing power, remained basically stable, buying approximately as much in 1900 as in 1800. This is emphatically not true as regards America's currency in the twentieth century; and the end of this story is not yet. In very recent experience, items large and small, newspapers, concert tickets, shoeshines, haircuts, doctors' charges, hospital costs, food, furniture, have been changing in cost more or less rapidly, and always in one direction, upward.

The result has been very much that of clipping the coinage, a favorite inflationary device in the Middle Ages. Holders of bankbooks and insurance policies have seen the real value of their holdings shrink. This development is not surprising, because politics has more and more dominated financial policy, and all political pressures are inflationary.

Legislation giving privileged status to trade unions has taken the risk out of striking. (Has anyone heard of a major strike lost in recent years?) As might have been expected, some unions have abused this new-found power to extort wage settlements quite out of line with increased productivity, with resultant government spending and inflation to forestall unemployment. Another cause of the rising cost of living and another blow at the taxpayer's pocketbook is the elaborate system devised for paying farmers more for producing less, or producing nothing at all.

Another obvious cause of inflation is the persistent refusal of either the legislative branch or the executive branch of the federal government, despite much lip service to the ideal, to make any serious attempt to practice economy in public spending. Most private individuals could cheerfully spend a good deal more than they earn, but are obliged to adjust their spending to their incomes.

Unbounded Government

The root cause of many of our difficulties is that public administration, at the federal, state, and municipal level, is under no such restraint. All too often public budgets are framed on the basis of spend-

ing without limit, and making up the difference by inflationary borrowing or by dipping into the pocket of the taxpayer for a new grab.

That the high cost of government is a matter of concern not only to the well-to-do but to people in the lower brackets is evident from an item recently published in the *San Francisco Examiner*. A part-time typist, Mrs. Helen Burch, submitted the following breakdown of her earnings and taxes for the years 1958 and 1966

	1958	1966
Salary (gross)	\$2,521	\$3,414
Real property taxes	340	681
Income tax withheld	102	521
Social Security tax withheld	56	144
Total taxes	498	1,346
Salary (net)	2,023	2,068

Considering the decline in the purchasing power of the dollar Mrs. Burch has evidently been running fast without even being able to stay in the same place. Even worse is the plight of elderly retired persons who cannot report a gain in gross salary.

Reversing the Trend

The plight of the Forgotten Man who would like to stand on his own feet economically is bleak today and will be bleaker tomorrow, unless the merry-go-round of ever higher public spending and ever higher taxation can be stopped or thrown into reverse. Perhaps there is consolation in the thought that, when an evil becomes intolerable, reform, brought on by public indignation, cannot be far away.

There is also cause for encouragement in the eminently sound economic resolutions adopted at the recent congress of Young Americans for Freedom. These young Americans, who stand for integral freedom and realize that economic freedom is not the least important element in this ideal, came out for abolishing the graduated element in the federal income tax, for dropping the minimum wage, and for making participation in Social Security optional. And they gave cogent, detailed reasons for each of these stands.

They characterized taxing of income at different rates as a violation of the laws of justice and "an economic attack on the initiative of

individuals to use their own income as capital for maximization of future income and a penalty on those who are industrious and able." They rightly see in the minimum wage "a major cause of unemployment among the young, especially among minority groups." And they show that a 22-year-old worker, earning \$6,600 or more will have paid the government \$63,894 in Social Security taxes by the time he is 65 and could earn a much higher income than his Social Security pittance by investing this sum with normal prudence.

The evils of excessive and ever increasing appropriation of the fruits of individual labor by the state and of inflation have reached crisis proportions. If the Forgotten Man does not wish to become the Extinct Man, he should bestir himself for remedial action.

II. INSTRUMENT OF SOCIAL REFORM

The Squeeze on the Middle Class

by William Henry Chamberlin

The Middle Class, the large group of many occupations—professional men, engineers, skilled mechanics, farmers, small businessmen, salaried employees, farmers, to list only a few—that stands between the extremes of wealth and poverty has always been the standardbearer and the surest and most solid support of a society based on political liberty and economic freedom. It began to emerge with increased power and influence with the decay of the medieval feudal system and waxed strong in the struggle to curb the arbitrary power of monarchy and establish free representative institutions.

The middle class was active in the leadership of the three principal revolutions of the Western world, the British in the seventeenth century, the American and the French in the eighteenth. The French was perverted and distorted to some extent by the greater misery of the masses, especially of the Parisian mob, which lent itself to the manipulation of extremist demagogues, intoxicated with doctrinaire ideas of establishing not equality of opportunity, the American ideal, but complete material equality, to be enforced by dictators operating in the name of virtue and using the guillotine whenever moral suasion failed. Out of all the turmoil and excesses of the French Revolution, its Napoleonic aftermath, and the various royal, imperial, and republican regimes that followed during the nineteenth century, middle-class social and economic values acquired a firm footing. France supplied some of the most eloquent and erudite exponents of the free economy, such men as Frederic Bastiat and Jean Say.

It is the nature of absolute power, whether it be that of a king surrounded with inherited pomp, ceremony, and pageantry or that of a revolutionary dictator, to recognize no limits on what it may do with regard to those under its rule. So it is significant that John Locke, the outstanding philosopher of the British constitutional revolution whose ideas very much influenced the leaders of the American Revolution, insisted upon the natural right of man to "life, liberty, and property."

Mr. Chamberlin wrote this essay for the February 1969 issue of *The Freeman*.

There was never any doubt in Locke's mind, or to those of the educated middle class for whom he spoke, that property, far from being opposed to liberty, is one of the essential rights of free men. Locke, a true liberal in the original sense of a word now often perverted and misapplied, went so far as to describe the preservation of their property as "the great and chief end of men's uniting into commonwealths."

The rising and expanding middle class was open to any able and industrious citizen, whatever his origin and background. What they more or less consciously wanted and needed was a state authority strong enough to protect honestly acquired possessions against spoliation but not so strong as to engage in spoliation itself.

No Taxation Without Representation

It is not surprising that some of the movements that led to the establishment of the supremacy of Parliament in Great Britain and to the separation of the United States from Great Britain were triggered by one specific property right—the right of the individual not to be taxed without his consent. In his effort to govern without the inconvenience of having a Parliament in session, King Charles I resorted to an old tax known as ship money. In the past it had been levied only in time of war and in certain maritime parts of the country. Charles imposed the levy in peace, and without geographical limitations.

One of the leaders of the opposition in Parliament, John Hampden, refused to pay the tax, contending that it was illegal. Seven out of twelve judges who heard the case, under strong pressure from the Crown, ruled against Hampden. But his stand aroused nationwide attention and sympathy and, as soon as Parliament was again called, "ship money" was ruled illegal. Hampden, a country landowner, was as willing to fight for liberty as to speak for it. When the differences between King and Parliament reached the point of civil war, Hampden raised a regiment among his tenants and lost his life in one of the many skirmishes and small battles that followed.

In the United States, also, "taxation without representation" was a fighting issue. Like many other small causes of big events, the British levies on stamps and tea were petty in immediate impact, but the underlying claim that a Parliament in London three thousand miles away might lay imposts on colonists who were not (and, under the

travel and other circumstances of the time probably could not be) represented there excited justified suspicion and resistance. The colonists knew very well that taxation accepted without protest would probably mean double or treble taxation in the future.

Irresponsible bureaucracy ranked high with arbitrary taxation among the causes which led the American colonists, when protests and remonstrances had failed, to take up arms. This is evident from the following clause in the indictment of King George III in the Declaration of Independence: "He has erected a multitude of New Offices, and sent hither swarms of Officers to harass our People, and eat out their substance."

How surprised and shocked would have been the men who fought against a foreign tyranny at Lexington and Bunker Hill and Saratoga and Yorktown if they could have foreseen today's bureaucratic monster, in the shape of federal, state, and local governments, costing almost \$9,000 a second to operate, and doubling its exactions from the labor of its citizens every ten years.

Design for Limited Government

No such monster was envisaged in the Constitution which the deliberations of a representative group of leading citizens of the various states yielded as the constructive fruit of the achievements of the American revolutionaries in arms and diplomacy. It is an uncommonly useful and instructive exercise periodically to read over this charter of American laws and liberties. And one of its most striking features is the sparseness of promises as to what the new government will do *for* the people (indeed, there are practically no such promises, compared with the many explicit guaranties as to what the government may not do *to* the people as a whole or as individuals. These immunities included, until the adoption of the Sixteenth Amendment in 1913, assurance against the imposition of the graduated income tax.

The kind of government outlined by the American Constitution is in line with the political philosophy of John Locke and Adam Smith that "every man is by nature first and principally committed to his own care." What the Constitution promised is not to make each citizen healthy, wealthy, and wise—something beyond the power of government—but to remove state obstacles to his achieving these objectives by his own efforts.

This was the logical outcome of the struggle against absolute monarchy and feudalism, a struggle in which the middle class played a leading role. It was under this philosophy that the middle class prospered and expanded, because it was no closed hereditary caste but a group in the community which anyone might join with the requisite conditions of industry and ability.

Social Security?

But today, at first gradually and imperceptibly, then more boldly and blatantly, a completely different philosophy of statism has tended to supplant individualism, both in the United States and in Great Britain and in varying degrees in other Western countries. (One need hardly refer to the European and Asian countries where the individual has lost all liberties—economic, personal, and political, to the grasping thrust of an all-powerful state.)

Under this philosophy the government promises its citizens various forms of alleged security, in return for which it exacts a first lien on what they earn by their labor, a lien that is indefinite and ever-expanding. The benefits may look good on paper, but their real value is steadily sapped by inflation, the erosion in the purchasing power of the currency that is the invariable accompaniment of vast government spending. Increasing amounts are taken from everyone's salary to pay for what is euphemistically called Social Security, while the dollars which may be someday paid out steadily diminish in value.

Following British Lead

This process has gone further in Great Britain than in the United States, so that a visit to Britain gives a preview of what may be the plight of the United States ten or twenty years hence. There was a time, before World War I and to a lesser extent in the interwar years, when the British pound was considered a desirable currency, not only to earn and spend, but to save. No longer. Malcolm Muggeridge, leading British television commentator, wrote recently:

Our currency is gently expiring which lets us off any form of saving. It would be as sensible to save next winter's snow as the Pound Sterling. We have come to think of our currency

as an ailing elderly uncle; yesterday he had a good day, this morning he was feeling a little better, and able to sit up and take a little nourishment, only in the afternoon to suffer a slight relapse. One day, of course he will pass away—dear old Pound Sterling. It had to happen, but even so he'll be missed.

Mr. Muggenidge has a habit of satirical exaggeration; but there is plenty of evidence to support his dim view of his national currency. What were once called gilt-edged securities are selling at fantastic discounts on the London Stock Exchange. New Zealand recently floated a loan in London at 6 3/4 percent, but with an interesting proviso: the value of the loan was to be reckoned in German marks, with correspondingly higher interest and principal payments in the event of a devaluation or writing down of the value of the pound in terms of other currencies. Such a devaluation did occur after the loan was floated.

The "English Disease"

The lack of adequate incentives to capital and to labor—due to inflation and the steady depreciation in the real value of the pound—is a basic reason for what is called on the European continent the English disease: the inability of Britain, year after year, to balance its international payments, paying out more than it takes in.

In America also the middle class finds itself more and more ground between the two millstones of inflation and ever higher taxation at all levels, federal, state, and local. It is, of course, a basic part of the welfare state theory that government bureaucrats can spend an individual's money better than he would spend, or save, that money himself if it were not siphoned off in taxes. Some aspects of the 1968 election in the United States can only be interpreted as the desperation of certain taxpaying, self-respecting, substantial citizens confronted with continually higher tax bills while their wives complain of ever higher prices at the supermarket.

The Tax Foundation recently reduced to specifics the impact of inflation and higher prices on an imaginary character named Charlie Green. Charlie is in relatively favorable circumstances; he earns \$12,000 a year, up from \$7,500 ten years ago. But not all is gold that glitters in Charlie's pockets, even though his income is about \$3,000

more than that of the average American family of four. Charlie has a 17-year-old son and a 15-year-old son and financing them through college, where board and tuition charges have been rising as fast as taxes, is not the least of his worries.

Between 1958 and 1968, Charlie's federal tax is up from \$1,266 to \$2,169; his state tax from \$169 to \$610, his local property tax from \$590 to \$1,301. All have been rising faster, the state and local tax considerably faster, than his income. And rising prices have wiped out \$489 of his after-tax pay boosts.

What makes the outlook even gloomier for the economic survival of the millions of Charlie Greens who comprise the middle class is the cumulative effect of many existing taxes. The full impact of the expense of much of the social welfare legislation enacted by the spendthrift eighty-ninth Congress has not yet been felt. This is also true of the cost of Social Security, which went up again, and appreciably, at the beginning of 1969. As invariably happens with such handouts, the price tag of Medicare, Medicaid, and similar social patent medicines is much higher than the original estimate.

And there is no lack of ingenious schemes for taking what others have earned, for reaping what has not been sown, for still further pillaging the thrifty for the supposed benefit of the thriftless. When, in a time of normal industrial activity, there are one million people on the welfare rolls of New York, when those who provide the most essential services, teachers, policemen, firemen, sanitation employees, hold up an almost empty municipal treasury for raises out of all proportion to the rising cost of living, it is clear that something is radically wrong.

A Backbreaking Burden

If present trends continue and accelerate, it is not difficult to foresee a time when incentive to creative work by hand or brain will disappear, because its fruits will be eagerly plucked by half a dozen sets of tax collectors. One root cause of the trouble is the change from the time when the American taxpayer was supposed to have done his civic duty when he supported himself and his family and the religious, philanthropic, and educational causes of his choice. Now, he is expected to carry on his shoulders the weight of supporting millions of workless indigent in this country, assuring the triumph of democracy

in countries that hardly know the meaning of the word, relieving the age-old poverty of Asia and Africa and Latin America, and paying the cost of such sociological experiments as busing children for miles from their homes and rebuilding slums which he never made.

The burden is backbreaking and it will not be surprising if some Americans, despairing of relief from an intolerable situation, are tempted to experiment with quack remedies that may be foolish and harmful. What is most needed is education in economic realities, education that will lead to remedial action.

When more people see the state as a robber baron that takes *from* them, not as a Santa Claus that gives *to* them, the prospects will have improved for the dismantling of the bureaucratic monster. (How completely out of hand this monster has grown is evident from the fact that the national budget, which only passed the billion dollar mark early in this century, now stands at \$186 billion). One essential condition for reform is for the voter to use the power of the ballot more intelligently and discriminatingly than he does at present. Every legislator, every executive, at state and national levels, who makes new taxes necessary should be marked for defeat the next time he runs for office.

When the majority of the people recognize that the free-spending leviathan state is the main source of their financial and economic grievances and insist on drastic retrenchment at any cost, the prospect of the survival of the independent middle class will be much brighter than it is at present.

The Mythology of State Spending

by John Hood

In 1991, 30 states facing budget deficits raised income, sales, excise, and other taxes a total of \$17 billion, with more tax increases promised for 1992 and beyond.

Most commentators blamed federal aid cuts and the tax revolts of the 1980s, which supposedly left the states unprepared for the 1990-91 recession. But rather than simply suffering the *effects* of a slower national economy, many state and local governments, by raising taxes and squandering resources, were a primary *cause* of slow growth.

According to Stephen Moore of the Cato Institute, state spending increased at an annual rate of 8.5 percent from 1982 to 1989—twice the inflation rate. Meanwhile, per capita state taxes almost doubled from 1980 to 1989, and "Tax Freedom Day"—computed by the Tax Foundation to identify when Americans effectively stop working to pay their federal, state, and local taxes and start working for themselves—fell on May 8 in 1991, the latest date ever. State employment rose by 19 percent in the 1980s, while the general population grew by only 9 percent. Federal aid to states and localities, after dipping in the early 1980s, increased by an inflation-adjusted 20 percent in the late 1980s. From 1989 to 1991, state spending rose at an average annual rate of 7.6 percent, 2.7 percent above the inflation rate.

Most of these facts are well known by state budget officials and policy analysts, but conflict with mythologies promulgated by the news media.

For the past two years, I have worked for a state think tank in Raleigh, North Carolina, that has been engaged in budget debates. I've observed the cozy relationship between reporters and public employee unions, teacher unions, and oft-quoted university "experts" on public policy. I have come to believe that the facts about state budgets don't make it into most news stories and commentaries because of the composition of news sources and interest groups in state capitals.

John Hood is research director of the John Locke Foundation in Raleigh, North Carolina, and a columnist for *Spectator*, N.C. magazine. This essay is reprinted from *The Freeman*, April 1992.

It isn't a nefarious process, but one of necessity: Reporters rely on advocates to generate story ideas, provide information and quotes about public issues, and to set the agenda for public debate. Much more so than in Washington, where a legion of reporters covers the federal government, and citizens' lobbies and think tanks point out wasteful spending, representatives of state employees, contractors, and consultants dominate the news-gathering process in state capitals.

A recent example in North Carolina demonstrates how budget myths are created. During the 1991 legislative session, the North Carolina Association of Educators was growing nervous about the prospect of not receiving pay raises promised in previous sessions. Indeed, early in the session, public educators warned that the state's largest budget deficit in many years would result in education cuts, though as it turned out the cuts were minimal. Major newspapers ran stories extolling the achievements of particular teachers or decrying the state's low test scores and graduation rates.

Meanwhile, our office provided the news media with statistics showing a tremendous increase in public education administration (from 75 teachers for every administrator in the 1970s to 50 teachers for every administrator now) and in non-teaching personnel (from two teachers for every non-teacher in the 1960s to one teacher for every non-teacher now). In addition, we showed that the average salary of the state's teachers was closer to the national average for teachers than North Carolina's private sector wage was to the national private sector wage. In other words, compared with other workers in the state, teachers were fairly well off. We also identified a massive increase in state employment during the past two decades.

State media organizations paid little attention to these figures, although outside media such as *National Review* and *The Economist* reported them in stories on state fiscal woes. Instead, reporters continued to do stories without statistics or other hard facts and which focused on quotes from union lobbyists and their legislative allies. It worked. Rather than cut significantly into non-teacher positions or other government waste, the North Carolina legislature enacted the largest tax increase in the state's history.

Even if more press attention had been focused on numbers and fiscal trends, the result might have been the same. That's because the policy-makers who raise taxes and create government programs are beholden to teacher unions, public employee unions, and industry

lobbies with an interest in state contracts. These groups provide political contributions and campaign volunteers. They hire lobbyists to haunt the halls of state legislatures, providing "information" and in some cases virtually writing the legislation that will protect their industry or their members. They host dinners, breakfasts, teas, parties, receptions, and other events to foster contacts and provide venues for deal-making. They manipulate media coverage by holding rallies and "marching on the legislature," although the ability to mobilize a couple hundred people doesn't really suggest public support or even newsworthiness.

These groups have been largely successful during the past decade in promoting their agenda. Public employee unions are the only healthy segment of the American labor movement. Andrew Bates of *The New Republic* reports that these unions added 1.2 million new members during the 1980s, a 30 percent increase, and that state employee salaries nationwide increased by 59 percent from 1980 through 1987, while private salaries rose 35 percent. Benefits also expanded rapidly, with retirement and health plan costs becoming the fastest growing category of state spending.

Ignoring the Appeal of Facts and Figures

In classic public choice style, those with an interest in government programs and higher taxes to pay for them exercise inordinate influence in state capitals and, to some extent, in city halls. The average citizen, whose interests lie in smaller government and lower taxes, often cannot meaningfully influence the process. The continued growth of state think tanks and taxpayer associations will help offset some of the advantages pro-government lobbies have, but no one should expect rapid change. In most state capitals, relationships between reporters and sources are chummy and take a while to develop. Also, legislators and other policy-makers have an interest in information and analysis, but an even greater one in political contributions—so the appeal of facts and figures isn't overwhelming.

Still, recent elections show that voters across the country are angry about taxes, dissatisfied with the way their governments are being run, and disgusted with waste and political scandal. To translate these feelings into specific opposition to programs, advocates of limited government and free markets have to be savvy, timely, and effective purveyors

of information about the history of government taxing and spending in their states and the potential impact on economic growth. It may take a while for the message to crystalize, but it is crucial that it do so. The immensity of state and local tax increases during the past two years will translate into significant economic costs. A repetition of the 1991 state budget debacle could wreak irreparable harm on the incomes and livelihoods of American families.

School Budgets and Town Meetings

by R. W. Boehm

In New Hampshire a popular topic of conversation during the first months of the new year is the local school budget. Newspapers report frequently on the heated proceedings of town meetings where school budgets are discussed. Television coverage shows that these gatherings can become highly emotional as aggravated citizens express their concerns. There is much gnashing of teeth.

There always are many in attendance who favor increasing the school budget for a variety of well-intentioned reasons. They are quick to express their opinions, but sometimes are intolerant of the views of others. Often these people have children in the school system, or work in the schools as teachers or support staff.

A growing number of citizens are tiring of ever-escalating property taxes and are bravely beginning to attend these meetings. They usually are fewer in number than the first group, frequently are the recipients of shrill denunciations of their lack of "charity," and generally are held to be beyond the pale. But many, quite simply, no longer can afford to pay their school taxes. In some towns, such as Bedford, these people are forming taxpayer associations. They want to control spending. They also resent the arrogant indifference of the school board to their differing point of view.

There is a third group of citizens who for a variety of reasons choose not to participate in school budget politics. That these people's rights often aren't even considered doesn't seem to evoke any concern. After all, goes the popular retort, they can vote too.

So, what's the problem?

A frequent result of the voting process is the redistribution of wealth. This occurs not only in the case of schooling but in most issues that have become politicized. The government that is supposed to protect our rights equally now takes from one group to give to an-

Mr. Boehm is an airline pilot living in Bedford, New Hampshire. This article originally appeared in the September 1990 issue of *The Freeman*.

other. As our appetite for special-interest politics grows, so does the plunder that supports it. True, this democratic process is a more civil way to settle disagreements than resorting to brute force. But, as James Madison warned in *The Federalist*, democracy can and often does produce results similar to the physical violence it seeks to avoid. The tyranny of the dictator is replaced by the tyranny of the masses when anything can be made legal by voting. It seems we should be frequently reminded that the voting process doesn't necessarily make something right, only legal.

History reports that our Founding Fathers held an underlying assumption when they formed our democratic, constitutional republic: We are a moral people, and this morality is based on the commandments of God. Therefore it cannot be imprudent to say that the degree to which we will improve our political situation is likely to be proportional to the degree we once again permit ourselves to be influenced by the Judeo-Christian tradition. The Bible reminds the faithful to be "the salt of the earth and the light unto the world." We are to reflect God's love as we interact with the world. This seasoning role certainly extends to the realm of politics. Our instruction remains the same. St. Matthew recorded the Great Commission from our Lord at the end of his Gospel.

The Bible teaches that responsible behavior primarily requires remembering our obligations to God and to our neighbors. Indeed virtually every religion teaches its faithful to love one's neighbor as oneself. St. Paul reminds the Romans: "Love is the fulfillment of the law." (Romans 13:10) We are asked not to do to our neighbor that which we do not wish done to ourselves. The Bible tells us that the main reason for government is to restrain the irresponsible or whoever wishes to diminish the liberty of another.

Before running down to the next town meeting, perhaps we first should make sure of the responsibilities we have to our neighbors: to love them, to forgive them, to pray for them, and to refrain from interfering with their ability to enjoy the same rights which issue equally to all. Forcing one's neighbor to pay for something other than the rightful role of government is not love. We are instructed not to judge our neighbor's lack of charity; rather, we are asked to set a better example and increase our own charitable efforts.

Good Intentions Are Not Enough

Given this, what subjects should be considered at a town meeting? The proposals from those of good intentions are never-ending. So the primary question becomes: Does the subject in question involve a legitimate role of government? Our good intentions are not enough. Scripture teaches that government is to be limited in power and is created primarily to regulate relations among the people of a fallen world. The functions of government are few: to maintain order, to protect life and property, and to provide justice. Quite simply, this involves little more than the operation of a police force and courts of law. This is what is Caesar's. The list is amazingly short and most definitely does not include such items as health, education, or welfare, to name just a few.

The skeptic will ask, How do you propose to replace the services the government provides? Doesn't the government do for us many things we can't do for ourselves? Beyond its rightful role, about the only thing the government can do for us that we cannot is legalize that which is wrong. As F. A. Harper was quoted in the March 1966 *Freeman*: "The government cannot possibly do anything that people can't do for themselves, for the simple reason that people comprise all that is government. Government is manned by the very same persons whose deficiencies are presumed to disappear when combined into a legal structure with bureaucratic, political trappings—a process which makes an ordinary person, if anything, less able than before to accomplish things."

The school issue, like all other issues that exceed the proper role of government, is not a budgetary problem nor is it a problem solvable by electing better representatives or instituting better government controls. Schooling simply is not a proper function of government. The involvement of government in matters beyond its proper role produces a coercive monopoly of special interests and privileges. This is a perversion of justice, for the only way the government can create entitlements is to take from one to give to another. In doing this, the government must forsake its rightful responsibilities.

The irony of this situation is the predictable outcome—mediocrity. An unhampered market stimulates competition. Economics, the study of human action, shows the result of competition to be higher quality goods and services for the lowest possible price. The current national

schooling crisis is an excellent case in point. The facts are these: We have a monopoly school system; we are being forced to support it; it is by recent government admission mediocre; and it is widely described as overly expensive. Were this monopoly eliminated, the quality of schooling would improve dramatically and the price of it would decrease. Educators could teach whatever they wished, but their ability to stay in business would be determined by the sovereign of the market—the consumer, not Caesar.

At town meetings we should be discussing how to return government to its rightful role. Instead of talking about the upcoming school budget, we should be discussing how to get government out of the business of schooling and all the other places into which it wrongfully intrudes.

The Forgotten Man (1985)

by Robert Awenius

In the last ten years of the nineteenth century and the first ten years of the present the American republic was thrust into a great drama of American Destiny carried to the far reaches of the world. America breached the trade barriers of Japan and China, and after winning the Spanish-American War, wrenched Cuba and the Philippines from Spain. The Philippines became an American colony and the idea of American Destiny moved strongly across the Pacific Ocean. We witnessed American imperialism, we were told it was our duty to carry the American concept to the world.

We strongly backed freedom for the Philippines, placing at one time as many as seventy thousand troops there and later sending ten thousand young American teachers and experts on sanitation, nutrition, tropical medicine, and agriculture to improve living conditions and wipe out disease. This Philippine adventure was a great pivot-point in American history, and as was stated by Richard O'Connor in his book *Pacific Destiny*:

It signaled our determination to gain and hold supremacy in the Pacific and over as much of Asia as our military power could sustain. The consequences of that move have involved us in three wars so far and promise an unending, possibly unavailing conflict on the Asian littoral.¹

Not all persons approved this stated American notion of world power. One great voice in opposition was a crusty conservative Yale University professor named William Graham Sumner, who based his opposition on humanist grounds. His voice was prophetic because what he said also relates to the title piece of this article. Sumner's reasoning is put this way:

Mr. Awenius, a retired attorney and free lance writer in Tulsa, Oklahoma, wrote this article for the March 1985 issue of *The Freeman*.

The Forgotten Man, to whom he referred continually in his essays, was not the slum-dweller but the person who paid his bills for what later sociologists would term the disadvantaged. The Forgotten Man of Sumner's canon was the one who "just when he wants to enjoy the fruits of his care, is told that it is his duty to take care of some of his negligent neighbors, . . . but the point now is, that if preaching and philosophizing can do any good in the premises, it is all wrong to preach to the Forgotten Man that it is his duty to go and remedy other people's neglect. It is not his duty. It is a harsh and unjust burden which is laid upon him, and it is only the more unjust because no one thinks of him when laying the burden so that it falls on him. The exhortations ought to be expended on the negligent—that they take care of themselves."²

Sumner was saying that the millions of dollars of American wealth and resources spent on military and civil affairs at home and abroad were paid by the Forgotten Man, and that this burden was imposed upon him as a duty. His thesis went beyond application to the bellicose events of his era, since he meant his general theory to be applied broadly to all acts.

So, likewise in the field of political science and sociology, the Forgotten Man is the common man who after working hard and paying his bills and taxes is told by the liberal establishment (oftentimes his government) that it is his "further" duty to become responsible for all the unfortunate persons, institutions, or other entities who, through negligence on their part or for other reasons, look to the government for their support.

Here, for example, is the teenage girl who becomes pregnant outside of wedlock. In the view of many, if she has no funds for an abortion or for childbirth, these expenses must be paid by the state. And, further, when she goes on welfare she will receive Aid to Dependent Children (ADC) until the child's eighteenth birthday. All of this is to be paid by the state from taxes of the Forgotten Man.

The Forgotten Man is told, also, that his taxes are needed to provide housing for families whose breadwinner fails to provide.

The farmer who produces more grain than the market will absorb at support prices is told by his government that his grain can be stored

as collateral for a commodity loan, with the loan proceeds coming from the federal treasury, and supported by the Forgotten Man's taxes.

The arts and humanities groups (museums, symphony orchestras, theaters, painters, sculptors, writers, etc.) claim they are entitled to receive—and do receive—millions of dollars of government aid. And all this comes from taxes paid by our Forgotten Man.

He is told that certain categories of citizens—and even non-citizens—are entitled to have legal counsel furnished by the government, and this expense is to be borne by him through his taxes.

He is told that certain classes of citizens are entitled to food stamps, and he must pay for this through his taxes.

Our Forgotten Man is told that when a large national bank in a great city makes ill-advised energy loans that jeopardize the bank's capital structure, the federal government should infuse billions of his tax dollars into that bank in order to save it.

In short, he is advised by liberal spokesmen that all the poor and unfortunate of the land should be taken care of by the government, and that he (the Forgotten Man) should pay for all this. Never mind whether many of the poor and unfortunate became so through their own negligence.

The Forgotten Man is told that besides managing his own life he also should manage others' lives. In that regard the late Leonard E. Read stated, "Managing one's own life is complex enough, managing the lives of others is impossible."³

And to support all this government spending again the Forgotten Man is called upon:

He is the Forgotten Man. If we go to find him, we shall find him hard at work tilling the soil to get out of it the fund for all the jobbery, the object of all the plunder, the cost of all the economic quackery, and the pay of all the politicians and statesmen who have sacrificed his interests to his enemies.⁴

Human Motivation

The Forgotten Man of whom we speak is in fact a very uncommon man in view of the burden cast upon him. He is a man of utmost integrity, and he has been so since civil social experience began. He has searched for certain ends and purposes in life and sought to reach

them. He does not welcome all the burden that so many well-meaning people impose on him, since he places first in all his thoughts the provision for his own family's welfare. The history of mankind shows this strong incentive is continually reduced by the state, as well stated by Russell Kirk in his book on conservatism:

A . . . motive always has been the desire to provide for the welfare of one's own family and heirs; but the assumption by the state of the functions of education, economic management, and responsibility even for foods-supply and housing, has diminished the responsibility of the individual here, while taxation has hacked at the very foundation of the idea of bequest.⁵

Today, as at the turn of the century in Sumner's time, the Forgotten Man is paying the public cost of those who do not pay their share. In the Forgotten Man we behold the principle of dualism present in every person who pays his expenses and also those of the state. "He will . . . accept heavy taxation if he feels it necessary for the maintenance of Society, yet make every legitimate effort to keep his own contribution as low as possible."⁶

This is the same Forgotten Man who during the war years of the nation does all of the fighting and most of the dying. In many of these wars he is told he is fighting for democracy, when in many cases the countries he is trying to save do not know the meaning of democracy.

When we are discussing the rights of our Forgotten Man, we are dealing in the field of civil liberty. In this respect William Graham Sumner ably stated it this way:

The notion of civil liberty which we have inherited is that of a status created for the individual by laws and institutions, the effect of which is that each man is guaranteed the use of all his own powers exclusively for his own welfare.⁷

All of history and philosophy tells us that the free citizen in a democracy should be guaranteed the exclusive enjoyment of all that he produces through work. It certainly is not the function of the state to make men happy; they must do it in their own way, and at their own risk.

The Oppressive State

For the Forgotten Man to be told by his own government or by other spokesmen that he has a duty to support others who do not support themselves, is to accept dictation by a privileged class that is asserting itself to create an immoral political system. This imposes upon his earnings an ill-defined duty to make others happy. Our Forgotten Man rebels at this duty others cast upon him because he wants the state to be kept within reasonable bounds of power and function. He full well knows that the state has a tendency to become oppressive.

The social doctors focus their attention on a group of people—the poor, minorities, workers—appealing to sympathy and imagination, and devising programs to care for them. They (the social doctors) set in force motion and forces that react throughout the entire fabric of society, and in the furtherance of their grandiose plans ignore the effect upon other members of society. They have developed the myth of a government competent to solve problems. They forget "that the State cannot get a cent for any man without taking it from some other man, and this latter must be a man who has produced and saved it. This is the Forgotten Man."⁸

Their programs thus shift capital from one group of men to another. The men from whom the capital is taken, individually, are the Forgotten Men. This transfer takes from one and gives to another, who performs no productive effort to earn the property that comes his way. The property transferred—usually money—is diverted from productive use. The person who produces this property is our Forgotten Man. This largess brings to mind the illustration of a man who gives a hungry man a fish. The better plan for the small philanthropist to follow here would be to give the hungry man a fishing pole and teach him how to fish. When he is hungry again, he will fish for his meal and not ask for a handout. Sumner phrases the situation in this manner:

There is an almost invincible prejudice that a man who gives a dollar to a beggar is generous and kind hearted, but that a man who refuses the beggar and puts the dollar in a savings-bank is stingy and mean. The former is putting capital where it is very sure to be wasted.⁹

In the above example the man who placed the dollar in a bank will start a process of the dollar going into the labor market as a demand for productive services. The real party in interest is the man who performs the productive service. He is the Forgotten Man. He is the one who the social doctors never think of when they lay their plans.

The way to keep the state within bounds is to restore to the individual his sense of self-reliance and the control of his private property and right to inheritance

The conservative is no anarchist, he knows that the just state, kept within reasonable bounds of power and function, is a force for our common betterment; but today the danger is that the state shall become all, quite as oppressive as the danger, in other times, that the state might waste away to nothing.¹⁰

The state certainly has a proper interest in expanding the opportunities for its free citizens to pursue their happiness. In this free democratic society, of which we speak, the only duty a free man has to other men of his same rank and standing is to render the others respect, courtesy, and good-will, here his duty ends. In other words, what we are saying is that men who have not done their duty to others in the world never can be equal to those who have done their duty tolerably well. The class distinction which we see in a democratic society results from the different degrees of success whereby men have utilized their chances from opportunities placed before them. Sumner, again, says it well: "Instead of endeavoring to redistribute the acquisitions which have been made between the existing classes, our aim should be to *increase, multiply, and extend the chances.*"¹¹

If, as a nation, we try to satisfy every demand put forth by the social planners who endeavor to help the "poor," we'll learn that there is no way to meet such a ravenous appetite. We might just as well try to bail out the Atlantic Ocean with a sieve.

At every step in the process of government, we should examine the effect on the Forgotten Man, since on his economic and political health depends the safety and security of our nation.

1. Richard O'Connor, *Pacific Destiny* (Little-Brown & Co., Boston-Toronto, 1969), p. 258.

2. *Ibid.*

3. Leonard E. Read, *Meditations on Freedom* (The Foundation for Economic Education, Inc., Irvington-on-Hudson, New York), p. 22

4. William Graham Sumner, *What Social Classes Owe to Each Other* (The Caxton Printers, Ltd., Caldwell, Idaho, 1978, Eighth Caxton Printing, 1978), pp. 125-126

5. Russell Kirk, *A Program for Conservatives* (Henry Regnery Co., Chicago, 1954), pp. 106-107.

6. Karl Mannheim, *Freedom, Power, and Democratic Planning* (Oxford University Press, New York, 1950), p. 282.

7. Sumner, *op. cit.*, p. 30

8. Sumner, *op. cit.*, p. 108

9. Sumner, *op. cit.*, p. 109

10. Kirk, *op. cit.*, p. 120

11. Sumner, *op. cit.*, pp. 144-145

The Growth of Government in the United States

by Robert Higgs

Big government—we heard a lot about it when Ronald Reagan was first seeking the Presidency. Lately the topic has attracted less attention from politicians, commentators, and scholars. But the thing itself has not disappeared. Over the past decade, as over the past century, American government has continued to grow.

Our nation was founded by men who believed in limited government, especially limited central government. They were not anarchists; nor did they espouse *laissez faire*. But they did believe that rulers ought to be restrained and accountable to the people they govern. If the founders could see what has happened to the relation between the citizens and the government in the United States during the past two centuries, they would be appalled.

The size and scope of government are important for many reasons. By virtue of their taxing, spending, and regulating, governments affect the allocation of economic resources, the distribution of wealth, and the rate of economic growth. Governments determine the very nature of our political economy, the character of the social organization within which we may lawfully conduct our affairs and pursue our goals. The size and scope of government determine—they are, so to speak, the opposite side of—our freedoms.

All but the few anarchists among us recognize that effective liberty requires *some* government, if only to define and protect rights to life and property. Beyond a point, however, bigger government begins to cut into our liberties, then the growth of government becomes synonymous with the sacrifice of liberty. In the United States, we entered this stage a long time ago.

Robert Higgs is the Thomas F. Gileed Professor of Business Administration in the Albers School of Business, Seattle University, and the author of *Crisis and Leviathan: Critical Episodes in the Growth of American Government* (Oxford University Press, 1987). This article, based on Professor Higgs' observations as the Fathauer Lecturer at the University of Arizona on April 2, 1990, appeared in *The Freeman*, August 1990.

Charting Government's Growth

When we say that government has grown, what do we mean? Government is not a single thing, measurable along a scale like inches of height or pounds of weight. The size of government can change in different dimensions, many of them incommensurable.

One dimension of government is the burden of taxation. In the early years of the twentieth century, federal, state, and local governments took in revenues equal to 6 to 7 percent of the gross national product (GNP). By 1950, revenues had risen to 24 percent of GNP. Over the past 40 years the tax proportion has drifted irregularly upward, and now stands at about 32 percent of GNP.

Many people seem to think that taxes were cut in the 1980s, perhaps because certain politicians worked hard to create the impression and to take credit for it. The truth, however, is that overall—that is, considering all taxes together—taxes as a percentage of GNP were slightly higher at the end of the 1980s than they were at the beginning of the decade. The tax laws were changed repeatedly, and some tax rates were reduced, most notably the top rate of the federal individual income tax. But other taxes were increased, most notably the payroll tax rate and the base earnings on which it is levied. Altogether, there has been no tax cut.

Another dimension of government—and an even more appropriate index of its fiscal burden than tax revenues—is government spending. In the early years of the twentieth century, federal, state, and local governments spent an amount equal to 6 to 7 percent of the gross national product. By 1950, government outlays, net of intergovernmental grants, had risen to 21 percent of GNP. Over the past 40 years the spending proportion has drifted irregularly upward, and now stands at about 34 percent of GNP.

Many people seem to think that a so-called Reagan Revolution cut government spending in the 1980s. In fact, nothing of the kind happened. Government spending continued to grow rapidly, and relative to GNP it was slightly greater at the end of the 1980s than at the beginning of the decade. Of course, some forms of spending grew relatively slowly, some relatively rapidly, but overall government spending grew faster than the private economy.

Still another index of the size of government is government em-

ployment. Early in the twentieth century federal, state, and local governments employed about 4 percent of the civilian labor force. By 1950, government employment had risen to about 10 percent. During the past 40 years, government employment rose and fell: it reached a peak in the mid-1970s at nearly 16 percent, then fell to its present level of roughly 14 percent—that is, one worker in every seven. (This figure doesn't include the two million members of the armed forces.)

Although the employment ratio seems at first glance to indicate a recent decline in the government's size, one should not jump to that conclusion. Many people who are classified as members of the private labor force actually work for governments as contractors (or employees or subcontractors of contractors). Between 1980 and 1987, for example, about a million additional workers found jobs in the defense industries—virtually all of them, obviously, working on projects set in motion and financed by the government. Similar changes have occurred elsewhere as governments have "privatized" more functions by contracting out the performance of tasks previously performed by workers on the regular government payroll. It would be a mistake to suppose that government has shrunk just because regular government employment hasn't kept pace with the growth of the labor force.

Increased Regulation

Indexes of government taxing, spending, and employing tell us something about the growth of government, but what they tell us is far from the whole story. Even if government had grown in none of these dimensions, it might have become a bigger factor in determining the allocation of economic resources, the distribution of wealth, and the rate of economic growth. It could have done so—and in fact it has done so—by means of increased regulation.

I refer to regulation in its broadest sense, including the legal requirements expressed in statutes, executive orders, and judicial decisions as well as the directives of regulatory agencies such as the Environmental Protection Agency and the Securities and Exchange Commission. The shelves are sagging under the growing weight of such authoritative commands—just skim through the *Federal Register* some time if you are willing to risk becoming deeply depressed, or, for an even more profoundly depressing experience, attempt to read any re-

cent regulatory statute, say, a consumer protection law. Tax laws also are *de facto* regulatory statutes, and perhaps the most incomprehensible of all legislation.

In regulation we come face to face with the visible hand of government at work imposing largely hidden costs. The costs are hidden in part because they are borne by private parties in the process of compliance—meeting prescribed standards, avoiding prohibited actions, and so forth—and spread across the consuming public in the form of higher prices for goods and services.

But that cost, great as it is, is not the whole. In large part the costs of an economy extensively controlled by government requirements and prohibitions take a form no one can compute: these costs arise when governments distort the price structure so that mutually beneficial exchanges are never made, so that new products never reach the market, so that new competitors never gain entrance into an industry, so that innovations of countless different sorts are never made, there being no prospect of profit to stimulate their development in the first place.

Americans, despite much habitual grumbling, are proud of their economy, which continues to rank among the world's most productive. What we have done, we can see and appreciate. But what we might have done, the miracles we might have wrought had we been free to do so, we shall never know. In this sense, the costs of an ever more regulated economy are truly incalculable.

But what of the recent deregulation we have heard so much about? Yes, something did happen along those lines. In energy, communications, transportation, and certain financial services, the heavy hand of government lightened somewhat in the late 1970s and early 1980s. By the mid-1980s, however, the steam had gone out of the deregulation movement, and little significant progress has occurred during the past five years.

Meanwhile, offsetting increases of regulation were taking place in other areas, including international trade and finance, environment, safety, agriculture, aerospace, insurance, and health services. The multi-billion-dollar bailout of the farm credit system might have deserved prominent mention had it not been completely overshadowed by the gargantuan bailout of bankrupt savings and loan institutions. In view of the mind-boggling magnitude, it is remarkable how little political debate surrounded this transfer of—who knows? \$300 bil-

lion? \$400 billion?—from the taxpayers to a select group of hard-lobbying beneficiaries.

Standing back and surveying all the regulatory changes, plus as well as minus, during the past decade, what can we conclude? I defer to the judgments of William Niskanen and Murray Weidenbaum, two of the best informed students of the subject. Niskanen concludes that "the net amount of regulations and trade restraints has increased" since 1980, and Weidenbaum says that "the federal government, objectively measured, is a bigger presence in the American economy today than when Jimmy Carter left office." So much for deregulation.

The Reasons for the Growth

So, government is still big, and government is still growing in the United States. Why? To answer this question, we need to understand some history. To start with, we need to find out whether American government was ever really small and, if it was, what made it get bigger.

You may recall from your school history text that the United States government in the mid- and late-nineteenth century adhered to the doctrine of *laissez faire*—the doctrine of hands off. Well that lesson conceals more than it reveals. In fact, in important respects the label of *laissez faire* shouldn't be applied at all. At no time did the United States fully achieve the condition denoted by the term *laissez faire*.

From about the 1840s to the 1890s, however, the United States approximated perhaps as closely as any large society ever did a condition we might call the minimal state. Certainly, governments didn't spend or tax on anything like the modern scale—5 percent of GNP would probably overstate the ratio. (We must rely on imprecise estimates, so we can't say for sure.) Not many people worked either directly or indirectly for governments, certainly no more than a few percent of the labor force even at the end of the nineteenth century. By these familiar indexes of the size of government, the nineteenth-century government appears to qualify as a minimal state.

And yet, to say that government was much smaller in these dimensions is not to say that the governments of the nineteenth century were unimportant or that Americans were reluctant to politicize essential economic questions.

Most important, governments established the legal framework of

property rights within which the price system could operate to allocate resources. As economic conditions changed, governments molded the law to new conditions and allowed economic growth to continue relatively unimpeded by obsolete legal restraints. Innovation of the doctrine of eminent domain, for example, played a crucial role in permitting construction of the canals and railroads that did so much to facilitate economic development.

In addition, the central government episodically committed the nation to war—at times to wars of conquest such as the Mexican War that added vast territories to the country's expanse. Governments disposed of the public domain, transferring the bulk of it, by sale and giveaway, into private ownership. Governments collected various taxes, including the tariff that was employed to carry out what nowadays would be called an "industrial policy." Governments invested in and regulated banks and transport systems, they supplied education; and at the local level they conducted the countless interventions subsumed under the heading of "the police powers," many of which would be found intolerable in our time. Before the Civil War, governments sustained the institution of slavery, a matter of momentous economic consequence as well as an arrangement so violently incompatible with higher American ideals that today no one would defend it. In sum, governments in the nineteenth century, though in most respects far more limited than governments today, were hardly insignificant.

In certain respects, nineteenth-century conditions made it possible for governments to be much smaller than they are today and still wield great power over the economy. Nineteenth-century governments didn't spend a lot of money to enrich politically influential parties. But they enforced slavery, a momentous matter all by itself, they disposed of the public domain (federal railroad subsidies alone transferred an area roughly twice the size of Colorado), and they managed property rights in fundamentally important ways. One reason modern governments do so much more by means of taxes, subsidies, and pecuniary transfers is that they lack some of the powerful means available to their predecessors—millions of workers to hold in thrall, a continent to give away.

Having acknowledged that *laissez faire* never was the case, and that even at its smallest, American government engaged in extremely important activities, we must recognize that governments still might

have been much bigger than they were during the nineteenth century. One way to confirm this potential is to notice that, occasionally, government did get much bigger. During the Civil War the U.S. government not only increased its taxing and spending hugely; it also printed and spent fiat paper money, overrode a variety of civil rights, including the writ of habeas corpus, and conscripted men to serve in the army. After the war, however, the government shrank—not quite to its pre-war dimensions, but back to a more traditional scope nonetheless.

At the end of the nineteenth century, James Bryce, a perspicacious British commentator, noted that America's poor, long invested with political rights, might easily have turned on the rich and "thrown the whole burden of taxation upon them, and disregarded in the supposed interest of the masses what are called the rights of property." But, Bryce went on to say, "not only has this not been attempted—it has been scarcely even suggested—and it excites no serious apprehension." There was, he observed, "nothing in the machinery of government that could do more than delay it for a time, did the masses desire it." What prevented such sweeping redistribution was, in Bryce's judgment (and mine), the prevailing ideology. In Bryce's words, "equality, open competition, a fair field to everybody, every stimulus to industry, and every security for its fruits, these [the Americans] hold to be the self-evident principles of national prosperity."

A Revolution in Ideology

Obviously, somewhere along the line, the dominant ideology of the United States has undergone a complete revolution. I exaggerate only a little if I say that now most Americans believe that governments may legitimately give to people or take away from them virtually anything, any time, any place—checked only by the license conveyed by government officials' having been elected in the Constitutionally sanctioned manner. Where once Americans viewed the powers of government as properly limited and the rights of individuals as primary and natural, Americans now view the powers of government as properly unlimited and the rights of individuals as subordinate to the pursuit of any declared "public policy." How did so many activities once viewed as "not the proper business of government" come to be undertaken by governments and accepted as legitimate?

I have no short, definitive answer. The process by which the domi-

nant ideology of the American people changed over the past century is surely complex, and no one understands it fully. It is possible, however, to identify certain critical aspects of the process.

Ideologies are, to a large degree, the product of people's social experience. Although polemicists and propagandists are always at work, they don't work in a vacuum. Ideas appeal to the public more or less, depending on how they seem to fit the broad contours of reality. When great events happen, ideologues always stand ready to interpret in a preconceived way what has happened, but again they are constrained by undeniable facts. It just wasn't possible, for example, to interpret the Great Depression as a triumph of capitalism.

With the economic transformation of the United States in the late nineteenth century, a process that witnessed rapid urbanization and the growth of big business as well as many other striking developments, collectivist views began to gain adherents here, as they did throughout the Western world. The ideological shift became quite striking during the Progressive Era at the beginning of the twentieth century. It was not unconnected with such consequential institutional changes as the Income Tax Amendment to the Constitution and the creation of the Federal Reserve System. So, clearly a tendency existed, rooted in the changing character of American society and economy and related developments abroad, moving American opinion leaders away from support for individualism and private property rights and toward support for collectivism and more active government involvement in economic affairs. By itself this tendency would have helped to promote the growth of government. But the secular tendency of ideology was hardly the only aspect of ideological change to affect our political economy in the twentieth century.

National Crises Contribute to Shifting Views

Even more important, in my view, was the succession of national emergencies that struck the country between 1914 and 1945, and to a lesser degree during the postwar era as well. Clearly the world wars and the Great Depression had the greatest impact, although the period from the mid-1960s to the mid-1970s also witnessed many significant events. How did these crises contribute to shifting American views about the proper role of government in economic life?

In brief, the process worked as follows. First, each crisis gave rise

to public clamor that the government "do something." In the post-Progressive era, no government wished, nor could rulers expect to prosper politically if they chose, to keep their hands off the economy when a problem of overriding public concern had arisen. So, whether to prosecute a war or to alleviate a depression or to suppress a great labor upheaval, the government adopted interventionist policies to deal with the crisis.

Any government policy entails costs. The greater the costs, the less willing the public is to support the policy. Hence governments face a hard choice: on the one hand they cannot just stand by, because the public demands that they act, on the other hand, any policy they adopt is subject to the law of demand, which means that, in the extreme, the public will reject a government that imposes unbearably large sacrifices on the citizenry. How can the government get off the horns of this dilemma?

The short answer is: adopt policies that obscure the costs as much as possible. One way to do so is to avoid policies that entail pecuniary (and therefore easily counted, aggregated, and publicized) costs; instead, adopt command-and-control policies whose costs tend to be hidden or extremely difficult to compute and aggregate.

For example, if an outright gift of public funds is made to farmers, everyone can see how much the government is taking from taxpayers in order to give to farmers. But if the government adopts crop restriction programs, the costs are spread across all those, including foreigners, who purchase the farm products whose supplies have been restricted. Who can say how great the transfer is? Indeed, many people will never appreciate the redistributive aspect of the program, as they would if an explicit farmer-benefit tax had been enacted and added, say, as a separate item on the income tax return.

Other prominent examples include the conscription of men into the armed forces, the suppression or restriction of certain industries or products during wartime, the establishment of priorities for the supply of selected goods and services, the rationing of consumer goods, and a whole array of price, wage, and rent controls that distort the structure of prices and alter the allocation of resources, benefiting some while placing burdens on others. The common aspect of all such policies is that their costs are more or less hidden, and hence the political reaction to them is muted.

When the government adopted cost-obscuring policies during the

great national emergencies, officials also undertook massive propaganda efforts to justify their actions. No doubt many citizens believed what their leaders told them about the virtues of the policies. In addition, during each crisis the administrators of the controls finessed them to eliminate some of their most objectionable aspects, and people more readily swallowed the medicine when its bitterness was diminished. All the while, people tried to make the best of a bad situation, and many discovered that even a controlled economy offers certain avenues to personal success, either within the government itself or within the favored sectors of the remaining "private" economy. People adapt.

But here is the crux: they adapt not just their actions but eventually their thinking, too. In William Graham Sumner's telling phrase, "it is not possible to experiment with a society and just drop the experiment whenever we choose. The experiment enters into the life of the society and never can be got out again." People who had experienced the abruptly enlarged government programs of the national emergency periods came away from those experiences with an altered view of the benefits and costs, virtues and vices, of an expanded government presence in American economic life. Further, in each case, committed collectivists took advantage of the event to hammer home the point that what the government had done, apparently with success, during the crisis demonstrated the great potential for good that lay in expanded government action even during normal times. To many people, the argument seemed to make sense. After all, we had won the war, we had got out of the depression.

In retrospect and with careful study, one can see that people were committing the fallacy of *post hoc, ergo propter hoc*. In many cases, if not in all, the genuine benefits accruing to the nation as a whole—escape from the depression, defeat of the Nazis—came forth in spite of, not because of, the government's imposition of sweeping controls. But, again, people in general didn't reach this conclusion. Rather, they tended to accept the collectivist claims or, more cynically, to appreciate that even if the country at large might suffer, they themselves now had a grip on a personally rewarding piece of the statist program.

By the end of World War II the United States had altered its effective Constitution radically from the regime in place at the beginning of the twentieth century. Now virtually any government action whatever in relation to the economy could be taken, so long as an electoral majority could be obtained by its initiators. In a political

economy so corrupted by interest-group politics, an electoral majority was itself something that could be bought, indirectly if not directly. There remained no fundamental check on the growth of government—nothing to perform the restraining functions that the old Constitution and the dominant limited-government ideology had performed in the nineteenth century. Politicians now could offer to sell virtually any economic policy whatever, no matter how few the gainers and how many the losers. Of course, such conditions were tailor-made to bring forth special interests prepared to buy the policies from the politician-suppliers.

In the welter of largely contradictory policies, deadweight costs mounted enormously. More and more resources were devoted simply to working for or against economic policies and to circumventing or adapting to the proliferating requirements imposed by government. Not surprisingly, more and more latent interest groups saw the need to organize for political action. By the 1970s the entire economy had been thoroughly politicized, so that even the most intimate matters, such as babysitting services or nursing homes or the religious calendars of employees, had become subject to government intervention. A few years ago, Grace Commission investigators discovered that the federal government alone was conducting 963 separate social programs, many of them designated "entitlements." America's political process has become the locus of organized predation on a massive scale.

The growth of government cannot continue forever. An economy totally dominated by government isn't viable—even the Communists now recognize this. Eventually the government will eat up so much of the private sector that it will destroy the means of its own sustenance. At some point the balance of political power will swing away from support for bigger government in an effort to revive the dying goose that lays the golden eggs. If such reaction can occur in the Soviet Union and Eastern Europe, it certainly can occur here.

But that glorious day, in my judgment, is not yet in sight. Despite the plethora of burdens laid on the American people, the private economy retains sufficient vitality to limp along at a modest pace, albeit far slower than a truly free economy could progress. And the American people continue to demand, or at least to tolerate, a multitude of government programs promising solutions to almost every conceivable problem. So long as the dominant ideology lends support to collectivist measures and acquiesces in a political system dominated by special-

interest deals, no far-reaching reform of our political economy is possible. So, as we look into the future of the United States in 1990, as far as the eye can see, we behold only big government and more big government.

III. REGULATING PRODUCTION

Incentives and Income Taxes

by Russell Shannon

Here's an intriguing opportunity. A book club now offers two free books to any member submitting the name of a friend who wants to join. But if you submit a *second* name, you will get *five* books!

Why does the club offer more than twice as much "pay" for just twice as much product? Is the offer obligatory or just odd? Surprisingly enough, it goes a long way toward explaining the movement to reduce income taxes.

Finding a second friend to join the club could be considerably more difficult than finding the first. You may have to travel further, or talk longer to convince him. That makes the larger reward crucial.

But what if extra effort were unnecessary? What if you could convince two friends of the benefits of membership simply by making a 15-minute phone call to each one? As it turns out, even then an additional incentive may be needed.

Examples of this fact pervade our economic lives. The need to increase incentives regularly appears whenever companies want employees for overtime work, usually they must pay workers time-and-a-half, even though the duties involved do not differ from the ordinary routine. Similarly, when you buy a box of cereal in the supermarket, you may receive along with it a coupon worth ten cents on a second box.

Diverse though these examples may seem, they all have one thing in common. They all illustrate the fundamental economic principle of "diminishing marginal returns." Sometimes, the same principle is called the law of "increasing costs."

Understanding of this principle dates back at least two centuries. In 1789 Thomas Malthus published his thoughts on population.¹ Using data provided by Benjamin Franklin and others, Malthus predicted that population growth eventually would outstrip the food supply.

Russell Shannon is a professor in the Department of Economics, College of Industrial Management and Textile Science, Clemson University. This article is reprinted from the November 1981 issue of *The Freeman*.

That prediction is one of the reasons economics even today is called the "dismal" science. In current discussions of famine in Third World countries, references to the "Malthusian specter" are not unusual. In Aldous Huxley's famous novel *Brave New World*, women wear "Malthusian belts" designed to prevent conception and control population growth.² But what has Malthus to do with book clubs and income taxes?

If you take time to find a friend to join a book club, you will be confronted by a cost. The cost isn't necessarily money—unless you actually take time off from your job. But you will have to give up working in your yard, playing a game of bridge, or watching TV.

Such a sacrifice might be fairly easy to make while finding the first friend. But what about the second? Giving up one TV program or half an hour of your yard work may not mean much. But the second half hour will surely mean more, that is, the cost increases. So you will need a larger reward to compensate. The people who run the book club obviously know this, and they have acted accordingly.

By the same token the company that sells cereal knows that a second box of their product will be less attractive to most people than the first. The cost—or opportunity forgone—will be larger. Thus, by making them a better offer on the second box, the company may entice people to buy more.

Progressive Rates of Tax

All of this may seem strangely remote from the matter of income taxes, but in fact it is not. Both our federal and our state income taxes are "progressive." That means that, as people earn larger incomes, they move into higher income tax brackets. So more pay means they end up sending a larger share of their income to the government.

Several arguments support the progressive system, not all of them objectionable. Some people, of course, urged on by envy, merely like the idea of trying to "soak the rich." Others, however, talk in terms of people's ability to pay; they maintain that wealthier individuals can surely afford to shoulder a larger share of the tax burden. But what effect do rising tax rates have on the incentive to work?

Clearly, the progressive rates generate a perverse response. Consider, for example, a married person whose employer offers him the opportunity to do more work and earn more income. Say this em-

ployee, in exchange for ten percent more work, could get 15 percent more pay. Based on what we have just discussed about human inclinations, we would reasonably expect the employer to make that kind of offer.

But the increase in pay may shift the employee into a higher income tax bracket. If his taxable income were about \$20,000, he could, as a result of the pay increase (and based on 1980 federal income tax rates), vault from paying 28 percent on marginal income to paying 32 percent. Thus the incentive to work may be so diminished that it will no longer be attractive.

For someone in an even higher income tax bracket, the adverse effect is augmented. Thus, to secure the employee's services, the employer would be forced to make an even better offer. Of course, the job might be offered to someone else but he might lack the competence. Thus the job will go unfilled and the work undone, and society will be the poorer for it.

In recent years, Congress has graciously refrained from raising our income tax rates. However, Social Security taxes have risen dramatically. Simultaneously, inflation, prompted largely by the rapid growth of government spending, has shoved more and more Americans into higher and higher income tax brackets.

Thus there is less and less incentive to earn incomes that are taxable. So unless we like more leisure, we are increasingly inclined to enter the so-called "underground economy."³

Of course, that doesn't mean people are actually burrowing beneath the soil—or looking for oil. Instead, they engage in barter or else make payments in cash, seeking thereby to escape the ever watchful eyes of the Internal Revenue Service.

In one case, for example, a worker presented a bill for some repair work to a homeowner for \$30. When the owner started to write out a check, the worker demurred and insisted instead on receiving cash. But when the owner discovered he had only \$25 in his wallet, the worker accepted it, gladly sacrificing the \$5 rather than pay taxes on \$30!

The Underground Economy

The phenomenal growth of such activities has become so substantial that, by some estimates, our "underground" activity may now be

the equivalent of 20 or even 30 percent of Gross National Product. Certainly, this production is, in some sense, less desirable than it would be if everything were out in the open. Besides that, our government is losing tax revenue which might otherwise be used to build schools or shore up our national defense.

If tax rates fall, American workers will have greater incentives to produce goods and services for American consumers. Some people who are already working will leave the underground for the more efficient open economy. Thus, income subject to taxation will grow.

In fact, it's even possible that, though income tax *rates* fall, the increase in taxable economic activity will be so great that tax *revenues* will rise. That is the thesis underlying the now-famous Laffer curve originated by the economist Art Laffer.⁴ The implication is that, while tax rate cuts will directly benefit individuals, in the end society as a whole will prosper.

At first glance, you might have thought the book club's offer was either totally absurd or grossly irrelevant. But it's not. It bespeaks a universal truth which underlies much of the current "supply-side" economics. When you understand that additional effort often requires increasing rewards, then, along with many others, you may be eager to ride the tide of enthusiasm rising relentlessly behind the tax reduction program.

1. T. R. Malthus, *An Essay on Population* (New York: F. P. Dutton and Co., 1958). See Vol. 1, Book 1, Chapter 1, pp. 5-11.

2. Aldous Huxley, *Brave New World* (New York: Bantam Books, 1962), p. 34.

3. See Alfred I. Malabre, Jr., "Underground Economy Grows and Grows," *Wall Street Journal*, October 20, 1980, p. 1; Robert M. Bleiberg, "Surfing the Scratch," *Barron's*, February 9, 1981, p. 7.

4. See Edward Meadows, "Laffer's Curve Picks Up Speed," *Fortune*, February 23, 1981, pp. 85-88; "A Guide to Understanding the Supply Siders," *Business Week*, December 22, 1980, pp. 76-78; Rowland Evans and Robert Novak, "What 'Supply Side Economics' Means to You," *Reader's Digest*, June 1981, pp. 118-122; "Laffer: A Steady Supply of Ideas," *Newsweek*, June 29, 1981, pp. 11-13; "The Laffer (not laughter) Curve" in Richard B. McKenzie and Gordon Tullock, *The New World of Economics: Explorations into the Human Experience* (Homewood, Ill.: Richard D. Irwin, 1981), pp. 227-241.

Educational Vouchers: The Double Tax

by Gary North

All State education is a sort of dynamo machine for polarizing the popular mind, for turning and holding its lines of force in the direction supposed to be most effective for State purposes.

—Henry Adams, *The Education of Henry Adams*

We are continually bombarded by newspaper and magazine headlines informing us of the continuing "crisis in education," which actually is a crisis in government-operated education. Virtually all the available data reveal that the crisis is accelerating. Inner-city schools have become literal battlefields between rival gangs, between teachers and students, between administrators and increasingly vociferous faculty unions, and most important, between outraged parents and the whole system. Yet the crisis is in no way confined to inner-city schools. The suburban schools of the white middle class are burdened with the multiple plagues of student boredom, drug addiction, and rapidly increasing alcoholism. A dozen years of falling scores on the college entrance examination reveal the steady nature of the erosion, despite the acceleration of costs associated with the public schools.

Educators cannot bring themselves to admit that the crisis is anything more than a temporary aberration—an aberration from the "normal" which itself was dead long before today's administrators were born. The theories multiply, the explanations proliferate, and the crisis gets worse. What the last decade has brought is an understanding on the part of the public and a minority of government school employees (untenured, generally) that there is no answer.

Like the sinking ship which finally takes on too much water, the government education system is irretrievable. It will be useful in the future only as scrap. But what about those millions of students who

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Dr. North is President of the Institute for Christian Economics, Tyler, Texas. This article, which originally appeared in the May 1976 issue of *The Freeman*, is reprinted here by permission of the author.

will go through the system before it finally sinks? Will they too become useful only as scrap?

Parents are becoming aware of the discussion syndrome. The endless discussions in half-empty halls between a few parents and local administrators have not altered anything. The teacher conferences, the administrator conferences, the PTA conferences, and all the other conferences have proved useful only for the cataloguing of the unsolved and increasingly unsolvable problems connected with government education. Solutions have not emerged from conferences—or at least no solutions acceptable to parents, administrators, school boards, students, state legislators, and an angry group of levy-rejecting voters. If there are no solutions, why pay higher taxes? This is the reasoning of the voters. The reasoning of the school administrators is different. They only want to discover a new source of tax money that will be acceptable to the voters, or better yet, that will not be subject to public elections at all.

The Root of the Crisis

The problems of American public education are the problems associated with any system of government enforced, tax-supported coercive wealth redistribution—the system of financing conflicts with the expressly stated goals of the planning agencies. This conflict between the method of financing and the stated goals of education has been with us since the days of the Puritans of New England who set up compulsory education which was to be financed, in part, by money collected by the local property tax assessor.

There is no education apart from conformity of thought. One thing is true and another is not. Education requires indoctrination. But the conformity of thought which is basic to all education creates conflicts when parents of differing first principles are required either to finance a hostile educational system or to send their children to it. The Puritans' solution was to enforce conformity by expelling hostile families from the community. The modern bureaucrat's solution is to force parents to finance an alternative school system as well as the government system, and then to take control of the private system later on. Sidney E. Mead, in his important book, *The Lively Experiment: The Shaping of Christianity in America* (1963), has argued perceptively that the public school system is America's only established church. His

point is well taken. Like all systems of established worship, some people are forced to finance doctrines and principles that they do not agree with. They resent this fact, but instead of seeking for the separation of "church" and state, the modern parent only seeks to "recapture" the public education system. So deeply rooted is the idea of the necessity of public-financed education that those who are being destroyed by the system—who are losing their children to the system—cannot bring themselves to abandon it on principle. If the moral answer of the free man to the socialist's policies of coercive wealth redistribution is "not yours to give," then the moral answer to those who would somehow take over the public school system is "not yours to recapture." The religious nature of the conflict has been noted by R. J. Rushdoony: "The state is [seen as] the order of liberty, and the school is the means whereby citizens are prepared for the good life. The state has become the saving institution, and the function of the school has been to proclaim a new gospel of salvation. Education in this era is a messianic and utopian movement, a facet of the Enlightenment hope of regenerating man in terms of the promises of science and that new social order to be achieved in the state."¹ Yet precisely because the new state religious establishment has become messianic, it has also become the center of men's criticism.

Education today occupies an equivocal position in contemporary life functioning both as a scapegoat for every failure and as a catch-all for every hope and expectation of society. The schools and colleges are berated for extending their authority beyond the fundamentals of learning into a program which envelopes the whole child or the whole man, and, at the same time, are given additional responsibilities which can only extend their scope even further. Fundamental to this unhappy and contradictory approach is a messianic expectation of education coupled with a messianic attitude on the part of educators. The attitude of people towards education is that it is a god that has failed and yet a god who can perhaps still be whipped into fulfilling his mission."²

The decade which has just passed—one which began only a few months after these words were published—has brought a massive disillusionment concerning education. Nevertheless, the public's faith in

government-financed and administered education still persists, at least to the extent that people think the system can still be reformed, transformed, or recaptured.

The pluralism of American life is now, and always has been, in direct opposition to a philosophy of public education. Yet the irreconcilable conflict between these two principles has never been faced by the vast bulk of our citizens and virtually any of its educational theorists. The financing of a pluralistic culture must be voluntary, springing from the deeply felt needs of the various religious, intellectual, and cultural groups.

Three centuries of conflict over the control, content, and financing of public education serve as a testimony to the futility of combining a system of tax-financed schools with a pluralistic culture financed by free men. The system of education is elitist, as all professional systems must be, but with taxation as its base, the system is in conflict with democratic principles. It leads to a system of minority rule. Weber was quite correct when he argued that bureaucracy is antidemocratic by nature; control is separated from those who bear the financial burdens.³ Tenure and civil service protection assure that control and financing are kept separate

The Assumption of Neutrality

An implicit schizophrenia undermines every system of public education. On the one hand, a primary justification for the existence of government-financed education is that the nation needs citizens who are educated for the responsibilities of democratic participation in the political processes. The schools are to educate men in terms of the "ethics of democracy" or "democratic values" or just plain "patriotism." Schools must inculcate "values," although the more vague these are, the better for the administrators.

On the other hand, in order to ward off criticism from various religious and ideological groups, public education is simultaneously defended as a system which inculcates no religious or ideological values whatsoever. Public education is simply technical, making possible a better, more productive, and more profitable life for all of its students. *The stated goals of democratic education and strictly vocational or technical training are in absolute opposition to each other.* The first absolutely af-

firmly the value-laden nature of public education, while the second absolutely denies it.

The schizophrenia of public education can be seen in the doctrine of academic freedom. The doctrine was first developed by the professors employed by the Prussian universities that were the products of state financing. (Prussia invented the kindergarten and the graduate seminar, two of the least productive educational developments on record.) The universities were supposed to be extensions of the Prussian state, and they were understood as such by everyone, but professors wanted to be exempted from any form of censorship or control by the agents of the state. Thus, they invented the idea of academic freedom—the freedom of inquiry belonging to any *certified* scholar in his area of expertise. He is to be entirely neutral, however; his instruction must be based only on facts. He must not indulge in propaganda.

Yet, steadily, as the implications of epistemology have been recognized, the idea that "facts" somehow create a neutral world of scholarship has been abandoned. The so-called sociology of knowledge (sociology of prejudice) indicates that men can investigate only a tiny fraction of the infinite number of facts, glean facts and assembling them in terms of a philosophical framework. Presuppositions therefore influence interpretations and interpretations are now recognized as ultimately religious in nature, i.e., they are accepted as unchallengeable first principles. While few students recognized this fact as recently as the early 1960s, the effects of the Vietnam War and the counterculture have reversed this. The students, and many of their professors, now acknowledge what has always been true: education is not neutral. But if education cannot be neutral, then the public school system's legal pillar—the assumption of neutrality—is exposed as a false justification for the maintenance of an established church and a tenured priesthood.

The Locus of Sovereignty

The ultimate source of the educational crisis stems from an error in first principles. Once committed to this error, the public education system has floundered repeatedly. To locate the source of the error, men need only ask themselves a single question: Who is responsible for the education of a child? The answers, of course, are varied: the parents, the church, the civil government, or a combination of the three.

The conflicts in education are in fact conflicts over a much more fundamental issue: the locus of sovereignty, and hence, the locus of personal responsibility. The person or institution which possesses sovereignty must be the one which takes on the responsibility. By affirming the legitimacy of tax-supported education, voters have attempted to transfer their responsibilities for the education of their children to another agency, the state. Yet at the same time, they affirm their own sovereignty over the content and structure of the educational system. That they have lost almost every battle in their war with tenured, state-supported educational bureaucrats, is the direct result of the public's abdication of personal responsibility, family by family, for the education of their children. The war was lost on the day that parents, as voters, decided to transfer the financial responsibilities of educating their own children to other members of the body politic. While Horace Mann can be regarded as the general who was victorious over private education in Massachusetts, he was only conducting mopping-up operations. The end had been determined two centuries earlier when the Puritans of Massachusetts affirmed the principle of tax-supported education.

Any system of education must ultimately be the reflection of and product of the philosophical principles of those who finance the system. The decision about the financing of any institution inescapably determines the shape and content of that institution. Modern men, being secular, now recognize this fact when applied to the institution of the church. They see that a state supported church is antithetical to the principle of freedom of conscience. They see, and religious zealots like Roger Williams see, that state financed churches become the tools of the state which supplies the funds. But modern men do not see that this strict relationship between financing and operations applies equally well to government school systems. Somehow, the relationship is *ad hoc*; it works when churches are involved, but it is irrelevant in the field of public education. Like the established churchmen of two centuries ago, today's priests and parishioners of the public schools refuse to recognize the nature of their relationship to the state.

Who Pays?

Do men finance their children's educations directly, through the personal financial sacrifice of the family unit? If so, then the family is

sovereign over education. The school is then merely an extension of the family. The family makes use of the efficiencies associated with the division of labor. Parents hire professional educators to train their children, but those who are hired are paid to adapt their educational skills to the needs of the families that are financing the education. This can be done directly, through family-controlled school boards, but it can also be accomplished through the indirect means of the market. The family hires the tutor, or the school, in the same way that it hires any other servant. The parents are directly responsible for their children, and the selection of a school is an act of responsible stewardship. The family has not delegated the responsibility of educating the children to anyone else. It controls the purse strings—the ultimate affirmation of earthly sovereignty.

The more distant the source of the school's funds from the family, the less control the family has over the selection of the teachers and equipment. If the church finances the education of its members' children, then a layer of institutional bureaucracy is interposed between parents and teachers. This may be agreeable to many parents, but if church members other than the parents are expected to finance the school (as is the case in most instances), then they too have a legitimate right to determine school policies.

By transferring some of the burdens of financing education to other church members, the family thereby relinquishes a portion of its sovereignty over the educators. The educators then serve someone other than the parents, or at least in addition to the parents: the deacons, the elders, the minister, the school committee, or whatever. By diluting sovereignty, the educational bureaucrats gain more autonomy, since they can play off one church faction against another until everyone gives up and grants more autonomy to the administrators.

The bureaucrats gain their greatest control in tax-supported systems. Sovereignty is so diluted at the level of the individual citizen that the expertise of the professional and tenured bureaucrats is overwhelmingly powerful. But their power is not tied to a personal relationship with the children (as it is with a parent), nor is it linked to a financial dependence on the parents, nor is it even linked to a community of shared values, as in the case of a church school. Their power stems from the unwillingness of legislators to turn off the funds. And the legislators' unwillingness to interfere stems from two primary facts of political life: 1) the experts have an aura of invincibility about them,

plus tenure; 2) the voters still believe in the establishment of the public school church. It is easier to give speeches than to take action, so legislators give speeches. Most of them are re-elected most of the time, so the policy pays off in the coin of the political realm: votes.

The crisis of education is therefore a crisis in the realm of values, with the values of the parents coming into conflict with the values, philosophies, and incompetence of those in control of the tax-supported educational system. If the parents continue to capitulate to the philosophy of public education, then they will continue to be defeated in their attempts to gain the kind of education they want for their children. There is only one way that all parents can gain such satisfaction: they must pay for the education of their children. They can earn the money or they can convince some third party to give them or their children the necessary funds on a voluntary basis, but the parents must pay. If they want to get what they pay for, they must pay directly, rather than paying through the coercive means of state taxation.

Until men are willing to cut off the political funding of the established church of America, they will see the educational crisis escalate. The visible sign of sovereignty is the ability to pay for a service and the willingness to do so. Nothing short of this will suffice to solve the crisis in the schools, for the educational crisis is ultimately a conflict over sovereignty. He who pays with his own funds will win, he who continues to pay by voting cannot possibly win.

Pseudo-Market Schemes

Professor Milton Friedman of the University of Chicago is one of the most technically proficient economists in America. As a defender of the principle of market efficiency, he has been able to gain many adherents within the economics profession. He has been especially successful in challenging the inefficiencies of the federal regulatory commissions. His most popular and widely read book, *Capitalism and Freedom* (1962), was a landmark of the 1960s, for it was popularly written by a professional economist who had long before established his technical proficiency before his peers. Some of the policy recommendations of the book, such as the abolition of occupational licensure by civil governments, have not been taken seriously by most economists and certainly not by professionals who now hold occupational licenses from the civil government. Yet from the point of view of those

who are convinced of the technical superiority of the free market over governmental regulation, it is this kind of compromising stand taken by Professor Friedman which is most valuable in the defense of freedom, not to mention capitalism.

The problem that many free market advocates have with some of Professor Friedman's policy recommendations is that too often he spends many pages in devising ingenious schemes that would make government programs more efficient and, Professor Friedman fervently hopes, less burdensome to the taxpayers, businessmen, and innocent citizens of the land. These policy recommendations have one feature in common: they are pseudo-market devices. They would create a kind of shadow market—"almost a free market"—that could provide success indicators analogous to those provided by a truly free market. In doing so, he argues, these pseudo-market alterations would make government more responsive to the needs of citizens.

Economic Calculation

Back in 1920, Professor Ludwig von Mises wrote the most famous essay of his academic career, "Economic Calculation in a Socialist Commonwealth." Mises argued that the inescapable weakness of all systems of central planning is the inability of the planners to assess the actual value of any product or service in the economy. Without freely fluctuating prices that are the product of the private ownership of both consumer and capital goods, there can be no means of imputing value accurately by any of the participants in the economy. What should anything cost? What is it worth? What should be given up to attain any particular goal? Without market prices, meaning without open entry to markets by buyers and sellers, there can be only random guesses by the planning bodies. Randomness is not efficient, except on random occasions. Thus, concluded Mises, the socialist commonwealth is of necessity inefficient. It cannot plan rationally. So long as the monopoly character of the state-controlled markets continues, the planning authorities will remain blind to the true conditions of supply and demand.⁴

Understandably, Mises had no use for pseudo-market schemes of any kind. In fact, the most important (though ineffectual) reply to Mises from the socialist camp was made by Oskar Lange, and it consisted of a system of hypothetical pseudo-market responses by central

planners: artificial and arbitrary prices to be set by the planners, followed by adjustments in the price system in order for planning agencies to stimulate the desired response from buyers and producers.⁵ The problem, as always, was the closed nature of the system. The planners could never be sure that they were not wasting resources in their attempt to attain any goal. Those who set prices are sovereign, and in the case of the socialist commonwealth, the sovereign is economically blind.

In short, the creation of a pseudo-market cannot guarantee increased government efficiency or increased economic power on the part of consumers. All that will be accomplished is the irrationalization of the central economic plan by mixing it with non-socialist yet non-market elements. Lange's scheme was never adopted by the Polish planning agency he belonged to, nor have the Soviets adopted it. It is neither socialist nor market, it is only economically irrational.

The Voucher Scheme

Perhaps the most interesting of all of the pseudo-market policy recommendations promoted by Professor Friedman is his educational voucher plan. Under such a school financing system, each family would receive one voucher for each school age child in the family. The voucher would be redeemable in money upon presentation by a private school to the state or country government. Its value would be equal to the average per student cost of education in the district. (This figure, by the way, is seldom even calculated by school boards, for obvious political and public relations reasons, and when it is calculated, it virtually never includes such crucial items as the interest which the government might have earned had it sold off the school buildings and invested the money elsewhere, such as in the bank which would lend the purchase money to a local profit-making school.) The parents could then send their students to a public school or to a private school. If the cost of tuition were higher in the private school than the value of the voucher, the parents could make up the difference by paying more money.

The advantages of this scheme, argue the supporters of school vouchers, would be considerable. The parents gain back their lost sovereignty. They decide where the children will attend school. The public schools would be forced to compete for students, thereby increasing

their efficiency. Private schools would spring up everywhere in response to the existence of vouchers. The diversity of educational opportunities would be fostered. The costs of administration would be very low. (One advocate back in 1962—a respected libertarian philosopher—announced that it would only take a computer and four secretaries to run the whole system for the state of California. If this were true—and it certainly is not true—it would insure the doom of the program in the eyes of the most potent group of special-interest pleaders in the state, the civil service employees.) The state could establish specialty schools of all kinds to lure back parents and their vouchers. The authority of parents would be re-established, and this would guarantee a truly progressive educational system.

There is no doubt that the logic of the voucher program is initially impressive. Parents would seem to have far more power in selecting educational alternatives under the voucher system. The below-market pricing monopoly of the state would be eliminated. The conformity of bureaucratic education would be challenged by a new diversity. A new educational pluralism would be the creation of vouchers. It would save money and increase freedom. What more could we ask for? In any case, what more can we expect in an age of wealth redistribution? This is always the key argument in favor of the creation of pseudo-market schemes: no way exists to re-establish a truly free market, so this is the best we can hope for.

The Locus of Sovereignty Revisited

It all sounds so plausible. Yet it overlooks the fundamental problem of voucher-financed education. The question must still be asked: Where is the locus of sovereignty? And the answer must still be the same: the civil government. The voucher program violates the most important principle of education: parents are responsible for the financing of their children's education. He who is responsible is also legally sovereign, and vice versa. Operationally, the source of the funding determines the locus of sovereignty. The goal of all those who would defend market arrangements must be to determine the moral locus of sovereignty in any particular circumstance, and then see to it that the sovereign agent be made legally and economically responsible for the exercise of his power. By failing to demand that parents be the source of funding for their own children's education, the promoters of the voucher scheme

have abdicated their responsibility in extending the principle of voluntarism and its concomitant, personal responsibility.

In the voucher system, the source of the funding is still the taxation system. The financing is based on the principle that it is legitimate to use political power in order to grant benefits to one group at the expense of the other. The principle of coercion is still dominant. The dominant principle, over time, will thwart the elements of voluntarism in any pseudo-market scheme. The state is still the operational sovereign over education, simply because the threat of violence, which is the state's legal monopoly, is the source of the funds for education. There is no doubt that Professor Friedman recognizes this fact, yet he does not emphasize it. He believes that the technical alteration of the way in which coercively collected taxes are redistributed can overcome the sovereignty of the state. He acknowledges that the authority of the parents in a voucher scheme cannot be absolute. The state-financed "educational diversity" under a voucher system is a diversity operating within government-established guidelines. Money spent by the state can never be on a "no strings attached" basis. There is always more demand for government money than there is money available to meet the demand (unless the purchasing power of government money falls to zero). Those legally responsible for the distribution of tax money must have legal guidelines, or else rampant waste and dishonesty will instantly appear, and the treasury will be emptied overnight.⁶ This is why statist education must be bureaucratic education, with guidelines imposed from above, since the money comes from the state. There is no escape from the rules of bureaucracy in a voucher system. Friedman acknowledges this fact:

Governments could require a minimum level of schooling financed by giving parents vouchers redeemable, for a specified maximum sum per child per year if spent on "approved" educational services. Parents would then be free to spend this sum and any additional sum they themselves provided on purchasing educational services from an "approved" institution of their own choice.⁷

The key word, of course, is "approved." Why Professor Friedman has chosen to put the word in quotes is not altogether clear. Does he mean "kind of approved"? Certainly, he is wise enough to know that

when the state bureaucrats approve or disapprove, they do not hide their actions in quotation marks. They simply decide. They decide in terms of criteria appropriate to the continued functioning of the statist educational bureaucracy. As Professor Friedman writes:

Any subsidy should be granted to individuals to be spent at institutions of their own choosing, provided only that the schooling is of a kind that it is desired to subsidize.⁸

Desired by whom to subsidize? The parents? Hardly; they are the ones to be dictated to, not dictated by. The parents will be told where they can freely spend their vouchers, and they have to that degree lost their sovereignty. The state provides the funds through its monopoly of coercion; the state shall determine, coercively, how and where those funds are to be spent.

Controlling the Alternatives

What the decades-long erosion of the government school systems has provided is a long list of reasons why it would be profitable for each family to remove its children from the subsidized schools. A small but growing minority of parents is doing just that. The state bureaucrats are legally prohibited from providing religious schools, ideologically prohibited from providing free market education, and apparently unable to provide competent instruction. They see their task as insuring standards, which means insuring educational conformity. The rise of an independent school system, which is replacing the declining number of Roman Catholic parochial schools, is a threat to public school administrators. They are as hostile to alternative educational programs as the postal system's administrators are to United Parcel Service or anyone else carrying first-class mail.

Private school administrators in Indiana were recently imprisoned temporarily for having cooperated with parents who attempted to remove their son from the public school system against his will. Parents in Ohio have been threatened with the removal of their children to foster homes if they persist in sending their children to unaccredited schools. This is warfare, not some simple debate over financing. Technical solutions are insufficient to solve problems of ideological and religious warfare.

What we are witnessing is a conflict over sovereignty. Who is responsible for the training of children, the state or the parents? The lines are being drawn far more sharply today than at any time in this nation's history. Pseudo-market schemes cannot solve questions of ultimate sovereignty, or at least they cannot solve them for the benefit of free market institutions.

State schools rest on a whole series of erroneous assumptions. First, that the state is ultimately sovereign in the field of education—the pseudo-parent of every child. Second, that state schools can teach children totally neutral values—universally acceptable principles that all education must provide. Third, that it is the moral as well as legal obligation of taxpayers to finance the school system. Fourth, that the professional, tenured, and civil-service-protected officials of the educational monopoly are the people best prepared to operate the educational system.

Buying Off the Competition

The voucher system challenges directly only the last of these assumptions, and then only superficially. (After all, state schools will still be permitted to operate.) The voucher system necessarily requires the *licensing of schools*. For those who favor bureaucratic licensing of alternative educational systems by the state bureaucrats whose jobs are threatened by alternative educational systems, I can only recommend chapter nine of Professor Friedman's *Capitalism and Freedom*—the chapter on occupational licensing.

As private schools continue to replace the disintegrating government schools at the primary and secondary levels, the state's educational bureaucrats will have to take decisive action to protect their monopoly. One way to accomplish this is to refuse to certify any more schools. (I am assuming that outright abolition will not be tolerated politically or in the courts.) This approach may work for a time, since parents are concerned about quality schools. By some peculiar twist of logic, the parents of private school children somehow believe that the state licensing boards are competent to certify educational performance, despite the fact that the schools that they themselves operate are anathema to the parents in question.

Private school administrators, who come to parents in the name of a superior educational program, are equally hypnotized by the

boards of certification. The most intelligent response is that made by Robert Thoburn, owner of the profit-making and highly successful Fairfax Christian School of Fairfax, Virginia: "If the bureaucrats want me to certify their schools, they can come to me and I'll look over their programs. That's my view of certification."

If the certification ploy does not work, then the last hope of state educational bureaucrats is the voucher system. If parents continue to send their children to uncertified schools, then the state must find a way to convince private school administrators that they must register with the state and conform their programs to state educational standards. The voucher system is the most logical means of achieving this goal. Vouchers will create a second, pseudo-free market school system, using "free" in both senses— independent and without cost to the users. The state-operated schools will then compete with the state-licensed schools. Almost no third alternative will be economically possible.

Taxed Again and Again

Those parents who want their children out of the government-operated schools (which their taxes support) will also be paying for the operation of voucher-supported, state-licensed schools. These parents must turn down the first subsidy (free public education in a government school), turn down a second subsidy (vouchers for government-licensed schools), and come up with after-tax income to finance their children's education in a truly independent school.

This is assuming they can find such a school. To do so, they must locate other parents equally committed religiously and ideologically to the principle of independent education, and also financially able to put their preference into action. How many concerned parents will do this? How many private school administrators will be able to operate a school while denying admittance to those who would pay with vouchers? How many of these schools with total commitment to private education will there be? I can tell you: very, very few.

Not until the blight so obvious in the government-operated schools has spread to the government-licensed voucher schools will parents even consider bearing the second tax (vouchers) and find money to pay for an independent education. In short: *Vouchers are the most promising tool for the suppression of independent private education now at the disposal of state educational bureaucrats.*

What will the price be? What may not have been clear to Professor Friedman back in the early 1960s is clear to us now. We will have HEW guidelines operating in every voucher-using school equal opportunity policies, quota systems of every kind, teacher hiring and firing policies, racially and religiously mixed student bodies. There will be a whole army of federal bureaucrats, not to mention state bureaucrats, policing every private school. The so-called private educational system will be swallowed up in a mountain of red tape. How much imagination does it take to see what is coming? Isn't it sufficient to look at what our independent private colleges are now going through? Can you imagine the kinds of controls in store for schools that are set up to permit an escape hatch for the crumbling state educational monopoly—the most horrendous visible failure of socialism in America?

The statist educators and politicians of Great Britain are calling for the abolition of all independent schools in Britain, not because they think the government schools will be improved, but because it is intolerable in a society guided by the politics of envy to let any class, any family, any religious group escape the blight of the socialist educational system. If the sons and daughters of the laboring class must suffer the terrors of the government school system, why should the sons and daughters of the rich be permitted to escape? The logic is impeccable. After the Civil War we abolished the right of men to buy their way out of conscription by paying the government a fine sufficient to enlist another man. This practice was thought to be undemocratic. The same will be true, I fear, for those who would escape conscription into the public school system.

Conclusion

The state is not about to adopt pseudo-market schemes unless the bureaucrats believe that the adoption of the scheme will remove competition from consistently independent private competitors. The state is not going to consider the latest pseudo-market proposal to come out of the graduate seminars of the pro-free market professors unless the scheme can be rewritten to enhance the sovereignty, power, and efficiency of those who would suppress the independence of private men. This should be the lesson of the age—statist ideologues and their tenured hirelings do not commit suicide voluntarily. They do not abandon the ideology of the control economy simply because some

new scheme promises to make the government benign or reduce the tax burden of the public.

Pseudo-market schemes, promoted in the name of the free market, are adopted by the enemies of freedom for very specific purposes: to reduce the zones of freedom. Those who believe in increasing all state sovereignty will adopt pseudo-market schemes only when they are convinced that the free market is too great a threat to pure, uncompromising bureaucratic failure—the same reason why the Soviets allow semi-market pricing in a few restricted areas of the economy.

The state may adopt vouchers for education on an experimental basis, in order to test the scheme. If it does foster independent education, vouchers will be scrapped. But they will not have to be scrapped. Vouchers may well become a permanent fixture of our government education system. If so, it will be for a reason: the school voucher offers vast new powers of control over a vibrant and growing independent school system that threatens to undercut government schools.

The great threat to freedom from school vouchers is that they strike at the heart of society—the family. As a pseudo-market device, they promise to be remarkably successful in destroying a tiny but important pure free market development. I am reminded of Lenin's dictum that if the Communists announced that all capitalists were to be hanged tomorrow, the capitalists would trip over each other today trying to sell Lenin the rope. The profit system does not regard the origins of profits, at least short-run profits. Men act to improve their positions in life. Private school administrators and most of the private colleges have been eager to receive federal aid; only a minority of a minority have held out against the lure of federal money. (Their schools, it should be remembered, are very small and may grow smaller.) The lure of vouchers almost certainly will prove too great a temptation for thousands of our struggling little private schools. It may take another generation to recover from the defection of these schools, should that defection have an opportunity to manifest itself.

If vouchers are to be stopped, they will have to be stopped by parents who recognize the double taxation nature of the voucher scheme. Those who truly want independent schools and are willing to pay for them must not seek after vouchers, for vouchers are the very seal of doom for the independent school system. Pseudo-market schemes generally lead to anti-market results. The opposition to vouchers must be made on principle and in opposition to the superfi-

cial logic of the pseudo-market. He who is morally responsible must pay. Abandon this principle, and you abandon your sovereignty as a free man. Good results stem from good principles. Vouchers are an intellectual, moral, and educational disaster. They will not work to expand the realm of freedom.

1. Rousas J. Rushdoony, *The Messianic Character of American Education* (Nutley, N.J.: Craig Press, 1963), p. 4.

2. *Ibid.*, p. 6.

3. Max Weber, "Bureaucracy," *From Max Weber: Essays in Sociology*, edited by H. H. Gerth and C. Wright Mills (New York: Oxford University Press, 1946).

4. Ludwig von Mises, "Economic Calculation in a Socialist Commonwealth" (1920), in F. A. Hayek (ed.) *Collectivist Economic Planning* (London: Routledge & Kegan Paul, 1935).

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Exporting Taxes Threatens State Economies

by John Semmens

The most popular tax is one paid by someone else. Thus state legislators, in their quest to raise spending without angering local taxpayers, are devising more and more schemes to "export" taxes to out-of-state residents.

These include higher taxes on goods and services most frequently purchased by tourists (e.g., taxes on hotel rooms and car rentals), higher taxes on extraction industries (e.g., oil production and mineral mining), and efforts to collect more taxes from business income earned outside the state through "unitary" taxes. In each case, the targeted taxpayers live outside the taxing jurisdiction, so they won't be able to express their dissatisfaction at the polls.

Economists, however, point out that there are no "free lunches." Everything has a cost. The apparent free lunch to be had from attempting to export the tax burden is illusory. The short-term gains are more than offset by larger long-term losses. What the proponents of exporting taxes fail to see is that they are also exporting the enterprises and job opportunities that could help their state grow and prosper.

When the Constitution was written in 1787, its authors were careful to include a clause prohibiting the federal government from imposing taxes on exports (Article 1, Section 9, paragraph 5: "No tax or duty shall be laid on articles exported from any state"). They knew that a tax on a state's exports could devastate that state's economy. They didn't bother to similarly restrict states from taxing their own exports because, apparently, they didn't anticipate that any state would be so foolish.

Attempting to export a tax puts a state at a competitive disadvantage when it comes to importing income and wealth. While it may well be true that nonresidents are nonvoters and as such probably won't have much impact on state and local elections, they are still consumers. Unlike the local taxpayers who may have little choice but

Mr. Semmens is an economist for the Laissez Faire Institute in Tempe, Arizona. This article first appeared in the January 1991 issue of *The Freeman*.

to pay the higher taxes imposed by their legislature, the out-of-state taxpayers may more easily take their business elsewhere.

Consider the dilemma of the in-state firms that are supposed to export a tax to their out-of-state customers. If the tax is added to the price of the exported product (as state legislators seem to assume it will be), competing products from other, lower-taxed locations will have an advantage. Tourist attractions in these other locations will become slightly more alluring. Manufactured goods produced elsewhere, perhaps in a foreign country, will gain a small price edge on every unit offered for sale. Consequently, sales revenue for the in-state businesses will fall. Lower revenues mean a smaller business operation, fewer employees, and less economic growth.

On the other hand, if the in-state businesses absorb the tax in order to maintain competitive prices in out-of-state markets, then their profits will fall. The higher profits of out-of-state businesses will become more attractive to investors. Investment capital will tend to flow out of state, which will mean less growth and fewer economic opportunities for would-be in-state employees.

Some proponents of export taxes argue that the rates are too low to have any effect on economic decisions, or that the targeted taxpayers are "locked in" anyway. The locked in thesis has some plausibility. A mine, for example, is where it is because that's where the ore is located. A tax won't change that. However, a tax will change the relative profitability of the firm or the salability of its output. These small effects at the margin can have large long-term effects on business expansion and choice of business location. Mines in other locations will gain a larger market share. New mines are a bit more likely to be established in lower-taxed locations. A few percentage points of difference in the short run grow into millions of dollars and thousands of job opportunities lost in the long run.

Whether taxes are exported or not, they still remove funds from the private sector. The money that goes into export taxes will be unavailable to invest in tourism, mining, or other businesses, further hurting the local economy.

Economic growth rarely comes in huge leaps forward. More typical is the continuous compounding of modest single-digit growth rates. In a multi-billion dollar economy, a reduction of just a fraction of a percent in the return on investment or growth rates can amount

to the loss of billions of dollars of wealth and millions of job opportunities over a single generation.

Both equity and efficiency point away from the policy of attempting to export taxes. A government that rejected the "free lunch" appeal inherent in the exportation of taxes would better serve its constituents. If the residents were disabused of the notion that someone else is going to pay their state government's bills, they would be less tolerant of waste and excessive spending.

The ethos of contemporary tax policy is misguided and, in the long run, self-destructive. A revival of a "no taxation without representation" policy would be more equitable and more profitable for those who adopt it.

Boom Time for State and Local Government

by John Hood

If the press has anything to do with it, the 1990s will be a decade of higher taxes and government expansion in America. The last year or so has seen article after article, editorial after editorial, proclaiming an end to the "Decade of Greed" and calling for a new surge of activism—and a corresponding surge in taxes to pay for it. Much of the media's pro-tax and pro-government sentiment coalesced around Earth Day 1990, which was really a couple of months of constant calls for America to "invest in a clean environment."

The most recent development in this barrage has been the addition of state and local budget gaps to the perennial example of the federal budget deficit as proof that Americans are undertaxed. In both 1989 and 1990, state governments around the country experienced slower-than-expected growth in tax revenues, leading to record budget deficits in some states. Since most of the affected states have balanced-budget provisions, they have not been able to delay their day of reckoning—as has the federal government so far. Consequently, highly visible battles have been waged between advocates of budget restraint and those of tax increases to balance state budgets. The national press, among others, has seized upon these state budget woes to predict that the 1980s of governmental restraint are preparing to give way to the 1990s of renewed governmental expansion.

Whether or not their prognostication is correct, the press and the various interest groups that manipulate it (teachers' unions, state employee unions, etc.) have based their entire case on a false proposition: that the 1980s was a decade of governmental contraction. Nothing could be further from the truth. Although the rate of government expansion may have slowed a bit on the federal level during the Reagan Administration, the share of national income consumed by federal

John Hood is a newspaper columnist, a contributing editor of *Reason* magazine, and research director for the John Locke Foundation, a state policy think tank in Raleigh, North Carolina. This article is reprinted from the November 1990 issue of *The Freeman*.

spending was the same in 1989 (22 percent) as it was in 1980. "Budget cuts" blamed on Reagan were only reductions in the rate of increase in government spending, not real reductions in government's role in society and the economy.

On the federal level, this story has been told more than a few times. But since the new battlegrounds of government activism are state legislatures and city halls, it is important to recognize the truth about state and local government in the 1980s—that during a time when the federal government retained its already large role in American society, state and local governments increased theirs dramatically, by 17 percent in real per-capita spending from 1981 to 1989. And the state and local tax burden on typical households increased steadily during the same period, according to the Tax Foundation, while the federal burden remained roughly the same. Far from being a decade of fiscal conservatism, the 1980s were a boom time for government on the state and local level. Consider the record of government expansion in two similar states: New York, the stronghold of Northeastern liberalism, and North Carolina, a Southern state with a conservative image.

New York

As of April 1990, New York State faced a projected \$3 billion budget deficit for fiscal year 1991. While Governor Mario Cuomo, other state politicians, and the state press have attributed the state's budget problems to tax cuts, slower-than-expected economic growth, and the 1987 stock market crash, Ed Rubenstein of the Manhattan Institute attributes the deficits to runaway government spending. During the 1980s, he reports, New York state spending outpaced inflation, population growth, and per capita income growth, consuming 16 percent of New Yorkers' personal income in 1988—up from 14.7 percent in 1983.

The state's general fund, which doesn't include federally funded programs or capital projects, grew at an average rate of 9.6 percent a year from 1980 to 1989, doubling every seven and a half years. Chip in federal and other funds, and the total state budget grew by about 53 percent from 1983 to 1989.

Naturally, the meteoric rise of state spending in New York has been accompanied by higher effective tax rates on New York households. From 1983 to 1988, state taxes as a percentage of personal

income rose by almost 10 percent—a rate more than three times as fast as that in “Taxachusetts.”

In New York, as in many other states, one reason asserted for state government expansion has been President Reagan's New Federalism, which shifted the burden for some programs from the federal level to the state level. But the fact is that federal funds followed the programs more often than not. In the case of New York, federal aid money to the state and to local governments actually increased by 15.4 percent *after inflation* between 1983 and 1988, according to Rubenstein.

Where did the state and local government in New York spend their massive influx of taxpayers' money? Virtually every area of the state budget increased in real terms during the decade, especially in education, environment, anti-poverty, and economic development programs. For much of the decade, New York led the nation in per capita state spending on public welfare; in fiscal year 1987, it spent almost \$600 per capita on public welfare, over \$100 more than the next highest spending state, Massachusetts. New York maintained higher-than-average spending levels in education and environmental programs during the decade, and expanded the state government's role in “economic development.” By 1987, it had attained the dubious distinction of being second only to Illinois in state spending to encourage tourism.

North Carolina

While New York's reputation squares with its profligate record during the 1980s, North Carolina has somehow maintained an image of a small government, low-tax state while expanding government programs, expenditures, and taxes at almost the same rate as New York. In some ways, as a matter of fact, North Carolina taxpayers have had an even rougher time of it.

From 1978 to 1990, the state budget increased by 50 percent after inflation, which far outstrips the increase during roughly the same period in population growth (up 13 percent) or state per capita income (up 15 percent). Moreover, the spending authorized for the current 1990 fiscal year capped several years of uninterrupted budget growth, establishing a spending plateau 49 percent higher than in 1983.

Meanwhile, North Carolina taxpayers paid an average of almost \$1,500 in state and local taxes in 1988, 26 percent more after inflation than they did in 1978. North Carolina levies the highest individual and

corporate income taxes in the Southeast, and recently raised its gas tax to almost 21 cents per gallon—one of the highest rates in the nation. Significantly, observers outside the state are beginning to regard North Carolina as a high-tax state. In January 1990, *Money* magazine ranked North Carolina 11th in the country in total tax burden levied on a typical reader of the magazine, and first in the Southeast.

As in New York, state officials have blamed the increases in spending on Reagan's New Federalism, complaining that new federal mandates have forced more spending. But the flow of federal funds to the state has increased by 26 percent in real terms since 1978.

During the 1980s, North Carolina dramatically increased state spending on education and on economic development programs, assuming that higher government expenditures would "solve" these and other problems. State subsidies for private industries and organizations, deemed a "progressive" investment in economic development, expanded greatly during the 1980s. One subsidy, to the North Carolina Microelectronics Center, rose to \$26 million by the end of the decade.

What About the Tax Revolt?

Some might be surprised to learn that state and local governments in so many states have expanded during the 1980s. After all, a nationwide tax revolt, starting in 1978 with California's Proposition 13, was supposed to be a defining political event for the 1980s.

And, indeed, it was—in those states where the "revolt" actually ended up restraining the growth of government and even rolling it back a bit. Usually, this required some kind of mechanism restricting taxes or spending, or requiring large legislative majorities to enact increases. California's tax limitations spared the state the kind of fiscal woes that occurred in New York, Massachusetts, North Carolina, and other states.

The problem was that during the 1980s, an expanding economy led to increasing revenue collections, both at the federal level and in many states and localities. These revenue windfalls gave legislators the latitude to increase spending on so-called "pressing needs" while maintaining their reputation as fiscal conservatives. This became a politician's dream (regardless of party affiliation) and a public choice economist's nightmare: while special interest lobbies were successful in ex-

panding government's role, taxpayers felt no real incentive to call for restraint. Some states did enact tax rate hikes, but most financed massive expansions of government on projections of increased revenues for future years.

In the last two years, however, this bubble has popped. As the economy has cooled off, revenue collections have failed to keep up with projections, and suddenly government officials are faced with a dilemma. They must either impose new taxes on the slackening economy to meet their revenue needs, or they must scale back the tremendous surge in government action they enacted during the 1980s. Their decision will determine whether the United States is headed for a true rebirth of limited government and free markets, or for the continued growth of bureaucratic, interventionist government that regulates and subsidizes virtually every sector of the economy.

Whatever their decision, public officials will eventually have to answer to the public. And despite the constant drumbeat to maintain the current level of government spending, there is some evidence that voters won't countenance new taxes to finance it. Recent initiatives to increase state or local tax rates in Michigan, Washington State, North Dakota, and Virginia have lost at the polls. And a recent vote in California to increase the state's gas tax to finance highway renovation and construction succeeded not due to voter acceptance of big government, but instead because the taxes were successfully depicted as "user fees" dedicated to a specific purpose.

There are even signs that a new tax revolt might be brewing. Tax limitation referenda in states from Massachusetts to Oregon are attracting substantial public support. The question now is whether voter resistance to taxes—the "supply side" of government expansion—will lead to reductions in the demand for government programs, subsidies, and regulations. Advocates of government restraint, free markets, and liberty have much to do if a new tax revolt is indeed to be translated into a fundamental rollback of government on the state and local levels. An important first step is simply to realize that the 1980s, widely believed to be a period of government restraint and contraction, was a boom time for state and local government—and that after this decade of big government ascendancy, no problems appear to have been "solved."

Government Policies and Capital Growth

by Christopher Witzky and Rolf E. Wubbels

Although many factors have contributed to current U.S. economic problems, the subject of insufficient capital formation has received foremost attention in recent years. Sparked by the obvious failure of traditional Keynesian demand management policies, supply-side economics has captured the public imagination while eliciting approval from a broad spectrum of economists and politicians.

The essence of the capital formation problem is that an insufficient portion of national income is saved for investment, while too much is spent for government and private consumption. Decades of fiscal and monetary mismanagement coupled with a perverse tax system have generated a consumption boom at the cost of chronic double-digit inflation, sluggish productivity and lackluster economic growth. Consumer indebtedness helped finance the boom, rising from \$188 billion in 1976 to \$305 billion in 1980.

Disincentives to replacing our aging capital stock are resulting in wide-spread plant obsolescence and declining rates of capital utilization.

Never as avid savers as their European and Japanese counterparts, Americans have become one of the least thrifty peoples of the industrialized world. The less a nation saves, the fewer are the resources to be devoted to the formation of capital necessary to insure healthy economic growth and mitigate inflation. The net supply of funds from household savings provides almost all of the net funds raised by the other primary sectors of government and business. Both government and business are net dissavers.

Developing Incentives for Savings and Investment

In seeking to encourage future savings and investment, policymakers are now scrutinizing the incentive systems developed by America's

Mr. Witzky is currently Director of Corporate Finance with United Technologies Corporation in Connecticut. Dr. Wubbels retired from New York University, where he was Professor of Finance. This article is reprinted from *The Freeman*, October 1981.

trading partners. Although savings rates and consumption patterns are partly a cultural phenomenon, the U.S. tax system is effectively biased against savings and investment, while foreign countries tend to rely much more on consumption-based levies such as the value-added tax. The United States also depends more heavily on capital gains taxes. Beyond such factors, a number of countries have adopted clearly positive investment and savings-oriented tax policies.

The Japanese have a tradition of saving, which is reinforced by a tax policy that exempts virtually all interest income earned by Japanese citizens. This exemption includes interest on deposits of up to \$13,300 in both postal savings accounts and banks, interest on up to \$13,300 worth of government bonds, and interest on as much as \$22,000 held in employee payroll savings accounts. In this way, a maximum of \$62,000 in savings can be sheltered from taxes on interest income. On average, the Japanese now save about 26 percent of their disposable income.

Since the 1960s a cornerstone of the West German policy to increase savings had been a government tax-free bonus program for special savings accounts held for six or seven years. These accounts could take the form of bank accounts, life insurance policies, building society shares, and stocks and bonds. Any adult with a taxable income of less than \$13,700 could deposit up to \$475 per year into such an account, which would earn an annual tax free bonus of 14 percent a year plus 2 percent for each dependent child, in addition to accrued interest. Deposit and income ceilings were doubled for married couples.

Furthermore, an employee could set up a special account to service regular payroll deductions of up to \$357 annually and qualify for a government bonus of 30 to 40 percent, depending upon family size. Individual annual interest income of up to \$460 has been tax-free, and life insurance premiums are deductible under certain conditions. Such policies have helped to generate an impressive savings rate of 14 percent.

The cost of these tax rebates and savings programs amounted to \$4.1 billion in 1980, about 3.5 percent of West German federal spending. Facing a projected 1981 public sector deficit of some \$32 billion due to rapidly mounting costs for social-welfare programs, the government has eliminated many portions of the 14 percent bonus scheme.

Austria, with its relatively low inflation rate, provides similar in-

centives to save and invest. A portion of interest on savings is exempt from tax, and numerous other deductions and tax privileges provide the Austrian investor with a positive rate of return. Austria is also well-known for its banking secrecy laws which are more stringent than those in Switzerland.

France Offers Advantages

In France all individuals, including children, are allowed to earn tax-free interest of 7.5 percent on deposits of up to \$10,840 in mutual savings banks. The first \$723 of dividend income from stocks is tax-free under various conditions.

The popular French savings incentive is the 1978 Monory Act (after former Finance Minister René Monory) which became effective May 1978. The law allows individuals who invest in French equities to deduct up to 5000 francs (about \$1200) from their taxable income each year for four consecutive years. The deduction limit is raised 500 francs for the first and second child and 1000 francs for each additional child. The money must remain invested for a minimum of three years, though not necessarily in the same securities. Investments may be made in mutual funds, provided that at least 60 percent of the portfolio is devoted to stock of French companies.

Observers regard passage of the Monory Act as an important factor in the resulting boom on the Paris Bourse. French industry has also benefited from over \$1.95 billion in new equity offerings, spurring investments in new plant and equipment.

"Loi Monory" has been an overwhelming success. Mr. Monory was able to report to the Cabinet on February 15, 1980, that in 1979 more than one million people took advantage of the law, investing an additional \$1.8 billion in equities since its enactment. Since 1978 French production has risen by more than 17 percent; and in 1979 the French saved approximately 17 percent of disposable income. Since the Monory Act is only a temporary four-year relief measure, some government officials are already worrying about the possible withdrawal of investors from the Paris Bourse when the Act expires in 1983.

The election of Socialist President François Mitterrand in May 1981 had placed the French economy in jeopardy and undermined many of these advances.

The problems of England's economy are well known. Although

the Thatcher Administration has made major strides in curbing monetary growth and reducing inflation, government policies have been largely oriented toward "tax-shifting" rather than real tax reductions.

After taking over in April 1979, the Thatcher government cut personal taxes for middle and high-income groups but soon found that the red ink was excessive. The administration then nearly doubled the value-added tax, from 8 percent to 15 percent, raised gasoline taxes by 20 cents per gallon, and moved away from promises to cut corporate taxes.

These factors, plus rising interest rates, led to an explosion in the retail price level and an unfavorable economic climate. The nation's bond market had already virtually been destroyed in 1971 by the combination of inflation and high marginal personal tax rates. Equity markets, though also depressed, received some benefit from reductions in the destructive top marginal tax rate on investment income from 98 percent to 75 percent.

For many years the United Kingdom also had one of the highest capital gains taxes. All investment income exceeding £5,000 per annum was subject to an additional 15 percentage point tax over and above the maximum individual rate of 60 percent. The maximum tax rate on capital gains thus amounted to 75 percent. The capital gains tax now stands at 30 percent on any gains above £3,000.

Even with these reforms, however, it is likely that high inflation and falling productivity will continue to plague the United Kingdom unless both taxes and spending are further reduced.

Adverse Policies in the United States

What does the United States do to encourage savings and investment? Virtually nothing. In fact, most existing policies work to make consumption a virtue and savings a risk.

In the United States nominal interest and dividend income has been taxed as unearned income at marginal rates up to 70 percent. This policy, combined with high inflation and interest-rate ceilings on bank deposits, has made savings a guaranteed-loss proposition. As a percentage of disposable income, the U.S. savings rate dropped from 7.4 percent in 1970 to 6.9 percent in 1976, reaching a low of 3.4 percent in the first quarter of 1980. (In 1981, the Commerce Department issued a new statistical measure of the savings rate. Although the

new savings rate statistics are nominally higher, the declining trend remains.) Thanks in part to this decline, productivity growth slowed to an annual average of only 1.2 percent in the 1970s, down from 2.5 percent in the 1960s. Between 1963 and 1973 American output per person rose by 1.9 percent, the slowest of any major industrial country.

Under current tax law, taxable income is not adjusted for inflation. As a result, during an inflationary period, individuals advance into higher tax brackets due to increasing nominal money incomes, while real incomes are rising much less or may even be declining. In addition, capital gains computed in dollar terms enter into the tax base, even though such nominal gains can represent very much smaller real gains (or possibly real losses). Thus, inflation raises personal taxes by a much larger percentage than nominal incomes, causing the average tax rate to rise and tax payments to increase in real terms.

According to Martin Feldstein, president of the National Bureau of Economic Research, even if corporate profits and stock prices could manage to keep pace with inflation (an unlikely possibility) and maintain traditional rates of real growth, a 20 percent tax on nominal capital gains would mean an 80 percent tax on real gains given a 7 percent inflation rate, depending on the holding period. An 8 percent inflation rate would push the effective rate over 100 percent. Thus, capital gains taxes have actually been massively confiscatory. Similar inflationary effects on income tax rates result in confiscation of savings.

Penalizing Capital Gains

Small investors nearly abandoned the American stock markets in the mid-1970s, partially due to exorbitant taxes on capital gains pegged at a maximum of 49 percent for most of the decade. In addition to depressing equity market values and reducing new capital formation as measured by venture capital funds and new public offerings, capital gains taxes tend to inhibit capital mobility. If a capital asset appreciates substantially, the accumulated capital gains tax liability upon realization can deter the asset's sale. This is referred to as the "lock-in" effect. It is difficult to measure the opportunity cost of this capital immobility in terms of diminished exploitation of new technologies.

Over the entrenched opposition of the Carter Administration, Congress enacted the Steiger Amendment to the Revenue Act of 1978, lowering the maximum tax on long-term capital gains to 28 percent.

According to a Treasury Department study, the net revenue loss in 1979 from this reduction was only \$100 million, far less than the forecasted loss of \$1.7 billion. The rate cut was offset by \$2.5 billion in new revenues from higher turnover rates.

An extensive 1980 survey of stock ownership by the New York Stock Exchange has shown that the small investor returned to the stock market during the latter part of the decade, perhaps in response to the Steiger Amendment. Even with the current surge, however, the 1980 shareholder total was still one million less than the high of 30.8 million in 1970, when 15.1 percent of the American population held stock. In 1980 that percentage was 13.6 percent, up considerably from 11.9 percent in 1975.

These developments should be interpreted with caution, however, for the average portfolio size has shrunk. In addition, during the 1970s there was a great increase in the rate of inflation and a serious decline in the prices of common stocks, measured in constant dollars. In fact, the total return on common stocks for the whole period, in constant dollars, was negative. Between the end of 1969 and the end of 1979, the value of common stocks on the New York Stock Exchange declined by about 42 percent. This drop is far greater than that of the 1930s when the value of stocks on the New York Stock Exchange fell by about 31 percent. Thus, investors in high tax brackets tended to experience losses greater than those of the Great Depression, since dividends were taxed at higher rates in the '70s than in the '30s.

The decline in real stock prices was probably made worse by market adjustments in response to two types of inflationary tax-raising effects which arise from standard methods for computing business costs and profits. First, depreciation expenses are computed on the basis of historical cost of acquisition rather than on replacement cost, resulting in underdepreciation. Second, cost of goods sold from inventory is sometimes valued at current rather than replacement cost. These accounting procedures understate real current costs and hence overstate real profits. Thus, taxation of inflated corporate profits effectively results in the net confiscation of capital.

Tax Rates Outrun Inflation

In summary, the federal government's tax collections rise substantially as a share of both corporate and personal income as individuals

and corporations are exposed to the effects of inflation. In fact, taxes have risen in the United States at almost twice the rate of inflation since the late 1960s.

Inappropriate tax policies and inflation are not the only sources of our problems. Government routinely attempts to direct the flow of funds toward socially desirable goals. These attempts fall under the heading of the social allocation of capital. Such intervention has become increasingly popular in recent years through various means: (1) usury laws or interest rate ceilings, (2) government loan guarantees; (3) interest rate subsidies, (4) government borrowing and re-lending, and (5) regulations

Special interest groups see government intervention as a means for improving the condition of a particular sector of society, enabling it to borrow funds which might not otherwise be available or might only be available at significantly higher interest rates.

Through such intervention, the function of the financial markets is altered. Funds no longer flow on the basis of expected return and risk. When the government explicitly directs funds to certain investments, it tampers with the workings of the marketplace. This tampering can lead to less efficient financial markets with the result that savings are allocated at higher cost and/or with greater inconvenience.

Put another way, such intervention produces the case in which investments are undertaken which are not optimal in terms of market efficiency relative to market standards. As a result, there may be an adverse effect on real economic growth. Financial markets simply become less efficient in channeling savings to investment opportunities on a risk-adjusted return basis. Clearly, cost estimates due to these induced distortions should be included in any cost-benefit analysis of capital gains taxation. Unfortunately, such cost estimates are nearly impossible to formulate.

Of course, government is not the only culprit causing our myriad capital formation problems. Management and labor must share the blame. Often management continues to use nearsighted incentive programs which reward short-term results rather than long-term strategic thinking. As a result, executives have been slow to introduce reporting techniques that are in the best interests of the organization. For example, two-thirds of American industries still use the First-In, First-Out inventory valuation method, resulting in an inflated bottom line. American management has also failed to provide the work force with

incentives for finding and initiating new ways of reducing the amount of labor in the production process.

Politically Feasible Measures to Encourage Growth

Productivity and innovation are not solely management functions. Organized labor has complicated matters by locking management into Cost of Living Adjustments (COLAs) and by resisting automation. In contrast, Japanese workers generally embrace technological changes which result in more efficient production processes. Fujitsu Fanuc Ltd. is now operating a \$38 million plant that uses robots and numerically controlled machine tools to help build other robots and machine tools, requiring one-fifth the number of workers that a conventional plant would need.

Given this operating environment, what can realistically be done to restore adequate capital growth? Congressman Richard Schulze has introduced H.R. 63, the Individual Investors Incentive Act. This bill would provide a 10 percent tax credit up to \$1,000 for individuals (\$2,000 for married couples filing jointly) for new or additional investments in stocks and mutual funds of domestic corporations. Patterned after the French Monory Act, the "Schulze Bill" would directly encourage savings and investment and would provide a needed incentive for our stagnating economy.

New York's Republican Senator Alphonse D'Amato has introduced the Family Savings Incentive Act. This Act would raise the exemption for interest income to \$1,000 for individuals and \$2,000 for those who file joint returns. This concept has been endorsed by the Savings and Loan Foundation.

The Jones-Conable Capital Cost Recovery Act, better known as "105-3," provides for simplified accelerated depreciation of capital investment. Because such changes only affect the timing of after-tax cash flows, the effective reduction in the tax rate is merely the result of the time value of money. The effect is, therefore, somewhat illusory, since taxes will be even higher in later years when depreciation charges are exhausted. Such taxes may only be avoided in future years if any tax savings are immediately recapitalized and depreciated.

The ultimate long-range solution to the capital formation problem hinges on concerted actions by all factors of production. Natural resources must be allocated by the market. Management must once again

seek to innovate, along with the active cooperation of labor and government. Savings must be encouraged and productively employed, and obstacles to the market allocation of capital flows must be abolished. The Kemp-Roth program, though a step in the right direction, is only a band-aid remedy. More substantial action will be needed in the future.

IV. WEAPON OF DESTRUCTION

The Assault On Capital

Robert G. Anderson

One of the sad political paradoxes of our times is the simultaneous assault on capital throughout the world and the continual clamor, often from the same sources, for greater worldwide prosperity.

Perhaps the affliction can best be described as "political schizophrenia." Political rhetoric extols the virtues of the good life and greater material abundance for humanity, and yet, in the next outburst, attacks the very foundation of such a society. The demagoguery and nonsense of such political outbursts are most discouraging to those who understand the economic policies required for human progress.

Mankind's evolution into the modern era of the industrial society was not an historical accident. It was, instead, the direct result of forces that brought into existence the private property order and its concomitant free market economy. The market system of social organization opened to man the full potential of the social division of labor and the efficient employment of the scarce economic resources at his disposal.

The history of material progress relates directly to an increase in productive capacity. Material advancement for mankind simply means, "getting more goods out of the woods"! And from the dawn of human existence this process has been primarily accomplished through the substitution of capital for human energy in the means of production.

What distinguishes a so-called "rich nation" from a "poorer nation" is the abundance of productive capital employed in the social division of labor. The productive output of a worker moving dirt with his bare hands can hardly be compared with the accomplishments of a worker operating a giant bulldozer. The capital tools with which they work make the difference. While greater work effort and better work techniques have certainly contributed to greater productive output, the accumulation of ever-greater quantities of capital employed in production has been the essential "key" to prosperity.

The "key" to *greater* prosperity, therefore, is *more* capital. Societies

Mr. Anderson was a member of FEF's senior staff until his retirement in the spring of 1992. This article originally appeared in the November 1979 issue of *The Freeman*.

become rich because individuals within the society become more productive. And this greater productivity of the individual is attainable only through the effective employment of more capital—multiplying the product of his efforts through the use of tools.

The assault on capital throughout the world today has become a direct attack on man's material prosperity. Even worse is the planned and systematic destruction, through political interference, of the institutions that are essential to the creation of capital. This combination of consuming accumulated capital and destroying any incentive to replace capital is leading to the impoverishment and suffering of millions of people throughout the world.

For an example of what is happening, look at the United States, the "richest" nation in the world today in terms of the material well-being of the people. It attained this enviable status as a result of a lengthy historical record of being "friendly" to the accumulation of capital. Throughout the nineteenth and early twentieth centuries, millions of individuals were drawn to the United States by the vast opportunities for personal economic advancement.

Phenomenal Growth

From the period following the end of the Civil War in 1865 until the beginning of World War I, unbelievable change and advancement took place in the United States. The degree of individual freedom that prevailed during this period led to an expansion of economic activity and an accumulation of capital unmatched in human history. Neither before nor since has a more rapid rate of growth been experienced by a group of people than during the twenty years from 1870 to 1890 when the real incomes of the people more than doubled.

During this same period of phenomenal growth in prosperity, entire new industries were born. The oil industry, railroads, electricity, and modern steel-making are among the better known examples. Methods of agriculture, which had remained unchanged from the dawn of history, were radically altered. The introduction of capital equipment vastly increased the productivity of the individual farmer in the planting and harvesting of his crops.

This remarkable era of economic freedom and improvement also brought other changes in the structure of life and industry. The productive employment of increasing quantities of capital literally annihi-

lated many ancient and established industries. We may look back now with amusement at some of the individual failures that occurred in those early days, from the prairie schooner to the pony express. But with the individual's freedom to fail came also the chance for success. Man's creative energies were unleashed in such a setting of economic freedom, and the outcome was a material progress that became the envy of the world.

Reaction to Change

In 1859 Colonel Edwin Drake successfully drilled for oil in Western Pennsylvania, and the petroleum industry was born. The subsequent competition of kerosene took a heavy toll on the whaling industry of New England. But what electricity later did to the candlestick makers, and the internal combustion engine did to the blacksmiths and horsebreeders was even more devastating to the old ways. The changes imposed by economic progress were dramatic, to say the least.

The point is that this entire transformation of society was made possible only because individuals possessed economic freedom, and were able to freely accumulate and employ the needed capital to compete against existing industry. And while greater prosperity was a direct result, so too was the demise of the old ways. The price of prosperity is always change, and for many the price seems too high.

A reaction to such rapid change may have been inevitable. In any event, such a reaction has been most evident in the United States during these past fifty years. Powerful political forces have assaulted, directly and indirectly, both individual freedom and private property in an attempt to "preserve" the status quo. Disguised as "progressive programs" to benefit "the people," political intervention is consuming the wealth of the citizenry and hampering the incentive to replace it.

The source of the wealth and material abundance of the United States citizen today is to be found in the accumulations of private capital made possible in an earlier era. The continued prosperity stems from the momentum of the past, not from the political intervention of recent years. The losses of individual freedom have been so gradual and subtle that perhaps only within the past decade are there clear signs of a declining standard of living.

It is of the utmost urgency that this development be seen. Given the dynamic history of economic freedom and prosperity that were

once the hallmark of the United States, the identity of these recent destructive forces must be disclosed—at home, as well as abroad. The people of other nations, who would emulate the United States, otherwise might misconstrue these forces to be the causes of our wealth today. To pattern political intervention after the example of the United States government today would be nothing less than a human tragedy. The resurrection of individual liberty and continued material prosperity demands the repudiation of this intervention, and not its expansion.

Capital Accumulation

The “key” to prosperity is capital. To consume more, a people must first produce more, and to produce more requires more and better tools. Real economic growth is a direct consequence of ever-greater quantities of capital being employed in the tools of production.

The greatest service a government can render its citizenry is to safeguard and encourage this process of capital accumulation. Protecting the lives and property of citizens by keeping the peace is absolutely vital to an orderly society. The law thus serves as an instrument of justice. Such a government has always enjoyed the popular support of its citizenry, for in a society of peace and harmony, the individual citizen is freed to produce and serve the consumer through the market.

In the United States today government is far more engaged in plundering property and controlling people’s lives than in pursuing its traditional role of protecting life and property. In the name of “progressive government,” we see the law being used in the most reactionary way to destroy private capital and human liberty.

The accumulation of capital requires both productive effort and saving on the part of individuals. There is an old adage that “anyone can make money—it’s keeping it that is difficult.” The point is that saving rather than consuming will occur only if there exists an incentive to do so. Production and saving requires the personal sacrifice of not consuming. Only when the potential for greater future consumption can be clearly seen from saving and working today, will individuals willingly produce and save. As the theoretical economist usually states it, “all other things being equal, leisure and consumption are preferred over work and saving”!

Government intervention in the United States during the past fifty years has time and again undermined this process of production and

capital accumulation. While no one law or policy can be isolated as the cause of our lost freedoms and falling standard of living, the combined intervention is generating a burden that is destroying the material welfare of society.

The manner of government's assault on capital is varied, but of all these actions, nothing inflicts more damage on productive effort, saving, and capital accumulation than a policy of monetary inflation. The insidious effects of inflation disrupt the entire pricing structure of the market, the sole guide for the actions of traders in the marketplace.

The destruction of money through a policy of inflation consumes every form of monetary saving. Individuals quickly learn the bitter consequence of conserving money in the form of bonds, savings accounts, or cash balances. Monetary holdings of liquid capital become nothing but certificates of guaranteed confiscation of wealth.

Inflation Disrupts Markets and Consumes Capital

The disruption of the price system through inflation generates awesome losses of capital. Both consumers and producers are led into economic chaos. The false signals of inflated prices alter the allocation of economic resources in production and encourage artificial levels of consumption. The ultimate result is a general impoverishment, as capital is taxed and destroyed.

Inflation imposes a heavy penalty tax on productive activity. Any incentive to employ capital in productive activity is soon lost to the urgent necessity of preserving what little capital remains. Individuals turn to speculation in an effort to survive.

The result is not economic survival, but instead market disruption and capital consumption. Money markets no longer perform the function of serving producers and consumers, but instead become devices for speculators. Long-term capital markets vanish with the creditors, as everyone tries to become a debtor. The order of the day in an age of inflation is to consume capital in "things" before it is consumed by the ravages of inflation.

Inflation's message is clear to all. Increase consumption, save nothing. The outcome is the inevitable destruction of accumulated capital with no incentive to replace it. The tragic price is lost prosperity.

While inflation is one of government's oldest weapons in the assault on capital and productive effort, it is by no means the only tool

of such destruction. A multitude of laws, edicts, and policies are joined in the attack.

In the United States, modern tax theory often is more concerned with penalizing capital or redistributing wealth from savers to spenders than with the acquiring of public funds. The federal inheritance tax is a classic example of such a practice; many larger estates are wholly consumed by the tax rather than transferred to the heirs.

The accumulation of private capital and its productive employment is the cornerstone of an advancing market economy. Inheritance taxes have consumed untold billions of dollars that would otherwise have been productively employed. Productive individuals are left with no choice but to consume their wealth. Luxury cars, fancy yachts, and exotic homes have replaced job-creating productive investments. Enjoy it today rather than have it taxed away tomorrow becomes the rule of productive people confronting such confiscatory tax policies.

The Impact of Taxes

The taxation of corporations is another weapon in the assault on capital. While a corporation, as a legal entity, can be a collector of taxes, the burden of corporate taxes must always fall upon the corporate owners, employees, customers, or some combination of these three. The corporation is merely an institutional entity productively employing the capital of its owners. The result of corporate taxation is a political transfer of capital away from private corporate use and productive employment.

The individual income tax is another example of a tax policy that is specifically structured to discourage productive activity and capital accumulation. The percentage rate of taxation on personal incomes is highly graduated, assuring an ever-larger seizure of the private capital of those who are most productive. Wealthy individuals are subject to a federal income tax rate of up to seventy percent, a rate that imposes a severe penalty on the expansion of productive capital and work effort.

Perhaps the most subtle tax against capital, in the sense that it silently erodes the personal incentive to save, is the Social Security tax. This tax transfers wealth from productive workers to the elderly members of society in retirement and thereby reduces the personal concern for one's welfare in old age. The expectation of a government source of income in later years thus leads to a reduction in personal savings.

But inflation and taxation are only the beginning of government's assault on productive capital. The competition for votes among politicians has led to a mass of legislation providing all manner of special interest political largess. The redistribution of wealth through the political process has become firmly entrenched in the United States. Every sector of society is clamoring for more. Everyone is plundering everyone with the cry that, "we're paying for it, so let's get our fair share." The result is a society of political victims and beneficiaries, all using the political process to further consume private capital.

Such a system breeds politicians rather than statesmen. Politicians, responding to a "now mentality" among voters, win elections. The statesman, expressing concern for the future consequences of such political plunder, is the loser at the polls. The result is that democracy becomes synonymous with demagoguery, a vehicle for the political plunder of capital.

The Welfare State

This political transformation is well illustrated in the United States by the growth of the welfare state. Vast quantities of capital are being transferred today through the political process from those who work to those who don't. Without exception, every welfare reform increases the individual's incentive to choose leisure over work. Low-productivity labor is literally priced out of the market by the welfare benefits from the state.

The withdrawal of welfare recipients from the labor market stalls the further creation of capital. The heavy burden upon the productive persons who support the welfare programs again drains the capital so essential to progress. The bias against work and against the productive employment of savings is a built-in wedge hampering economic growth.

The final assault against capital, and against the very structure of the market economy itself, comes by way of direct controls upon prices and wages. As long as market prices remain free to reflect the actions of traders, the market can absorb massive doses of hostile government intervention. The assault against capital from inflation, taxation, and the redistribution of wealth through the political process certainly reduces the magnitude of productive capital, and thus the material standard of living. But these forms of government intervention do not in themselves destroy the essence of the market process.

The imposition of direct wage and price controls, however, terminates the market price system of allocating economic resources. The economic freedom of buyers and sellers to engage in voluntary exchange on their own terms is denied. The result of such government intervention is the massive destruction of capital and productive effort.

There is, of course, even under wage and price controls, some escape from the economic chaos that the controls inevitably generate. The escape route is by way of "black markets." While "black markets" are merely the practice of freedom of choice among traders when their liberties have been denied by the state, such illegal markets can never attain the efficiency of free and open competition.

A point to remember about government-imposed wage and price controls is that governments don't control wages and prices, they control people. A price or wage control is simply a disguised way of denying the voluntary choices of traders. The establishment of government-imposed prices or wages below or above the market rate assures either shortages or surpluses, and the loss of freedom.

With a government biased against capital, the direct controls are nearly always established below the market for prices, and set above the market for wages. The result is the certain destruction of capital productively employed and the creation of a permanent barrier to new productive activity.

Wage and Price Controls

The imposition of wage and price controls by government always creates an allocation crisis. In the United States today an "energy crisis" exists in the form of uncertain gasoline supplies. The reason is simply explained. The price of retail gasoline is established by government rather than by the voluntary actions of buyers and sellers. And the government-imposed legal price is now less than market prices. With demand exceeding supply at this government-imposed price, arbitrary limits on gasoline sales and long lines before the pump are inevitable.

Price and wage controls symbolize the end of the market economy and individual freedom of choice. Such government interference transforms society from a nation of free traders into a society of regulated consumers and plundered producers. The imposition of direct controls

upon the market process is truly the final assault on capital and the private property order.

Far advanced in the United States today is the economic chaos and destruction of capital that government inflicts upon society through inflation, taxation, transfer policies, and direct controls. There are serious threats of private property seizure through nationalization and the erection of economic barriers to international trade. The market economy which had brought forth prosperity in an atmosphere of peace and harmony is becoming a battleground of internal conflict. Bitterness and disillusionment are expressed everywhere one turns in the United States.

If the assault on capital continues, the result will be, not the good life that is enjoyed today, but conflict, hardship, and a return to poverty.

So the people of the United States stand at a point of decision—either to abandon the private property order for socialism, or to return to freedom and the free market. Two points must be clear. First, it must be understood that prosperity can only come through freedom, and second, that the political institutions of society must support this freedom rather than deny it.

Throughout the world are tens of thousands of individuals who understand this relationship between prosperity and freedom. In addition, literally millions of individuals have been the beneficiaries of the prosperity and material abundance market economies have provided. The world has seen and experienced the good life under freedom. It is inconceivable that such a system of social organization could ever be abandoned for the impoverishment and serfdom of socialism.

The intellectual arguments that have been advanced in defense of socialism are bankrupt. Socialism has been a dismal failure wherever tried or found. From the slaughtering of Kulaks by Stalin to the holocaust of Cambodia today, socialism has been synonymous with human misery and death. Socialism is not the wave of the future. It is the sickness of the past.

The way of the future is freedom. The assault on capital is too costly to be continued. There are signs that the intellectual tide has turned in favor of freedom. There are signs of dwindling support for overextended government, as individuals demand to be free.

Freedom will prevail because freedom works. The creative poten-

tial of individuals in sovereign control over their own lives and property is an established fact. The hampering of productive people through the assault on their capital will be repudiated. The failure of socialism and overextended government will be the great lesson learned from the twentieth century.

The people of the United States have enjoyed freedom of choice for over two hundred years, and it must never be forgotten that the market society they created was the generating source of the great wealth that exists today. The destruction of the market order, like any social order, occurs slowly. To mistake what is occurring in the United States today as a source of this nation's wealth and material abundance would be the ultimate human tragedy.

What good life still prevails is in spite of the government policies of these past 50 years, and not because of such intervention. A nation of great wealth may be able to sustain an assault on its capital for a while, but to the poorer nations of the world such an assault would be instantly fatal.

The lesson to be learned is simple. It is that the hope of the future is not to be found in government management of the economy. Future productivity depends upon the individual, and it can be brought forth whenever he is free.

Capital Punishment

by John Semmens

A widely forecast recession did not occur in 1978. The Carter Administration stood practically alone in its insistence that there would be no recession. So, when the year ended with healthy gains in reported corporate profits there was much rejoicing, right? Well, not quite. It seems that while prosperity is a circumstance to be much sought after, profits—one of the symptoms of prosperity—are a “catastrophe” that the body politic cannot abide.

There is no rejoicing. Instead, the occasion serves to stimulate demands for mandatory profit controls from union potentates, while the President seems intent on providing an opportunity for in-house economists to grope for new meaningless phrases to describe and defend government economic policy.

The most amazing aspect of the whole spectacle is that so much inspiration could be generated by an event which never occurred. There was no increase in corporate profits in 1978. When adjustments are made to account for the effects of inflation, net profits actually declined by 4 percent rather than increasing by 16 percent, as the reported figures seem to imply.¹

This discrepancy between reported and real profits is one of the less ambiguous government accomplishments of recent years. On the one hand, a manipulative monetary policy has facilitated a phantom doubling of nominal profits over the last decade. On the other hand, a tax code which makes no provision for the declining value of each dollar, allows the government to confiscate ever larger portions of the nation's wealth. It is the old story of crime and punishment. Only in this case, while it is an agency of the federal government which robs the holders of money of their purchasing power, the punishment is dished out to the productive sector of the society.

Such a policy, though it may be temporarily expedient in the aggrandizement of government power, has significant negative effects

Mr. Semmens is an economist for the Laissez Faire Institute in Chandler, Arizona. This article is reprinted from *The Freeman*, September 1979.

on the general welfare. The progressively worsening bouts of stagflation, with each episode more unnerving than the last, are a manifestation of the future that such a policy portends.

It is possible, one must suppose, that the originators and executors of this counterproductive treatment of business profits are unaware of the damage wrought or, at least, that they discount its seriousness. However, a supposition of this sort must border on the absurd, given both the extensive discussion of the issue in academic and business circles, as well as recognition of the need to warn investors of the distortions to a firm's reported financial condition evinced by the Securities and Exchange Commission.

In May of 1976 the S.E.C. issued ASR 190, which required publicly held corporations to prepare additional financial statements estimating the impact of inflation on reported financial results. Thus, the business firm's access to equity financing is being stymied from all sides. The Internal Revenue Service, ignoring the effects of inflation in creating imaginary profits, siphons off retained earnings. Meanwhile the S.E.C., citing the effects of inflation, is warning off would-be investors from providing external sources of equity finance.

Since the counterproductive policy persists, despite its absurdity, we must demonstrate more convincingly its effects and why it is imperative that it be changed.

Suppressed Evidence

The most convincing evidence we would cite to illustrate the seriousness of the problem is the lack of progress in the stock market. The Dow Jones Industrial Average, the most famous of stock price indices, has failed to advance much above 1,000 in the past ten years. In fact the DJIA now stands lower than it did ten years ago. This is in spite of a near "doubling" of earnings over the span.

Customer's men and stock market touts are not the only ones to be mystified by the "sick" market. Viewed from the standpoint of the "value" of the assets owned by the firm, it would appear that shares are undervalued. The ratio of market price to book value is about half of what it was a decade ago. And since the nominal return to equity is approximately the same as it was then (about 12 percent on the Dow Jones Industrials), the shares must be worth twice as much, right? Wrong. The shares' price-to-earnings ratios are halved and the number

of companies whose shares sell for amounts less than tangible book value is substantial.

An obvious case of market irrationality, it would seem. Unless, that is, one is willing to consider an alternative hypothesis. What if it is not the market that is out of step with reported earnings, but, the reported earnings which are out of step with an "efficient" market? There are sufficient grounds for such a hypothesis in economic theory. At the root of the capitalistic theory of the economy is the presumption that given a reasonable period of time, the market is the most effective and efficient allocator of resources. Now, if a cost level adjustment to the reported financial statements of a sample of firms were made for the years 1967 through 1977 and the resulting figures appeared to conform more closely to the market value of the shares, then would it not be logical to conclude that the sickness is in profits and not the market?

For the purpose of evaluating the above hypothesis, the earnings and market values of the 30 companies which now compose the DJIA were compiled for the ten-year period. Use of these firms is defended on the grounds that combined they account for nearly 15 percent of the total earning power of all U.S. non-financial corporations. This is a significant slice of the total economic pie in this country.

Using an unweighted average of common stock earnings divided by average market prices of DJIA shares, we find an apparent rise in rate of return from 6.4 percent to 10.0 percent between 1967 and 1977. The return on common stock, by this measure, has increased substantially. However, if we adjust earnings to reflect the effects of inflation on the firms' depreciation reserves for long-term assets, an entirely different picture is revealed. In this case we find virtually no change in the return on common stock. In 1967 the rate was 5.2 percent, while in 1977 the rate was 5.4 percent.

Tortuous Taxation

"As a consequence of the U.S. tax system, inflation unambiguously reduces incentives to undertake new investment projects, and therefore, business investment spending declines."² It would appear that the chickens of Keynesian monetary manipulation have come home to roost. American investors can no longer be duped into accepting nominal rates of return which conceal lower real rates of return.

Despite demagogic rhetoric attacking "obscene profits" and "tax loopholes," an examination of real earnings portrays a much different story. Even though inflation effectively reduces income, the tax code makes no allowances for the reduction in real income. As a result, the after-tax return to equity takes a beating. In the last decade real after-tax return to equity dropped by over 50 percent, i.e., from over 10 percent to under 5 percent. Meanwhile, the effective tax rate on real income has soared to over 70 percent. Far from escaping "fair" taxes and piling up "windfall" profits, American corporations are being progressively bled dry.

This rising effective tax rate has been cited by numerous studies of the tax consequences of inflation. The important consequence, of course, has been the powerful disincentive for capital investment that is created. The real reduction in return that occurs when cash flows can recover only the original historical cost of fixed assets leads, quite naturally, to a more negative assessment of investment payoffs, and therefore, to less investment.

Ostensibly, the accelerated depreciation schedules that the IRS allows are supposed to offset the tax effects of inflation. While this may have been an adequate resolution of the problem 20 years ago when inflation rates were more modest, it does not provide much help today. An article in the *Federal Reserve Bank of St. Louis Review* found that the presence of a negative inflation effect was independent of depreciation methods used.³ A similar conclusion was reached by Richard Kopcke.⁴ Whether one used straight line or sum-of-the-years-digits depreciation under high inflation rates, the difference was minor, i.e., with an equipment life of 10 years and an inflation rate of 9 percent per annum, the difference in present value of the streams of cash flow under the two depreciation methods was only 1 percent.

Neither is the investment tax credit adequate to overcome the penalty resulting from taxation based on historical cost recovery depreciation allowances. A study by Parker and Zieha showed that under inflation rates of recent years, even an investment tax credit of 10 percent was not sufficient to offset the negative incentives of the basic tax code.⁵

The Real Crime

A look at the earnings performance of the 30 DJIA companies will serve to indicate the magnitude of the disincentives produced by the

taxation and inflation combination. After adjustment for inflation, *every company* has experienced a decline in return on equity between 1967 and 1977. For the entire period, profits were overstated by 29 to 55 percent, (using weighted and unweighted averages respectively). A year-to-year comparison reveals the growing distortion in reported figures. In 1967, nominal earnings were overstated by only 8 to 16 percent. However, by 1977 nominal earnings were overstated by 66 to 116 percent.

These phantom earnings are, of course, taxed as if they were real. In 1977, out of a pre-tax net income of \$39 billion, \$28 billion went to cover tax liability, \$10 billion was paid out in dividends, and only \$1 billion was retained to facilitate company growth. The ratio of taxes to real retained earnings in 1977 was 28 to 1. For each dollar these firms retained for future expansion, \$28 had to be set aside for government consumption. This compares to a calculated ratio of \$3 in taxes for every \$1 in retained earnings in 1967.

Excessive taxation is the real catastrophe, not corporate profits that are "way too high." The retained earnings of the 30 companies used in this study amounted to less than .3 percent of the total assets of these firms. Since it requires at least \$80,000 in real capital (adjusted for the effects of inflation on replacement costs) to support each job, the total employment-generating capacity of these firms from internal sources was 13,000. If this phenomenon can be said to be typical, then the total number of jobs that could be generated by the retained earnings of all U.S. nonfinancial corporations in 1977 was fewer than 90,000. This equates to an employment growth rate of one-tenth of one percent.

These figures may shed some much needed light upon the great mystery of modern economic orthodoxy: the simultaneous occurrences of high inflation and unemployment. Keynesian monetary manipulation assumes that more inflation means less unemployment, and vice versa. This theory relies heavily on the presumption that non-government investors are dopes. This, of course, is the fatal flaw in the system. Independent economic actors will seek to protect themselves against the losses resulting from investments penalized by inflation.

Job-Creating Programs Consume Available Capital

The progressively worsening results of monetary manipulation have been compounded by the implementation of various public job-

creating programs. If \$80,000 in capital can provide only one job in the private sector, then \$80,000 ought to be able to make work for at least five persons if it is simply spent by the government on salaries. Such a simplistic solution ignores the lesson told in the golden goose fairy tale. Private capital normally earns a return in excess of its cost. Over an extended period, the \$80,000 in capital would not only regenerate itself, but provide an increment for the expansion of the enterprise and employment. In contrast, the government program which consumes the \$80,000 to create five jobs is exhausted within one year. Repeated resort to consumption-based job creation must inevitably erode the long-term employment opportunities of the economy.

There can be little question that inflation and taxation lead to a lower rate of capital formation. Output is reduced, but the question is: by how much? One researcher called the total social welfare loss resulting from the current tax treatment of earnings on capital "astounding."⁶ His estimate of the yearly welfare loss was \$50 billion. The chief victims of this loss are working people. The punishment of capital and the reduction of returns on capital also reduce the returns on labor. Consequently, upward mobility and an improving standard of living are hampered by the poor returns on capital investment. These consequences are no less real merely because they are unintended. Policy makers would do well to remember this point the next time they seek to punish corporate "profiteers."

The persistent reliance on inflationary policies has created what may be the most difficult problem to reverse—inflationary psychology. The penalties inflicted on thrift and productive investment have nurtured an "eat, drink, and be merry for tomorrow we die" philosophy. It was Keynes himself who said "in the long run we're all dead." True to his word, Keynes is dead, leaving the rest of us to reap the harvest sown by policies based upon his theories.

The "long run" of 1935 is here today, with all of the distortions and disincentives that Keynes' early critics predicted. More and more, we see purchases made in order to avoid higher prices later. This rush to acquire hard goods increases the proportion of malinvestment. The earlier one commits to a specific investment, the less certain one can be of the future. This in itself would tend to lower return on fixed assets, even were inflation to be ended.

Further, manpower and resources are diverted to nonproductive pursuits. The deterioration of monetary assets impels an increase in

money velocity and paper financial transactions, as firms and individuals seek to minimize cash balances. This creates a demand for financial services in great excess to what would be necessary under a more stable monetary unit. These transactions consume resources that might serve more productive ends. In addition, managerial talent must be directed, at least in part, toward coping with the problems of inflation and its tax consequences. This diverts talent from dealing with matters that could be of more substantive benefit to our material well-being.

Possibly the most damaging effect of the inflation-taxation policy is the destruction of truth in both financial reporting and policy discourse. The disintegration of the monetary unit goes a long way toward invalidating corporate annual reports. Even worse, this distortion pollutes the price system and upsets the balancing and allocating functions performed by this system.

But the lowest blow of all is the contribution this policy makes to the deterioration of public policy debate. The whole "advantage" of a deliberate provocation of inflation is the element of deceit based upon the "money illusion." The money illusion concept is an illustration of Keynes' contempt for the intended victims of government manipulation of the money supply. People are not astute enough, Keynes reasoned, to perceive the erosion of purchasing power in the monetary unit. As long as the nominal dollar amounts of their incomes remained unchanged or higher, they would not react to protect themselves from the effects of inflation of the money supply.

Disciples of this "money illusion" theory attempt to trick the economic units in society into pursuing actions they would not ordinarily take. This makes dissemblers of our public policy spokesmen. How can a political system based upon democratic decision-making operate when the citizens must be fed lies as a matter of course in the implementation of national economic policy? One critic even goes so far as to claim that the whole process is intentionally dishonest—not for the people's own good, as apologists might argue—but for the express intent of increasing the government's tax take.⁷

The Ultimate Punishment

We have examined the effects of inflation and taxation on corporate profits. There can be little doubt as to the negative consequences. Corporate profits are, as a result of inflation, overstated. Since the tax

code makes no allowance for inflation, profits are then overtaxed. Real earnings are substantially reduced.

The penalties against earnings from capital investment have, naturally, discouraged such investment. This portends a rather dire future for the United States economy. Discouragement of investment shrinks the capital stock. If the effect on the 30 DJIA companies we have examined is representative, then the economic growth capacity of private business in the United States is less than 1/3 of the rate of population growth. If the long-term standard of living is to rise, or at least avoid a decline, more capital must be created. This is precisely what the government's policies on inflation and taxation are preventing.

Perhaps the greatest irony of the manipulative monetary policy has been the rising value of that "barbarous relic"—gold. At the same time that stock prices and the return on productive assets have declined in real terms, the price of gold has surged. The inflationary monetary policy spawned by Keynesian economic theory has done more to promote the resurgence of the "barbarous relic" than all hoarders and speculators could ever have hoped to achieve. Which only goes to show that in the long run, crime does not pay.

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Capital Consumption

by Hans F. Sennholz

Government spending seems to be an all-purpose remedy for economic and social ills, the key to important political ends. The world of scarcity with which man always has struggled is finally giving way to a fabulous world of fulfillment and plenty.

In the world of reality, every economic good must be produced by man and his capital in cooperation with nature. In order to consume more, man must produce more unless he is prepared to eat into the capital substance that is helping to produce the goods. Capital refers to the monetary net amount of all the productive assets of an enterprise, which may consist of anything from cash to receivables, inventory, tools, and economic equipment, or even land and buildings.

The amount of capital invested per head of the population basically determines the productivity of our labor, wage rates, and standards of living. We speak of a progressing economy when the per capita amount is increasing, which causes income to rise through an expansion of production. And we speak of a contracting economy when the amount of capital per person is shrinking, which reduces incomes and standards of living.

Every day we either accumulate capital through saving or reduce it through overconsumption. Businessmen either form capital through reinvestments of their earnings or dissipate it through losses or overconsumption. Every day total productive capital in the U.S. either expands or contracts, which causes labor productivity to rise or fall, and incomes and living standards to move accordingly.

The growing popularity of many government programs rests on the inability of the public to understand the nature and importance of capital. The redistributive policies of the U.S. government have consumed productive capital on a massive scale. At first, these policies merely slowed down capital accumulation and improvement in the

Dr. Sennholz was Chairman of the Economics Department at Grove City College, Grove City, Pennsylvania, for 36 years. Author of several books and hundreds of articles, he is now president of FEE. This article is reprinted from the May 1976 issue of *The Freeman*.

rates of production. But with the acceleration of government spending in recent years, it appears now that the U.S. has embarked upon net consumption of capital that was accumulated in the past. If this conclusion is correct, our redistributive policies have arrested further economic progress and now are reducing our wage rates and standards of living. Neither law nor regulation can prevent pernicious poverty if we choose to consume our capital substance.

We are the heirs and beneficiaries of the capital that was formed by our forebears. We are better off than earlier generations of Americans because we are working with capital goods that they created and accumulated for us. But if, for any reason, our generation chooses to consume more than we produce, we must prepare for reduced living conditions and all the social and political consequences thereof. And our children must learn to face further poverty and deprivation.

The Taxing of Progress

With the growing popularity of redistribution by political force, all levels of government have embarked upon specific policies of capital consumption. Their favorite tool at first was taxation of the income and wealth of rich capitalists and entrepreneurs.

From a modest beginning in 1913, the federal income tax rose steadily from one percent of personal incomes above \$3,000, or \$4,000 for married couples, plus surtaxes of 6 percent on incomes of \$500,000 or more, to a maximum personal income tax rate of 94 percent in 1944. Corporate income taxes soared to 90 percent of "excess profits." Simultaneously the federal tax rates on larger estates rose to 77 percent, on top of which the states may claim their shares. It is true that in recent years individual and corporate income tax rates have come down a little, but a variety of other taxes, from Social Security to state and local taxes, have taken even larger shares.

No matter what the motivation, this confiscation of the income and wealth of millionaires must have certain economic and social consequences. Corporate income may be distributed as dividends to owners or reinvested in business activity, that is, in capital goods that continue to render productive services. Expanding enterprises tend to reinvest most of their earnings in the business. Confiscatory taxation surely reduces the amount of revenue that can be reinvested in produc-

tive assets. And it curtails the dividends paid to stockholders and thereby reduces the savings that are reinvested.

Progressive income taxation has the same effects. Most successful businessmen with large incomes make large investments, that is, they convert income to productive capital which renders additional services. Confiscatory taxation obviously curtails this creation of capital and thus prevents production of goods and income. Labor productivity and living standards are debilitated as the taxing authorities consume this income.

Inheritance taxation to a large extent is an outright confiscation of productive capital. The wealth of a multimillionaire mainly consists of business assets that are producing goods for millions of customers and giving employment to thousands of workers. What the wealthy person holds to consume, such as his housing and clothing, usually constitutes a tiny fraction of his total wealth. Confiscatory estate taxation is bound to fall preponderantly on his productive assets, which means that the taxing authorities directly consume productive capital, and thus limit living standards and employment.

And finally, the taxpayers are influenced by the fear of such tax rates. Instead of making more productive investments—the profits of which are destined to be seized, or worse yet, the substance of which will some day be claimed by estate tax collectors—the individual may prefer to consume and enjoy the wealth himself. Why strive and struggle if the fruits will be reaped by tax collectors? Why preserve his capital for the benefit of politicians and their beneficiaries?

Deficit Spending

When the public demand for government services and benefits grows beyond the ability of business and wealthy taxpayers to pay, budgetary deficits become unavoidable. After all, the popularity of redistribution by political force tends to grow with every dollar of "free" service rendered. The clamor finally becomes so intense that, in order to be heard, every new call is presented as an "emergency" that must be met immediately before all others. Redistributive government then rushes from one emergency to another trying to meet the most noisy and politically potent demands. As no one wants to pay for the new expenditures, least of all the beneficiaries, the transfer administration is bound to suffer budgetary deficits.

When a corporation suffers losses for long periods of time, it inevitably comes to the end of its capital substance and ceases to operate. Any remaining assets will be distributed to its creditors. While government deficits may not throw the government into bankruptcy, they nevertheless have economic consequences. They destroy productive capital. Indeed, the deficits of the U.S. government have consumed, and continue to consume, capital substance on a scale far greater than all losing enterprises combined. In the decade of the 1950s total U.S. government deficits amounted to a mere \$17.7 billion. During the 1960s the total was \$56.9 billion. Deficits during the first half of the 1970s soared to \$71.4 billion, and, as if they were following an exponential curve, in fiscal 1976 alone are expected to exceed \$74 billion.¹

It is difficult to estimate the number of factories and stores that were not built, the tools and dies that were not cast, the jobs not created, the wages not paid, the food, clothing and shelter not produced on account of this massive consumption of capital. This generation of Americans and countless others to come will be poorer by the productive capacity that could have been, but was not created.

Of course, the beneficiaries of the redistribution process may have enjoyed every moment of it. Among men lacking vision, today's enjoyment is always more pleasurable than saving for tomorrow. They may applaud the very favors and handouts that are destroying their jobs and the wages they could have earned, and costly emergency programs may be hailed as progress though they yield the opposite. The bank or insurance company that is investing the people's savings in Treasury bonds, notes, or bills may be enjoying "safety" for its investments. What is significant is the fact that it is channeling potentially productive savings into the maelstrom of government consumption. The returns it seeks from its investments will not come from new production but from taxes to be collected in the future.

In dim awareness of the importance of capital, some social spenders are quick to maintain that government spending is merely another form of investing. Therefore, they want government to "invest" in a greater society that is to be built by political force and redistribution of property. Their judgment of what is most urgent and important is to prevail over that of all others.

All such planners are would-be dictators. No matter what the objective, government expenditures always constitute economic costs that

are borne by taxpayers, lenders, or inflation victims. Even when the government builds roads or canals, utility plants, or airports, the expenditures invariably flunk the tests of the market. Demanded by voters, authorized by politicians, and administered by bureaucrats, public works constitute huge malinvestments that waste scarce resources and consume productive capital.

Inflation Destroys Capital

When the redistributive society has exhausted its favorite victims—wealthy taxpayers and lenders—it can be expected to resort to inflation as a desperate method of fund-raising. The inflation then taps the savings of the middle class whose material wealth mainly consists of monetary assets and claims. It destroys the capital markets that provide the necessary savings for the expansion and modernization of productive enterprises. And above all, it causes businessmen to overestimate their earnings, overpay their taxes, and consume their fictitious profits.

When the purchasing power of money depreciates, all claims depreciate at the inflation rate. Creditors lose and debtors gain. Now the creditors—for instance, physicians, dentists, attorneys, business executives, and all others holding savings bonds, life insurance, pension funds, and the like—may, in spite of their inflation losses, endeavor to maintain the levels of consumption to which they have grown accustomed. The physician whose Keogh fund has lost half or more of its purchasing power, will not sell his home or automobile, or postpone his vacation because of his inflation losses. On the contrary, in reaction to his losses, he may save less and consume more because of the apparent "futility" of saving. Or, he may want to hedge against further losses by investing in durable goods, which do not enhance the capital supply.

On the other hand, the debtors who are gaining from the debt depreciation may immediately raise their consumption. The government whose real debt, let us say, is cut in half will surely increase its spending. In fact, it may be tempted to add more debt until its old level of real debt is restored. Most individuals tend to react the same way. The house owner whose mortgage debt has diminished to insignificant monthly payments may buy new furniture or appliances. His consumption rises as his debt decreases.

Corporate Losses

Corporations, which as a class are the largest debtor, lose most of their inflation gains to tax collectors, labor unions, and their customers, all of whom are eager to boost their consumption. As prices rise, taxes rise at progressive rates. When corporate income doubles on account of the inflation, the multiplicity of corporate taxes will surely more than double. Labor unions will make massive demands that are to compensate them for past losses and anticipated losses during the life of the contract.

And finally, customers may reap inflation gains as corporations tend to pass their gains from debt depreciation on to their customers. After all, when a bank loan falls in value or a corporate bond loses in purchasing power, a corporation usually does not raise the prices it charges its customers. On the contrary, facing the competition of many other enterprises reaping similar gains, the corporation may keep its own prices lower than it otherwise would. This means that customers pay prices that do not fully cover the rising costs of capital. Only gradually, when the inflation raises interest rates and corporations face higher interest charges on new loans, do business costs rise and ultimately the prices of goods. Thus, corporate customers are reaping gains at the expense of corporate creditors, gains that may find their way into additional consumption. Only a small fraction of the capital lost by creditors may be retained as productive capital by the corporation.

Capital Markets Disappear

Inflation destroys the capital markets. Surely, there are always debtors eager to borrow money at "low" interest rates, that is, at rates that do not fully compensate the lender for the anticipated inflation losses. But the number of creditors willing to lend their funds at such rates tends to shrink with progressing inflation. Instead of suffering losses, the would-be lenders may prefer to consume their funds, or invest them in durable goods that may rise in price rather than depreciate in purchasing power.

Thus, the capital market tends to wane and economic expansion is checked for lack of capital. In fact, there may not even be enough capital to *maintain* the apparatus of production if business should fail

to earn sufficient profits to rebuild and replace the capital goods that were used in the production process.

In countries that are plagued by chronic inflation, as in Asia and South America, long-term capital markets have long ceased to exist. Consequently, new plants and enterprises requiring large investments of capital cannot be built, labor productivity cannot rise, and living conditions are destined to remain at misery levels.

Inflation makes economic calculation nearly impossible, which invariably causes businessmen to overestimate their earnings and overpay their taxes. Both accounting convention and tax legislation permit businessmen to treat as costs only those costs of capital that were expended in the past. But economic action always aims at future provision of goods and services, the past is significant only as it provides the means for future action. The fact that a certain item of capital equipment cost \$1 million five years ago is irrelevant for business decisions if it costs \$2 million today. If only \$1 million were set aside for its replacement the production process cannot continue. But tax accounting only depreciates past capital costs and thus during inflation understates present cost and overstates business earnings.

Earnings Overestimated, Taxes Overpaid

The overestimation of American corporate earnings in recent years runs into tens of billions of dollars. Capital intensive industries, especially, are badly affected by this delusion, leading to massive capital consumption. To illustrate the point, let's take a chemical company with capital facilities of one billion dollars earning 20 percent before taxes, but after taxes only 10 percent or \$100 million per year. If the facilities need to be replaced on the average of every five years, our company will depreciate \$200 million per year. Let us now assume that in a given year inflation raises the costs of the capital equipment by 25 percent, which is a realistic assumption today. Our company needs \$250 million for replacements this year and every year thereafter. If capital goods prices continue to rise at the 25 percent rate, it will need \$312 million in the following year, \$391 million in the year thereafter, \$488 million in the fourth year, and \$610 million in the fifth year—altogether \$2.051 billion in five years. But in order to accumulate this amount for mere capital replacement, in order to earn the extra billion dollars in five years, its profits after taxes would have

to rise by \$200 million per year, that is, from \$100 million to \$300 million, and its gross profits before taxes would have to soar from \$200 million to \$600 million. Only a 60 percent gross return on capital could maintain its substance; anything less would lead to capital consumption.

Few companies are enjoying such profits today. Most businessmen are happy to earn their "normal profits" regardless of the rising costs of capital goods. They continue to calculate with capital costs of the distant past and thus arrive at earnings that are greatly overstated, and at overestimated tax liabilities that further reduce the meager returns. Only when specific replacements of capital goods are made, perhaps with the help of loan capital, do present costs appear on the company ledgers and depress the calculated earnings.

Few capital-intensive enterprises today are earning returns that fully cover the higher costs of capital. This is why capital spending by American business is declining year after year. Even a Commerce Department survey admits that projected spending in 1976 won't keep pace with the rise in capital-goods costs. The spending projection suggests a decline in "real" spending of about 5 percent, which follows a decline of more than 10 percent in 1975, the worst in 14 years (Cf. *The Wall Street Journal*, Jan. 14, 1976, p. 3). The situation is even worse when we bear in mind that some of these capital expenditures are made by industries that cater to growing government consumption or are making mandated changes to meet the requirements of government regulations and controls. Such capital spending surely does not increase the stock of capital goods that are producing economic goods and services. They actually consume capital and thus lower the productivity of labor.

The businessman who, because of underdepreciation, overstates his earnings and overpays his taxes, may blithely consume his capital. After all, as goods prices rise he may allow himself to be impressed and deceived by his rising dollar profits and therefore indulge himself with higher outlays for consumption. While he is enjoying his "profits" he may actually be eating into his capital substance.

The Business Cycle

The boom and bust cycle, which is an inevitable consequence of inflation and credit expansion, is a powerful destroyer of capital. The

administration that resorts to such policies must be charged with the responsibility for this capital destruction.

When the monetary authorities create new money and credit in order to stimulate economic activity they set in motion a causal chain of ominous events. Let us say they, as lenders of last resort, are financing a \$75 billion federal deficit. They either acquire Treasury obligations directly in exchange for newly created funds, or they extend new credits to banks who then purchase the Treasury obligations. No matter how it is done—directly or indirectly—the Treasury comes into possession of newly created purchasing power that enables it to buy more commodities and services. It thus withdraws real goods from other members of society, from consumers as well as businessmen. Everyone who is not a recipient of the newly created deficit funds must now tighten his belt as government is consuming a larger share of production.

When the monetary authorities engage in credit expansion in order to stimulate economic activity they destroy capital on a massive scale. The newly created funds, i.e., fiduciary credits, that are injected into the banking system tend to disarrange the whole production process. They lower interest rates and thereby misguide business in all its investment decisions. After all, the market rate of interest is an important guidepost for business, and an important item of cost that determines the profitability of activity. Whether a time-consuming project can be embarked upon largely depends on the rate of interest.

False Signals

When our monetary authorities inject fiduciary credits, interest rates tend to fall. That is, they falsely indicate the existence of savings that in reality were never made. Misguided by such low interest rates, businessmen may be led to embark upon investments that later will be disastrous. After all, the real savings are not available for a new round of expansion and modernization; the guidepost has been misplaced. It causes business to launch an economic boom amidst confusion and delusion. Many expensive projects are undertaken that later will prove to be costly malinvestments.

The mistakes become visible as soon as the prices of the factors of production, which are business costs, soar on account of the boom while consumers' goods prices fail to keep pace with the former. Profit

margins are squeezed or turned into losses—powerful reminders of the mistakes that were made. Businessmen may then be forced to abandon their expansion projects for which there was no economic demand; many may fall into bankruptcy. Massive amounts of capital are written off—that is, are permanently lost. A society that indulges in such destructive policies must pay the price in the form of lower labor productivity, lower wage rates, and a lower standard of living.

Government Regulations

It will never be possible to calculate the economic costs of government regulations. A few are visible, but most are hidden in the dimension of economic action that never took place on account of the government interference. The order that closes a factory may cost little in bureaucratic expense; even the capital losses to owners may be moderate. But the reduction in public well-being which the factory used to serve, the goods no longer produced, the wages no longer paid, the income no longer earned, the savings and investments that will never be made, these are incalculable real costs that may greatly surpass the visible losses.

Government intervention by law or decree may assume several forms: it may be directly prohibitive or restrictive as it forcibly prevents economic production. It may weaken competition through licenses and franchises or even create cartels and monopolies. It may impose additional costs on the production process. The U. S. Environmental Protection Agency, for instance, may want American industry to spend some \$32 billion in order to reduce the occupational noise limit. And finally, the regulation may interfere with business management and efficient application of land, labor, and capital. All such controls and regulations tend to reduce economic productivity, depress wage rates, and lower our standard of living.

Capital is consumed when, for any reason, the capital goods expended in production are not replaced. If we consume more than we produce, we dissipate the productive wealth accumulated in the past. Or, even, if our consumption should stay the same, but production falls below our consumption levels, we are eating into our substance.

In the United States we are attacking capital on both fronts: our political institutions are pressing continuously toward higher levels of consumption as most politicians are clamoring for ever greater govern-

ment expenditures; and production is falling off because of costly government intervention.

The Environmental Decade

The 1970s are supposed to be the "environmental decade"—ten years devoted to cleaning and mending our environment. The laws and regulatory actions of the 1970–1975 period alone are estimated to cost industry some \$300 billion in addition to the major costs the taxpayers will be forced to bear. All such costs are "unproductive," meaning that the expenditures consume business capital without generating new production and income. Production costs per unit of output are not lowered, but raised, which causes real incomes to decline. F. C. Olds, senior editor of *Power Engineering* magazine, estimates that present environmental protection laws are costing every American family \$2,000 a year (*Power Engineering*, September 1975, p. 38 *et seq.*) If such costs merely were to reduce our incomes they would not destroy capital substance. But the \$300 billion which industry must spend is business capital that will never be used to produce economic goods.

According to a recent report of the U.S. Council on Environmental Quality, pollution control is a growth industry that has created roughly one million jobs during 1975 (*Chicago Tribune*, January 6, 1976, sec. 2, p. 4) If this should be true, we cannot escape the conclusion that this new industry with one million workers is busily consuming the capital substance of the productive industries rendering economic services to consumers. It cannot be surprising then that while the former is prosperous and growing, the latter industries are lingering in stagnation and recession.

This is not to imply that environmental pollution is preferable to clean air and water. On the contrary, let us favor full allocation of the total costs of property to its owners. As the undiminished benefits of an economic good should accrue to its owner, so should the costs be borne by him. But rather than rely on government regulation and an army of bureaucrats, let us rely on the safeguards of contract and the jurisdiction by courts of law. And let us seek to reduce the sphere of public property which is the principal source of environmental pollution.

Regulatory Agencies

Government regulation dissipates capital directly through imposition of capital outlays, and indirectly through restrictions of productivity that reduce income, saving, and investment. The American cartels are cogent examples of the latter. Through compulsory government licensing and rate making, government agents control the railroad industry, the motor carriers, water carriers, freight forwarders, air carriers, power generation, and broadcasting. Furthermore, government is manipulating labor and management in order to achieve its political and economic objectives. The National Labor Relations Act of 1935 and 1947, the Fair Labor Standards Act of 1938, the Employment Act of 1946, the Occupational Safety and Health Act of 1970, the Comprehensive Employment and Training Act of 1973, all are designed to prevent the application of labor according to the efficiency dictates of the market. Extensive government control over agriculture is preventing this important industry from working efficiently for its world-wide markets. And finally, the recent government takeover of energy production and distribution places all industries in serious jeopardy.

It is the very objective of such controls to interfere with efficient economic production. After all, if we equate profitable production for the market with economic efficiency, then government interference with this production must necessarily be inefficient and costly. It is costly to consumers who pay more for fewer goods, and to producers who may suffer losses in income and capital. A small reduction in business income entails a large loss of capital. After all, it is the yield of capital that determines its market price, a \$1 million reduction in income, for instance, may lower capital goods prices by \$10 million. A regulation that completely idles a productive enterprise completely destroys its productive capital, or at least reduces it to the salvage value of its component parts.

Labor Unions

Capital can be formed only by saving, that is, a surplus of production over consumption. An enterprise that enjoys an excess of proceeds over costs earns a surplus, commonly called profit, some of which

usually is plowed back into production. Profitable enterprises tend to grow; unprofitable ones must contract.

Labor unions owe their existence to the doctrines and notions of labor exploitation. They are pressure organizations of members who are afraid to stand alone in the economic world of competition. Through strikes and threats of strikes they aim to achieve one basic objective: to improve the lot of their members through higher pay and benefits, or through lower output and less work. In every instance, labor unions endeavor to raise the costs of production.

Productive business capital is consumed in nearly every phase of union activity. A strike may severely drain the working capital of an enterprise. After all, most business expenses continue although production is halted. Productive property may be damaged or even destroyed. And when the strike is finally settled, the costs of labor usually rise substantially. The hourly pay of union members as well as their fringe benefits, such as paid holidays, vacations, health and dental care, pension funds, and the like frequently double labor costs in just a few years. For the average General Motors hourly employee in the United States, the so-called fringes now come to \$4,500 a year (Remarks by Thomas A. Murphy, Chairman of General Motors Corporation before The Economic Club of New York, November 12, 1975). But this is not all. The work rules to which the company must submit under the new contract may prove to be even more costly as management loses its ability to manage labor efficiently. The seniority rule may prevent a more efficient younger worker from performing a task. The "bumping right" of a senior worker may even cause the younger man's dismissal. Management must helplessly watch the replacement of its best workers by senior union workers, the substitution of inefficient work rules for labor efficiency, or the application of unproductive methods and tools of production. And finally, the job discipline tends to suffer as union members may feel protected from managerial direction and supervision.

The demands and tactics of militant labor unions invariably reduce the expansion of profitable enterprises as business profits are turned into labor expenses rather than productive capital. Marginal enterprises that are burdened by new labor costs now suffer losses that dissipate business capital. And enterprises that were suffering losses even before the union extracted its coercive costs may be forced out of business.

In each case, economic output is reduced and productive capital is consumed.

Capital Consumption Tends to Accelerate

Every day, one's economic condition either improves or deteriorates. It is unlikely that anyone's condition would remain unchanged, as income and consumption are independent continuous processes that rarely balance each other. Even if your savings and cashholdings should stay the same day after day, you probably are suffering a decline in living conditions as your consumer goods, such as your car, refrigerator, and shoes, are wearing out. The same is true with business. Every day a business enterprise either accumulates capital through saving, or reduces it through overconsumption. In a prosperous society with high rates of productivity and income, many people are in a position to save and invest. After the most important needs are met, a part of income is left for productive improvements. On the other hand, in a poor country it is more difficult to save and invest. In India, which reports a per capita income of \$98 per year, it is more difficult to save \$50 than in the U.S. where individual incomes average some \$6,000. In fact, we can easily make more productive improvements, that is, spend more money on new factories, stores, machines, and equipment, than the average Hindu is earning. This fact, together with the institutional handicaps that cause some countries to be so poor in the first place, explains why the difference in living standards between various countries continues to widen.

As economic improvements may accelerate through ever higher rates of saving and investing, so may we see an accelerating process of capital consumption and economic decline. No matter what our incomes may be, if we consume more than we produce we are eating into our productive substance. And once we consume capital while stubbornly clinging to old levels of consumption to which we have grown accustomed, we descend at ever faster rates. The stockholder who liquidates some stock in order to supplement his dividends for living expenses faces lower income in the future. If, nevertheless, he maintains his living standard he will have to liquidate his holdings faster and faster until the last share is sold. Obviously he could halt his impoverishment at any time, or even restore his fortune, through suitable curtailment of his living expenses.

Changing the Body Politic

For a future-oriented, determined individual, it may be relatively easy to readjust his consumption to falling income. But for a society consisting of millions of voters who are bent on redistribution and consumption through the political apparatus, this readjustment may be rather difficult. If the public is indifferent or uninformed about the significance of productive capital, the political pressures for government benefits and services may grow when incomes are falling. The very forces that are debilitating productive capital through overconsumption are likely to oppose any reduction in consumption. They may move heaven and earth to maintain their spending levels which, after all, come from "social benefits and services" to which they believe they are morally and politically entitled. Thus, the process of dissipation once begun feeds on the public pressures for simple preservation of the economic way of life to which we have grown accustomed.

If declining productivity and incomes should finally cut into those benefits and services, the beneficiaries may rise in anger about the sudden "violation of their rights." There could be social disturbance and disruption of the production process, which would reduce output and income even further, which in turn would again aggravate the social situation—a vicious circle of frustration and decline!

But even without this particular social force of acceleration, we may consume productive capital at accelerating rates. Many people react to declining real incomes from employment by producing less. They may even blame their employers, those "greedy" and "ruthless" merchants and industrialists, whom the demagogues will be quick to condemn for the decline. Absenteeism, slowdowns, work stoppages, featherbedding, and other restrictive work practices may grow worse. But lower output on account of lower labor efficiency raises labor costs and dissipates business capital. Only greater output through harder, more efficient work can arrest the decline.

In Spite of It All

Facing such powerful restraint on his creative energy, why does man not just surrender? Why does he struggle against all such odds to preserve his material well-being instead of consuming it in the pleasures of the moment? Why, in spite of this massive capital consump-

tion by our political institutions, do we continue to enjoy a standard of living that is the envy of the world? It cannot be the nature of man that continues to guide us to high incomes and relative prosperity. For the vast majority of human beings throughout history have lingered in abject poverty and suffering. It cannot be a racial characteristic of the white man, for he, too, has lived with hunger and misery throughout most of his history, and millions still do today. It cannot be the natural resources at our disposal, for countries that are poverty-stricken may be rich in such natural resources. The answer must be sought in the moral antecedents to economic freedom and prosperity. Honesty, integrity, independence, self-reliance, respect for the rights of one's fellowmen and their property, the ethos of work and thrift, and genuine concern for tomorrow continue to live in the hearts and minds of millions of people. The moral values that gave birth to our political and economic order with its democratic institutions and the private property system in production are still alive and continue to guide many Americans. Attacked and wounded, hackled and mutilated, their individual enterprise system continues to deliver more goods, affords higher incomes, and better living conditions than any other system now or ever before. And although many Americans no longer embrace its moral antecedents, they are naturally cautious in eradicating all remnants of such a system. While enjoying its rich fruits, they may question its various pillars, but are reluctant to bring them down all at once.

Thrift and Industry Bring Forth Economic Progress

To avoid gradual impoverishment, we must reverse this ominous trend toward the consumption of our substance. If we seek to improve our working and living conditions and to give a better economic life to our children and future generations, we must save and build now. We must curtail our appetites for present enjoyment and allocate a share of our earthly goods to production for the future.

No matter what a man's motives for saving may be, he not only serves himself but also benefits society. Even the miser who saves more than other people deem appropriate, clinging to his savings in growing cashholdings, renders a valuable social service. His act of saving allows a supply of goods that were produced to be available for further production activities. But most people who save part of their incomes

either deposit their savings in banks and other thrift institutions, or directly purchase more factors of production. In each case, saving may directly be turned into capital accumulation. The farmer who builds a fence or barn or buys a tractor is creating capital that renders his labor more productive. The merchant who improves his store or enlarges his inventory is forming business capital. The oil company that builds a refinery or service station is creating capital goods that render human labor more productive. And the refinery worker who deposits his savings in his bank or credit union helps to create productive capital as some of their reserves are invested productively, yielding incomes on the investments.

A society that looks upon thrift and frugality as social virtues, that believes with Benjamin Franklin "if you know how to spend less than you get, you have the philosopher's stone," such a society cannot escape the rich rewards that come from capital formation. On the other hand, a society whose habits are not thrifty will soon be poverty-stricken.

Our economic well-being depends on our ability to master the world of production which depends on our power of work. Man must work, which is as certain as life and death. In order to earn more, he must produce more. And he can always work more in order to produce more, which gives him the means to create the capital for ever higher productivity in the future. Work is not a curse; it is the only means to sustain and improve human life. Work, hard work, and long hours of work are the parents of prosperity.

The Blessings of Work

A society that looks upon labor as a blessing that brings happiness and ennobles all those who labor, reaps rich rewards in economic prosperity and progress. After all, the greatest economic asset of any people is the determination and courage to work. On the other hand, a society that frowns upon work as a curse or man's device of exploitation is destined to be poor and wretched. As the man who lives in constant fear of exploitation and does not work for the love of work, but only for money, is likely to be poor and dejected, so is a society of such individuals likely to be plagued with poverty and torn by strife.

Man's thrift and industry yield rich fruits, even though his body politic indulges in profuseness and encourages idleness. In fact, when

the political institutions embark upon the consumption of economic substance, it becomes all the more important for the individual to preserve his productive capital through greater thrift and industry. And when the amount of capital invested per head of the population begins to decline, with ever lower real wages and standards of living, the individual may endeavor to offset the social decline through rising personal productivity. Indeed, he may successfully swim against the stream as long as the current of decline does not surpass his own forward movement.

When individual thrift and industry decline, man's political institutions invariably reflect his changing aspirations. The government of profuse and idle men indulges in capital consumption and sanctions idleness. To reverse our ominous trend toward poverty and conflict, our political institutions must learn again to live within their present circumstances. For no society can be rich whose expenditures exceed its means.

All present policies that consume productive substance must be abandoned. Confiscatory taxes that prevent the formation of productive capital must be repealed. The deficit spending that consumes the people's savings must be halted immediately. The inflation that is destroying the life's savings of millions of thrifty Americans must be abhorred as a crime against economic well-being and social peace. The business cycle must be prevented through resort to sound and honest money. The countless government regulations that are impeding economic productivity and consuming business capital must be repealed and bureaucratic labor returned to productive employment. And finally, the legal immunities and privileges of labor unions must be abolished and labor disputes returned to the courts of law. In short, government must remove its numerous shackles on the creative energy of man.

1. Federal budget deficits soared to \$364 billion during the 1970s, to more than \$2 trillion during the 1980s, and are expected to exceed \$4 trillion during the 1990s.

The Power to Tax Is the Power to Destroy

by Clarence B. Carson

Chief Justice John Marshall was at his axiomatic best in the Supreme Court opinion set forth in *McCulloch v. Maryland*. He propounded several interesting and profound axioms in that decision. The strange thing about these axioms is that they have been permitted to remain in the limited context in which he found use for them rather than being given general application. This is strange because axioms are, by nature, universal in extent and everywhere applicable, if they are true. Moreover, these axioms have been given added weight in the United States by being embedded in and used to buttress a unanimous Supreme Court decision which still stands.

The axioms in question are stated and appealed to in several ways in the course of the opinion. The most direct statement of them is contained in the following clauses: "That the power to tax involves the power to destroy, that the power to destroy may defeat and render useless the power to create . . ." The implications of the axioms had already been laid down a few sentences earlier:

These are, 1. That a power to create implies a power to preserve. 2. That a power to destroy, if wielded by a different hand, is hostile to, and incompatible with, these powers to create and preserve. 3. That where this repugnancy exists, that authority which is supreme must control, not yield to that over which it is supreme . . .

Before proceeding to the broader application of these principles, or axioms, it is in order first to explain the context within which they were employed by Chief Justice Marshall. The Court had before it a case arising out of a law passed by a state. In 1818, the Maryland

Dr. Carson has written and taught extensively, specializing in American intellectual history. He is the author of several books. Among them are *Organized Against Whom? The Labor Union in America* and the comprehensive *Basic History of the United States*. This article first appeared in the October 1976 issue of *The Freeman*.

legislature had enacted a statute levying a tax on all bank notes issued in Maryland by banks not chartered by the state. A branch of the Bank of the United States, a bank incorporated under the laws of the United States, was located in Baltimore. A man named McCulloch, cashier at the bank, refused to pay the tax on bank notes (currency) issued. The case came to the Supreme Court in 1819.

Two issues were taken up and decided by the Court. The first need not much concern us here. Suffice it to say that it involved the question of whether the United States government was authorized by the Constitution to create such a corporation and that the Court, following the reasoning which Alexander Hamilton had originally used to justify the chartering of a United States bank, held that it was. The other issue was the one which called forth the above axioms in resolving it. The issue was this: Could a state tax an instrument of the United States government created in pursuance of constitutionally permissible objects? The Court held, in as absolute terms as could be employed, that no state could tax an instrument of the United States government.

Chief Justice Marshall did not, then, restrict himself in writing the opinion to the simple question of whether or not Maryland could tax bank notes issued by the United States Bank. Instead, he explored the whole question of the taxation of any creation of the United States government by any state. Some of this exploration is both interesting and relevant to the even broader issues to be taken up in this article. Before quoting further from the decision, however, something else needs to be got out of the way.

Universal Application?

It is my contention that the axioms and principles set forth in support of this decision, if correct, *apply to all taxation*. That is, the power to tax any one by any government involves the power to destroy and that this power of government by taxation to destroy can defeat and render useless the power of individuals to create and preserve what they have created. Superficially, the conclusion—that the states could not tax the federal government at all—appears either to rule out all taxation by governments or not to apply to governments in relation to individuals.

It is tempting, of course, to apply the conclusion literally and rule out all taxation, but it is a temptation that should be resisted. The case

for taxation by governments is almost, if not quite, as good as the case for government itself. In theory, governments might be supported by voluntary contributions. In practice, however, the voluntariness of the contributions would always be suspect. Government relies on coercion to carry out its edicts, and there should be no doubt that if it depended on "voluntary" support it would extend its protection mainly, or only, to its benefactors. Moreover, it is unlikely that the power of government could ever be restrained from such confiscations as would enable it to meet its bills. Justice requires that all who can should pay for government. Taxation is probably the only means of achieving this result, or approximating it. In any case, the necessity for taxation is so universally accepted that it should be presumed to be the correct approach in the absence of conclusive proof to the contrary.

It does not follow, however, that Marshall's strictures about the power to tax do not apply to governments in their relations to individuals. Not only are they applicable, but they apply even more emphatically as between governments and individuals than between states and the Federal government. If the power of a state to tax the Federal government could destroy the instrumentality taxed, how much more readily could government taxation destroy relatively helpless individuals? There is nothing in logic to prevent the application of the axioms to individuals as well.

On close examination, it comes out that Chief Justice Marshall did not base the *absolute prohibition* of state taxation of instruments of the federal government on the axioms he adduced in *McCulloch v. Maryland*. Instead, he based the prohibition on the relationship between state governments and the federal government, a relationship which lacks the *proper limits* on the power to be exercised. It had apparently been argued that the Court should have confidence that the state would not abuse the power of taxation. Marshall rejected this line of reasoning:

... But all inconsistencies are to be reconciled by the magic of the word CONFIDENCE. Taxation, it is said, does not necessarily and unavoidably destroy. To carry it to the excess of destruction would be an abuse, to presume which would banish that confidence which is essential to all government. But is this a case of confidence? Would the people of any one State trust those of another with a power to control the most insig-

nificant operations of their State government? We know they would not. Why, then, should we suppose that the people of any one State should be willing to trust those of another with a power to control the operations of a government to which they have confided their most important and most valuable interests? In the legislature of the Union alone, are all represented. The legislature of the Union alone, therefore, can be trusted by the people with the power of controlling measures which concern all, in the confidence that it will not be abused. This, then, is not a case of confidence, and we must consider it as it really is.

Marshall proceeds to point out that if a state can tax one operation of the federal government, it may tax any of them.

If the States may tax one instrument, employed by the government in the execution of its powers, they may tax any and every other instrument. They may tax the mail, they may tax the mint; they may tax patent rights, they may tax the papers of the custom-house; they may tax judicial process, they may tax all the means employed by the government, to an excess which would defeat the ends of government

Granted that if states could tax one instrument they could tax others. Perhaps, too, such taxation could be used to defeat the ends of government. Strangely, however, Marshall goes on to argue that the Federal government could tax instruments of the states, and that power, so far as his argument had advanced, could be used to destroy the states or their instrumentalities. The difference, he said, is this

The people of all the States have created the general government, and have conferred upon it the general power of taxation. The people of all the States, and the States themselves, are represented in Congress, and, by their representatives exercise this power. When they tax the chartered institutions of the States, they tax their constituents, and these taxes must be uniform. But when a State taxes the operations of the government of the United States, it acts upon institutions created,

not by their own constituents, but by people over whom they claim no control. . . .

The crux of Marshall's argument for prohibiting state taxation of the federal government, then, was that state taxation lacked the proper base and limits. A part of the people could, at least in theory, be taxing the whole people. If states could levy taxes on the federal government, there would be no requirement of uniformity. One state might, for example, levy a 5 percent tax on notes of the United States Bank, another 10 percent, another 50 percent, and so on.

An Outgrowth of the System

The reason for the *absolute prohibition* of such taxation was accidental, not essential. That is, it did not arise from the nature of government or of taxation but from peculiar, hence, accidental, features of the federal system of government. The Court's decision in this case, of course, was concerned with ruling upon acts occurring within this system, and constitutional historians have usually held that Marshall was concerned with asserting the supremacy of the United States government. Be that as it may, it is not my purpose here to enter upon the question of the merits of the decision or of the particular arguments advanced in support of it. These have been brought up only to show that the absolute prohibitions against the taxation involved arose from peculiar arrangements and not from the axioms which were earlier cited. In short, they were brought up in order to get them out of the way so as to give the axioms the examination they warrant and suggest their implications.

The only reason for not applying the axioms—"That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create"—to government taxation of individuals, then, would be that they are not valid. It is not difficult to test their validity as axioms. It involves only determining whether in the nature of things they are necessarily true. Clearly enough, the power to tax does involve the power to destroy. The power to tax entails the power to take up to 100 percent of the income from any undertaking. No undertaking, no matter how well it is financed, can survive indefinitely if all its income is drained away in

taxes. Hence, any and every human undertaking, short of breathing, can be destroyed by taxation.

Counterproductive Taxation

If any human undertaking can be wiped out by taxation, it follows that taxation may "defeat and render useless the power to create." There would be no purpose in beginning undertakings if they were certain to be destroyed by taxation. The chances are good that man's ingenuity would not be completely stifled by such government action, but it would surely be rendered largely useless.

The axioms are shown to be valid by this line of reasoning, but, unhappily, they are thereby made very nearly irrelevant. One hundred percent taxation would dry up all sources of revenue, hence, such a level of taxation would be counterproductive, as the contemporary phrase has it. Or, the government would have to proceed by the enslavement of some portion or all of the population. The evil would then be slavery, though slavery is essentially nothing more nor less than 100 percent taxation. While the enslavement implications are not entirely irrelevant, they do tend to place anything less than 100 percent outside the frame of the axioms.

But does the validity of the axioms depend on carrying the argument to its logical conclusion? John Marshall did not hinge his use of them on some potential extremity. He did not even explore much the question of the degree of the taxation. He was very careful to exclude the whole question of abuse, for if he had admitted its relevance he would have been drawn in a quite different direction. In point of fact, he put in his axioms to serve as a foundation and then proceeded to cover them with his edifice of federal supremacy. Even so, if the axioms have the validity he ascribed to them, they should be valid in the absence of abuses.

All Taxes Affect Creativity

It is my contention that the axioms are valid regardless of the degree of the taxation. The power to tax involves the power to destroy whether the degree is some fraction of one percent or 100 percent. It is possible to demonstrate this by marginal theory. The marginal the-

ory as it applies to degree of taxation can be stated this way: Any level of taxation will make some undertakings unprofitable or submarginal. In practice, any increase in taxes will drive some people out of business, prevent them from going into business, or make it difficult or impossible for them to sustain themselves by whatever they are doing. The point is of such crucial importance that it should be fleshed out with some details.

This principle of marginality applies to anyone who attempts to produce, provide, purvey, sell, or transport any good or service; it applies to farmers, manufacturers, storekeepers, teachers, artists, industrial workers, or whoever, but the effects may be most clearly seen in business enterprise. The power to preserve what has been created is essential to all constructive human undertakings. Taxation impinges on that power and at the margins always is threatening and destroying undertakings. What happens to business enterprises dramatizes the general principle.

In the first place, taxation affects when and whether a business enterprise is begun. To go into business requires a greater or lesser amount of capital, depending on its size and requirements. To gather the capital, savings must be accumulated. Probably the form of taxation with the most devastating effects on saving is inflation. Government, by increasing money supply, reduces the value of money being accumulated as savings. Indeed, the propensity to save is discouraged by inflation, and the propensity to spend is encouraged.

The progressive income tax is another deterrent to capital accumulation. The tax is often talked about as if it were devised to take from the "haves." It should be better understood, however, as taking from those who are "getting," or trying to accumulate savings. A graduated income tax does not, *per se*, tax wealth that has been accumulated in earlier times; rather, it taxes current income. It bears particularly hard on potential new enterprisers.

Capital Formation Inhibited

Social Security payments greatly inhibit capital accumulation. Individuals are forced to pay into the "fund," yet all that is paid into it is, in effect, forfeit. It cannot be drawn out for investment. It cannot be used as security for loans. No creative use may be made of all the

money that goes into Social Security. Whether it will be available in old age may be questionable, but that it is generally unavailable at any other age is beyond doubt.

Even so, anyone who has managed to accumulate or borrow or persuade others to invest enough to go into business has just begun his difficulties with taxation. The man who enters business discovers all too soon, if he did not know it already, that he has a Senior Partner—government. More precisely, he has a committee of Senior Partners, composed of federal, state, county, and, depending upon the locale, township, and municipal authorities. Once he opens his doors, these Partners join the firm, so to speak, expecting him to perform special services for which they do not pay, having the first go at any profits that he makes, and besetting him with various costly requirements.

In the first place, the Senior Partners require the businessman to be a tax collector. Though he has not been a candidate for the position, though it may be alien to his nature to do such things, though the citizenry have not elected him to the post, a tax collector he is most apt to be. If he is a storekeeper or otherwise sells to consumers, there are a variety of taxes he is supposed to collect. Both the state and local governments may impose sales taxes which he has to collect. The federal government imposes excise taxes which he has to collect on certain items. If he employs other people, he has to deduct income taxes from their paychecks. Under most conditions, he must collect the Social Security tax by way of payroll deductions. Some areas have employment taxes which he may have to collect.

In addition to the taxes which he collects from others, the businessman has taxes to pay on his own account. He must pay the fees connected with whatever licenses are required. He has to pay income taxes, if he has sufficient income, to the federal government, and, perhaps, to other governmental divisions. Merchandise of all sorts carries with it an array of hidden taxes. If the governmentally prescribed minimum wage is in fact above what the market wage would be, the difference between the two is a tax.

The recordkeeping that must be done in order to account for all taxes which he collects and provides the basis for his own payment of taxes amounts to a tax also. Records must be kept of all taxes collected, of the gross and net income of the firm, of all expenses of operation, of goods in stock and of equipment purchased, sold, and discarded.

Occasionally newspapers carry stories of the failure of some company. Usually, it is some large corporation, such as the Penn Central Railroad. Most business failures, however, are noted only in local papers, if at all, and many of them go unremarked. A study a few years ago found that approximately one-third of all new businesses do not last a year, and about half of those that do are unable to make it through the second year.

There is no way of knowing how many of these failures are directly attributable to taxation. Some of them would no doubt have failed had there been no taxes to pay, none to collect, and no records to keep. But it is safe to say that taxes were a contributing factor in every failure and a determinative one in many, for taxation adds to the cost of doing business.

Businesses Abandoned

That the power to tax is the power to destroy can actually be viewed, then. All that is necessary to do so is to drive down almost any road. The empty stores, the abandoned filling stations, the factory no longer in operation, the rusting rails on the spur from the main track, the fading signs on the premises, are mute evidence of the destructiveness of taxation. They are the relics of someone's dream and hope. But these visible remains do not tell the whole story of the destruction wrought by taxation. That would have to include all those undertakings that might have been, but were not, were not because inflation and progressive taxation prevented the necessary amount of saving, were not because the cost of the undertaking was made prohibitive at the outset by the necessary recordkeeping, were not because failure in one undertaking forestalled expansion into other fields.

The power to tax, then, is the power to destroy. It is not just the power to destroy if states may tax the federal government. It is not just the power to destroy if the federal government may tax the states. It is not just the power to destroy if the degree is great and abusive. It is destructive wherever it falls and in whatever degree the levy may be.

The courts have never seen fit to extend to the rest of us the protection from this destruction that they have given to the federal government. It is unlikely that they ever will. Nor is it in the least probable that any other means will ever be used to give us absolute protection from the destructiveness of taxation. As already indicated,

the case for taxation is strong and probably conclusive. And, if there is taxation, it will have the effect of destroying some marginal undertakings. There is no way around it, if the reasoning and evidence adduced thus far are correct. What application, then, can be made of the principle that the power to tax is the power to destroy?

We can no more deduce the proper course of action from the axiom that the power to tax is the power to destroy than could Chief Justice Marshall in the case before him. The axiom is valid, but it provides no specific guidelines as to what course to follow. To find this, it is necessary to turn to the purpose of taxation. In turn, the purpose of taxation depends upon the purpose of government. The purpose of government is to keep the peace. The mode by which government properly does this is to use whatever force may be required to restrain and inhibit disturbers of the peace and effect just settlements among disputants who cannot otherwise reconcile their differences. The purpose of taxation is to raise the money necessary to achieve the ends of government.

The Need for Government

The maintaining of the peace by government is necessary to constructive creative efforts and preserving what is thereby produced. In short, government provides a necessary service by its efforts at maintaining the peace. The cost of that service is a proper charge against those producing and providing goods and services. They are the prime beneficiaries of it and may be expected to bear most or all of the cost. If a business cannot survive its proportionate share of the cost of this protection, it might be better thought of as a victim of its own ineffectiveness rather than of taxation. The power to tax is not only the power to destroy, then, but also a corollary of the power of government to preserve by protecting life, liberty, and property.

Nonetheless, the power to tax is an awesome power to destroy. Like fire and water, when it is tamed, confined, and limited, it serves a useful and beneficent purpose. But uncontrolled and unlimited taxation is like a wildfire or rampaging river out of its banks, destroying whatever is in its path. Chief Justice Marshall noted in his decision in *McCulloch v. Maryland* that taxation by the federal government was limited by the uniformity requirement. So it was, until the Sixteenth Amendment was adopted in 1913. This Amendment removed the

most important of the restraints imposed by the Constitution, or so it has been interpreted by the courts. Almost simultaneously, Congress set up the Federal Reserve System and has given it increasing power over the money supply. The destructive power of taxation was let loose, and when it is combined with the taxing power of all other government units it makes it increasingly difficult to create or to preserve a worthwhile portion of what has been created.

Two kinds of taxation are so potentially destructive and unjust that they should be absolutely prohibited. One of these is taxation by way of inflation, i.e., by increasing the money supply. The power to tax by inflating is the power to destroy the value of the money. Nor is it a potential power only; every increase of the money supply by monetizing the debt—the prevailing mode of inflation—destroys the value of money in existence to some degree. Inflation is an unjust tax. It penalizes savers and creditors, for the value of the new money is subtracted from the value of money in hand or loaned out. Moreover, taxation by inflation is unreasonable, for both saving and lending are legal, honorable, and sanctioned as good by the highest authorities. No sound reason can be adduced for penalizing them.

The second kind of taxation that should be prohibited is the graduated or progressive income tax. The graduated income tax destroys incentive to produce and provide goods and services. It attacks saving and investment in just those places where they could be most readily accomplished. It is unjust because it penalizes higher earnings, earnings which in the absence of proof to the contrary are evidence of greater service by individuals and corporations.

Both taxation by inflation and by the graduated income tax lead to a vast amount of wasted energy by citizens in order to preserve what they have created. Not wasted in that they may not be successful in doing so. Not wasted, either, in that they may not be able to use effectively what they have preserved. But wasted because it is energy that could have been spent on constructive undertakings. By imposing these taxes, government shifts from primarily aiding the citizen in keeping what is his to confiscating it from him. Much of the citizen's effort, and that of numerous lawyers, tax experts, and investment counselors, is devoted to finding ways to avoid paying the taxes or losing what they have by inflation. How much better off Americans would be today if this vast amount of energy could be devoted to productive and creative efforts! Such taxation, too, tends to destroy the rapport

between the governors and the governed. Confiscatory government becomes an adversary to be outwitted, not a benefactor to be aided and cherished.

At any rate, taxation must be circumscribed and limited else it will "defeat and render useless the power to create." By what principle should it be limited? There is a principle embedded in our system which provides inherent limits to all taxation. It is so basic to our political institutions that it should govern every legislator, every executive, and every judge. It precedes all our constitutions, all our laws, and all our political institutions. It brought them into existence; it sustains them; without it they are a nullity. It is nothing more nor less than this: All governments in the United States derive their just powers from the consent of the governed. This means, if it has its full meaning, that the people are superior to the government. That which creates is necessarily superior to what it creates. The government of the United States was created by the people. They are the superior, the governments are the inferior. Taxation by governments, then, is levied by inferiors upon superiors.

The Superior Authority

What rule governs the relation of the inferior power to the superior power? To answer this question, we can turn again to Chief Justice Marshall. In a section already quoted, he declared that "a power to destroy, if wielded by a different hand, is hostile to, and incompatible with, these powers to create and preserve," and that when this situation exists the "authority which is supreme must control." It would be easy to obscure this point, in fact it is regularly done by many political theorists, by having it refer to the mechanisms by which the people control the governments in the United States. It needs to be clear, however, that what we are talking about here is not government at all. The mechanisms by which people control the governments, when and if they do, are really mechanisms of the government—the inferior power here. What is at issue here is the power of creating, producing, and providing goods and services and the supreme authority which must control the disposal of them.

Who is the rightful supreme authority over what has been created, produced, or provided? It is he who created, produced, or provided it. The people brought into being the governments, hence, the people are

the supreme authority over them. But "the people" did not bring into being the economic goods and services which are at issue in taxation. These are brought into being by individuals, either by themselves or in co-operation with others. The supreme authority over these creations belongs to those who brought them into being, neither the people collectively, nor their political arm, the government. And, the "authority which is supreme must control."

The principle which inherently limits taxes in the United States is now before us, needing only to be stated. It is this: Taxes must be limited to a degree that will not divest the owner of control over his creations, productions, or provisions. They are his by right, and only so much of them may be taken as is necessary to protect him in his ownership of them. If the government, either by taxation or any other device, comes into control it is the control of the superior by the inferior.

There are certain corollary principles which should control taxation and help to keep it within proper limits.

1. All taxes should be uniform. Whether levied upon income, wealth, or spending—e.g., sales taxes—a uniform rate should apply in each particular case. This is not only the just approach to taxation but also it removes the lure of redistribution by which many people approve graduated taxes.

2. Taxes should be tied as closely as possible to the object for which the money is to be spent. The payment of a toll for the use of a road will illustrate the principle, though it is not always possible to link the taxation as closely as that to its purpose.

3. Taxes should never be levied for any purpose other than raising revenue. If they are imposed for controlling, regulating, or prohibiting something, taxes become not only destructive in character but also in intent, and are an abuse of governmental power.

4. Government spending should be limited to that necessary to maintaining the peace and providing those services to which the use of force is necessary and proper.

All limitation of government action is a limit on spending, hence upon taxation, and those who seek precise limits would do well to concentrate their efforts on placing these on government action.

Principles only serve as limitations, of course, if they are believed and adhered to by people. There are helpful guidelines, however, to those who have in mind the limiting of government. Government, if

it is to be limited, must be limited by prohibitions on it and by the weight of public opinion and the ballot.

A Congressman once gained a considerable reputation by asking this question after each spending proposal came before the House: "But where is the money to come from to pay for it?" It was, and is, a good question. The axiom that the power to tax is the power to destroy suggests an additional question. Namely, "Who and what is to be destroyed by the taxes to pay for it?" What businesses will fail because of the increased taxation? What services can no longer be offered because of the increased taxation? Whose property is to be confiscated to pay for it? How much of savings are to be subtly seized by the inflation? How many jobs will not be provided because there was no investment to pay for the tools to put men to work productively? What creative energies will be diverted or unreleased because of the taxes to pay for it?

There is no end of laudable objects for which money might be spent. Even children, especially children, are fertile sources of all sorts of spending proposals. In our day, every interest group in the country probably has on its agenda a goodly number of proposals for government spending. Certainly, politicians and bureaucrats bring forth an endless array of notions for spending taxpayers' money. There are so many goodies to be had if only government would unloose the purse strings and spend, and spend.

Children are so prolific with their spending proposals because their eyes are only on the goodies to be attained, not on the labor, hardship, and even deprivation on which their unwise spending would depend. Many politicians today treat the American people as if they were children, pointing them continually to the goodies to be provided and remaining silent about the price to be paid. They spend and spend to elect and elect, as a New Deal politician was reported to have said. They do something else at the same time. They tax and tax to destroy and destroy. Do they intend the destruction? It hardly matters, for the power to tax is the power to destroy, and there can be no government spending without the taxes to pay for it.

Thomas Jefferson once said that what was wanted was "a wise and frugal Government, which . . . shall not take from the mouth of labor the bread it has earned." Apropos the axioms announced in Chief Justice Marshall's decision, it is in order to add "a wise and frugal government which will destroy as little as possible by the taxes it imposes."

Sweden's Welfare State: A Paradise Lost

by Eric Brodin

The Swedish welfare state was initiated in 1932 and has long been heralded the model of the middle way. Seldom has there been so unique an opportunity to judge whether a vast socio-economic experiment, developed uninterruptedly for five decades under optimum conditions, will work or not.

Whether it is correct to call Sweden a socialist country depends on the definition we use. If socialism means government ownership of the means of production, then Sweden is not socialist. Perhaps not more than a fourth of the means of production is in government hands, although that now includes all wharfs, most communications, transport, forests and mines. I prefer to call Sweden a Social Welfare State. The creators of the Swedish Welfare State in the 1930s were Marxists of sorts, but they allowed a pragmatic attitude of gradualism to modify the radical ideological demands of state ownership. But if socialism means control over the results of production, there is no doubt that Sweden is a socialist nation, and the prime means of government control over the results of production is through taxes—now the highest in the world for the 8.3 million Swedish people.

Noted among the founders of the Swedish Welfare State are Gunnar and Alva Myrdal. In a book on Swedish Population Policy written in 1932 they stated: "The Scandinavian countries, and particularly Sweden, by historical accident, are given the most advantageous set of prerequisites for a bold experiment in Social Democracy [social welfare state]. If it cannot successfully be developed in Scandinavia, given by historical chance quite exceptionally advantageous conditions, it would probably not work out anywhere else." These conditions include an unbroken peace for 150 years, a nation completely unscarred by two world wars, and with an industry intact which could be transformed

Professor Brodin, a native of Sweden, is a naturalized U.S. citizen. He is Director of the Foundation for International Studies in Buies Creek, North Carolina. This article, which appeared in the December 1980 of *The Freeman*, is from a lecture at the 4th Annual Institute on Free Enterprise and Public Policy at Grove City College in Pennsylvania, June 17, 1980.

from arms manufacturing to manufacturing the goods desperately needed by Sweden's war-torn neighbors. It is a tightly knit, highly industrialized, remarkably homogeneous country rich in raw materials, including hydroelectric power, huge forests and rich sources of iron ore in the north.

From the 1930s through the 1960s Sweden developed a new social welfare state, sometimes called the Mixed Economy, containing both elements of private ownership and government control. That involved retention of the basic manufacturing in private hands, but accompanied by a taxation policy which was to bring about a redistribution and equalization of income. This was to be accomplished through a vast social welfare machine to insure every Swede against practically every exigency. The private and municipal insurance programs were the first to be integrated into a central compulsory system even before the Second World War. In the 1950s came the integration of nearly all pension plans into a compulsory government administered system.

To finance the elaborate womb to tomb or cradle to grave welfare system requires a lot of money. And the Swedish government has only the revenue collected through taxes and "social fees." Today no less than 64 percent of the Gross National Product goes to the public sector to finance the system. From 50 to 60 percent of the salary of a typical industrial worker is taken in taxes. But in addition to this basic income tax, there is an additional 22.5 percent in value-added tax (VAT), a form of sales or excise tax on all goods and services, including foodstuffs.

The Swedish Confederation of Employers has given us a concrete example of how the subsidy-taxation distribution system works. Let us say that a man with four children and a wife not working, earns \$4,600; add to this the social subsidies to which he is entitled, and he has an after tax actual income of \$14,000. But let us say that another man with the same sized family earned initially \$23,000, after taxes, and with little likelihood of subsidies, his income also would be \$14,000. Presumably the higher earner is also the harder worker, but what is the incentive in keeping that up? Of course this has a tremendous effect on productivity. It is no longer worthwhile to work. The difference, for example, in working full time and working half time is a mere \$2,000 for the year, and a lot of people are choosing more

leisure instead. Professional people such as doctors, dentists and lawyers seldom work more than five months a year.

The situation for the private entrepreneur is especially difficult. What is not generally recognized is that the employers' compulsory contribution toward employee benefits is nothing but another form of payroll tax. This averages 40 percent on top of the salary which, of course, means that the "government bite" of the total wage is even higher than the 50 to 60 percent indicated. Many small entrepreneurs, operating on a tight profit margin, cannot afford this additional burden, and face the options of going out of business, dismissing employees, or cutting back to a one-man operation.

Underground Economy

It is said that the only expanding sector of the Swedish economy today is that of the underground economy—the secret sector. The burden of reporting and paying a 22.5 percent sales tax has made it almost common practice in Sweden to ask if a transaction is to be "with or without receipt." It has been estimated that as much as a third of the work by painters, carpenters, mechanics and the like is performed in the secret sector untaxed. There does not appear to be any way in which government representatives can determine and prosecute this growing practice. Despite tremendous manpower resources (at least one third of all in Sweden are working for some form of government) they do not have enough people to prevent the secret sector from expanding.

Sweden is becoming a barter trade society. And this barter trade takes many forms. As a genealogist I searched the ancestry of my dentist, while he fixed my teeth. A plumber friend of mine could decorate his home with oil paintings in a deal with an artist acquaintance. And so on.

The malaise in the Swedish economy is in no small part due to the taxation policy which rewards indolence and encourages illegality. Even Gunnar Myrdal calls for new tax legislation: "Swedish honesty has been a source of pride for me and my generation. Today, however, I have an uneasy feeling that, due to bad tax laws, we are more and more becoming a nation of cheats."

The Absent Worker

There are many other ways in which the employed demonstrate their unwillingness to continue sharing the tax burdens of financing the elaborate welfare state system. With an illness insurance system paying 90 percent of wage compensation, absenteeism is spreading like some contagious disease through the Swedish employment sector. On any given day 10 percent of Sweden's labor force is absent. On Mondays and Fridays absenteeism may reach 20 percent. At times the Volvo car manufacturing plant or the Kockum Wharf in Malmö have recorded the absence of 25 percent of the working force, and this has also occurred in some hospitals. How can an economy stand such loss of productivity? How can an export-dependent economy compete in international markets against new industrial nations such as those of Asia whose workers perform efficiently?

With each liberalization of the illness insurance system in Sweden, the increased "absence due to illness" has jumped—by as much as four million working days in a year. The employers' association desperately urges legislation which would restore the three day waiting period before the insurance program takes effect. This would remove the temptation for leaves of short duration which often require no doctor's statement.

Absences are not due to illness alone. There are at least 12 different reasons for "excused absences" with pay from the Swedish places of employment. In a recent experiment, I tried to phone ten persons at their places of work and found only two of them available and in their offices. When I asked why they were absent, I was given an indication of the range of "excused absences." One man was taking advantage of the law which encourages the man to leave his place of employment to take care of a child (freeing the mother, presumably to enable her to go to her employment). Another one was said to be home caring for a sick child. Another one was taking a course in the Swedish language. Still another one was taking a union administered course in how to be "a worker's representative" on a company board. Still another was absent in order to take care of a document at a government agency. And so on. These are not cases of absence without pay. Either the employer has to pay in full or the employee gets compensated from one agency or the other of government.

The Public Sector

To provide the funds for such an elaborate system requires an immense bureaucracy, and the one-third of Sweden's work force which some call the non-productive sector must be paid. Today 64 percent of the total GNP goes to support the public sector's increasing demands. And they will keep on growing because there is a cumulative effect to these demands. The share of the GNP going into the public sector increased by 20 percent between 1950 and 1980. When the first non-socialist government since 1932 came into power in 1976, some of the groundswell support from the right thought that some alterations would be made in the social welfare system. No such thing has happened. And the cost-indexing of various forms of subsidies will cause the problem to grow as the inflation continues. The idea of the welfare state gains support from many quarters. The state-owned radio and television monopoly, for example, is required by law to devote 40 percent of programming to "informative" programs and these often take the form of propaganda for and about various social welfare measures. Advertisements in newspapers and on vehicles proclaim: "Did you know that you don't have to be married to get a housing allowance? If you're 18 years old you may still qualify." The result is an increased degree of utilization, and a peculiar interpretation which defines Sweden's high living standard by the increase in the number of persons living "on the dole."

The Budget Deficits

Sweden's national budget reveals the increasing burdens of the public sector on the national exchequer. And the budget also reveals, through its deficits, the inability of Sweden to finance these increases. The deficits grew from 649 million crowns in 1960 to 50.2 billion crowns in 1980. Much of the budget today consists of transfer payments, currently about 40 percent. These consist of revenue-sharing to local governments, transfer payments to families, and subsidies to ailing industries, the last of which amounted to 7 percent of the budget in 1978. In view of the failure by Swedish industry to compete for the reasons mentioned above, many enterprises are failing, especially in shipping and in the textile and shoe industries.

Inasmuch as the labor unions are still very strong (and Sweden has more of its labor force unionized than any other country) there are always pressures for the government to bail out ailing industries in order to maintain employment. This is done by various forms of subsidies, all of which are also subject to some misuse. The government has thus become increasingly involved in producing items which cannot be sold, and for which there is no market either at home or abroad.

The Real Face of Unemployment

It is necessary to turn to the unemployment situation to understand the current Swedish economic problems. Full employment has always been high among the goals of Swedish planners. But the government has been forced to take extensive measures of intervention in the labor market. For years government spokesmen have maintained the fiction that Swedish unemployment is among the world's lowest. Such statistics can only be maintained if the real extent of unemployment or under-employment is hidden.

Dr. Sven Rydenfelt has exposed the myth of full employment in a number of articles in Sweden and abroad. He points out that there is an official figure of 2 percent unemployment, or 94,000 of a work force of 4.1 million (half Sweden's population). However, WPA types of "make work" employed 3 percent in education or public work schemes. Investigations reveal that 25 percent of the college students in Sweden are there simply because they cannot get work, or a further 2 percent. Then there is an additional 90,000 who have asked for "early retirement" because they want to provide work to someone else, another 2 percent. Finally, there is the 2 percent employed in industries which are not economically viable, but which continue to hire workers only because of government subsidies. Dr. Rydenfelt concludes: "If these items are added we find a total of 11 percent unemployed, a share which better reflects the realities of the Swedish labor market than the official reports." While the work force in private manufacturing was reduced by 100,000 in the five-year period 1975-1980, it is significant that employment in the public sector rose by 250,000 during that same period.

Conclusions: A Welfare Society in Trouble

The Swedish Welfare State faces deep problems today. Many Swedes were jolted into some awareness of the depth of the crises during the General Strike in May 1980. Curt Nicolin, chairman of the board of the Swedish Employers' Association, said in 1979: "It is high time we comprehend that we are under severe threat . . . we, like sleepwalkers, have moved straight into an economic crisis so serious that we must count upon social unrest and the loss of freedom for most of us." Certainly the strike and lockout, and the further extension of the conflict by the Longshoremen's Union, are part of this social unrest. But there are many other indications, which are apparent for those who study the moral effects of the present crises in Sweden's welfare state.

In the economic sense, it is important to realize the limitations in the nature of the welfare state itself. Feeding upon itself, it is slated for extinction. The German Marxist Jurgen Habermas defined the dilemma in these words: "The division of labor between the state and the private sector that forms the basis for the Swedish model, requires that a continually increasing share of the national product be transferred to the public sector. Technical and economic changes must be accompanied by enormous public investments in order to insure the stability of the society. There is a point where a dislocation in the social structure caused by the free play of the market forces, becomes so great that the people are no longer willing to pay the price of the necessary remedies. The demand for security remains, but the desire of each person to contribute to the cost of this security diminishes. The welfare society then faces a crisis of confidence."

Those who seek to find the causes of the Swedish welfare-state *malaise* too often treat the symptoms not the cause. In some cases they prescribe medicines, like ineffectual nostrums, that long ago proved wrong. While they seek in international economic developments the *bête noire* behind the failure of the "Swedish Model" they are unable to question the Swedish welfare state itself, or any other welfare state. It is, of course, no longer just an "economic problem." The interdependence of economic and moral crises are well documented, not the least in the case of Sweden. At a time like this, it is worthwhile to recall the wisdom of a man who still speaks with a voice of authority to a living generation, Wilhelm Roepke:

“The desire for security, while in itself natural and legitimate, can become an obsession which ultimately must be paid for by the loss of freedom and human dignity—whether people realize it or not. In the end, it is clear that whoever is prepared to pay this price is left neither with freedom and dignity nor with security, for there can be no security without freedom and protection from arbitrary power. To this exorbitant price must be added another . . . namely, the steady diminution of the value of money. Surely, every single one of us must then realize that security is one of those things which recede further and further away the more unrestrainedly and violently we desire it.” (*A Humane Economy*, p. 172)

Public Finance: No Ways or Means

by John Semmens

Public finance is beset with the dilemma of meeting two objectives that may not be attainable. On the one hand, there is the prescription that any public financing scheme must be fair. Though there may be considerable divergence of opinion on what this means, there is some consensus that it must be considered in any financing proposal. The second objective is that the plan must be feasible. Contemplation of feasibility can range from simplistic administrative or enforcement concerns to more remote indirect impacts on the economy.

The problems faced in public finance are significantly different from those confronting governmental organizations. Private enterprises must obtain their funds via the voluntary transactions of the marketplace. Consumers are not required to purchase, or pay for, goods and services they may not want. Such is not the case when the government is involved as a participant in the transaction.

Fairness in private finance is achieved by virtue of the fact that all transactions are voluntary. Any would-be participant serves as the sole arbiter of the fairness of any bargain he may choose to make. In the non-voluntary transactions involving the government, the government serves as the arbiter of the fairness. The conformity of actual transactions with the great differences in perception regarding fairness must, unavoidably, be worse when one must judge for all (as in government enterprise) than when each may judge for himself (as in private enterprise).

In private enterprise the decision as to feasibility is rendered simply and swiftly. The marketplace is a strict disciplinarian in such practical matters. Unfeasible ideas never get off the ground, or quickly crash if they do. The marketplace performs this function continuously. The private enterprise, relying upon investors and customers for its resources, obtains a steady flow of information regarding the feasibility of its actual or intended plans.

Mr. Semmens is an economist with the Laissez Faire Institute in Chandler, Arizona. This article originally appeared in the March 1979 issue of *The Freeman*.

Public enterprise does not have access to the same convenient feedback from the marketplace. Government produced goods and services are not really marketed to consumers. Often the purchase decision is involuntary, at least from the perspective of the consumer. Instead, purchase behavior must be simulated, assumed, or arbitrarily determined by some government employee.

Under such a handicap, it is extremely difficult for public enterprise to evaluate the feasibility of any plan. Isolated from the necessary information to specifically identify those goods or services which can be feasibly supplied, government must rely upon more remote indicators of viability. In place of product sales or company profits as measures of feasibility, the public financier must grapple with political resistance to a proposed tax or analyze the more widespread economic impacts of the government's coercive intervention into a particular sphere of business activity. The severance of the transaction in which the service is provided from that in which the revenue is collected makes any such analysis that much harder.

Unfair Means

The issue of fairness in public finance revolves around the answer to the question: Who *should* pay for whatever service is contemplated? Three separate approaches have been traditionally brought to bear upon this issue. First, it is often asserted that those who benefit from a government service ought to pay for its provision. Second, it may be argued that the burden of payment ought to be related directly to the costs incurred to serve a particular user of the service. Finally, some maintain that payment should be based upon the ability to pay.

The first and second approaches generally lead to financing schemes based upon "users funds," such as the highway users fund. The attempt is to draw revenues from those who use and benefit from the service rendered.

The ability-to-pay approach abandons any attempt to link consumption with payment. Instead, it is asserted that services ought to be dispersed on the basis of need, while receipts ought to be drawn from individuals according to their ability to pay. Since the major forms of revenue generation—income, sales, and property taxes—employed by the government are already structured along ability-to-pay

lines, reliance upon this approach suggests that government services be financed out of a "general fund."

Each of these three approaches to public finance presents some problems. From a practical standpoint there is an immense difficulty in ascertaining just how much benefit is involved in any one user's enjoyment of public services. Private enterprise cannot serve as a model here because private firms do not concern themselves with attempts to estimate the benefits enjoyed by specific customers. If enough customers perceive sufficient benefit in purchasing a firm's products or services for the firm to meet its profit goals, then the product or service will continue to be provided. "Enough" and "sufficient," imprecise as they are, can be tolerated in non-governmental enterprises because they are disciplined by external market forces. On the other hand, such imprecision presents the government with horrendous problems because its goals are essentially undisciplined by any outside market forces.

While there can be more precision in the determination of costs incurred to meet a general specification of services or products supplied, the allocation of these costs to individual users may prove troublesome. It is true, of course, that private enterprises are also faced with cost allocation problems. These are, however, primarily book-keeping problems since the price of the service or product is determined by the marketplace. Knowledge or estimates of price and volume allow a private firm to work backward to determine how much cost can be covered by anticipated revenues.

Unfortunately, this process does not work in reverse. That is, knowledge of production costs will not tell us at what price and in what volume the final product will sell. All too often, public agencies become entrapped in a cycle of ever-increasing deficits by trying to price the services they provide on the basis of the costs incurred.

How Measure Demand?

Ability to pay is easier to measure than either benefit or cost. It is evidenced in tangible property or income and sales transactions. However, regardless of the ease of measurement here, we are completely severed from any information that would indicate the demand for the services to be provided.

As bad as pricing schemes based upon estimated benefits or costs are, a system in which there is no price is much worse. Consequently, determining the amount of resources to be expended for whatever level of service is an entirely artificial process. We can have no objective idea of what degree of effort is necessary. Instead, completely arbitrary decisions must be made. Of course, there will be no way to tell whether these decisions will even come close to meeting genuine needs. The prospects for a balance of supply and demand under these circumstances are rather remote.

Not only is the public enterprise isolated from information regarding price and quantity, but struggles with these problems may appear relatively simple in comparison with the need to determine the product mix that should be offered.

Typically, consumer needs, wants, and means are greatly diversified. The demand is for variety. Variety is what private enterprise must provide. The multiplicity of firms *facilitates* the fulfillment of these needs. The absence of the power to compel purchase forces private firms to cater to these needs.

In contrast, the government has the power to compel payment for such services or products it may choose to provide. This is not to say that the government will necessarily abuse this power by enforcing the consumption of frivolous or inappropriate private services. However, it is inevitable that at least some people will be compelled to finance services which they deem frivolous or inappropriate.

A sincere desire to minimize the instances in which compulsory levies will be perceived to be expended in an unjustified fashion usually results in a policy of standardized service geared to meet the minimum requirements. Some critics have characterized this as a process of catering to the lowest common denominator. Deficient as such a process may be in terms of some notion of an "ideal" resolution of varied needs and wants, it is, nonetheless, the best alternative, given the constraints under which the public agency must operate.

Can Might Make Right?

Our examination of the conditions pertinent to public finance would seem to indicate that there is no way in which fairness can be assured. To the contrary, any public funding scheme is bound to be

unfair. The involuntary nature of all transactions in which the government is a participant insures this.

Whether one takes an approach based upon the "users" theory and attempts to equate taxes with some element of service rendered, or whether one adopts the redistributionist logic of "ability to pay," the fact remains, some individuals will be made to pay for services they neither want nor even receive. Only governmental sovereignty prevents this *modus operandi* from being classified as criminal.

Fairness to the consumer is stymied in both key aspects of the product or service exchange. Whatever approach is used to determine price, he will have no option but to pay. Meanwhile, the quality and quantity in which the product or service is dished out will be decided by methods other than individual consumer choice.

Since attainment of universal fairness is not possible, the next best course open to the government is to minimize unfairness. This it has generally attempted to do in a number of ways. Almost without exception, the initial imposition of levies based upon ability to pay has started with low rates. Unfortunately, these have escalated to a point where the search for alternative revenue sources has become a widespread phenomenon at all levels of government.

The motivation behind the search for alternative revenue sources may stem from an uncertainty of conviction as to the justice of the "ability-to-pay" principle—that it must stop short of its logical conclusion to reduce everyone to an equality of wealth or income. Further taxes, it is felt, must be justified on some sort of "services rendered" basis. Despite the well-documented problems with both the benefits received and costs incurred approaches to public finance, there is a general consensus that reliance upon such methods is less unfair than any other option that includes continued government involvement in the provision of products or services.

Another motive inspiring the quest for new revenue sources is the belief that the supply of resources available under the ability-to-pay scheme may be "tapped-out." This "tapped-out" concept may relate to an estimate of the economic or the political infeasibility of heavier taxes for the general fund. The law of diminishing returns is a well established principle. It is inescapable that, at some point continued hikes in the burdens imposed on those able to pay will produce lower revenues. It is also inevitable that as increasingly larger numbers of

people are discovered to be capable of paying larger and larger amounts, the balance of political power is bound to shift. Political resistance to public financing demands cannot help but increase, as the appetite for larger servings of public revenue can only be satisfied by placing more taxpayers on the menu.

Infeasible Ways

Since the payment of taxes is normally an involuntary activity, the pragmatic issue of public finance is essentially a question of "who can be made to pay" and "how much he can be made to pay." This issue can be considered from two angles.

First, there are certain economic considerations. Who has how much? What is the cost of taking various amounts from him? What are the economic consequences of various levels of taxation?

Second, there are several political considerations. What is the capacity of the targeted taxpayers to resist the government's taxes? Are the targets ignorant and powerless? Or are they well informed and powerful? The answer to these questions will determine the extent to which the identity of who will be taxed will have to be disguised.

To date, the government has not made much progress in dealing with the economic implications of public financing activities. "Who has how much?" has been given devoted attention. The records of incomes, sales, and property are voluminous. The government effort in this area has been substantial. The cost of enforcing the taxes has been given some attention, but the effort has been inconsistent and marked by a measure of indifference. The economic consequences of various levels of taxation have been largely ignored. As a result, total public revenues are increasing, but not as fast as the costs of collecting them.

Meanwhile the impact of taxation on the economic health of the society is subject to a great deal of speculation, most of it suspecting the worst.

It has long been acknowledged that, at some point, the total burden of taxation would become "excessive." Objectively, this means that the next hike in the rate of the tax would actually produce lower public revenues. There has been no actual proof of what rate turns the tide. Therefore, a prudent course might restrict the government's taxa-

tion activities to the absolute minimum. Instead, government actions have continually increased taxes.

Whether the government's toll of the productive output has reached or passed the point of diminishing returns is a matter of serious concern. Recent public discussion of this problem and the fairly substantial argument over whether a cut in tax rates would increase government revenues, would seem to indicate, in an informal way, that we may be at or near a point of diminishing returns. At the very least, it is established that a substantial number of people are convinced that such a point has been passed.

The Burden of Taxes

Every governmental way and means proposal, then, is, of necessity, confronted with the question of its additional impact on the total tax burden. The fact that a particular tax proposal may be linked with a specific use for the funds generated does not insulate it from this total tax burden problem. Government imposed "users fees" are not market exchanges. The further removed these fees are from market exchanges, the greater the impact on the total tax burden.

The total burden, however, is not the only economic consequence of concern in public finance. The specific effects of each tax pose another problem. Tax rates or so-called users fees are not market prices. If the government's charge is less than the market price would have been, huge economic distortions may result. Demand for the underpriced product or service will be excessive. Demand for competing products will be suppressed. Greater supplies of ingredients to the underpriced item will be required. Each of these direct consequences will cause subsequent indirect consequences, creating a ripple effect of distortion throughout the economy. If the government's charge is more than the market price would have been, different, but equally serious, economic distortions would follow.

These distortions can lead to misallocation of resources and inefficiency. In effect, government taxes pollute the price system. The role of prices as feedback to the productive entities in the economy is thereby subverted. Wrong signals are given. Shortages and surpluses result. Resources are wasted. The rate of return on investment is reduced. Economic progress for all social groups is retarded.

This list of evil consequences may seem rather drastic. After all, how much devastation can be wrought by a few erroneous price signals? The degree of integration and sophistication that accompanies the advanced specialization of our high technology economy insures that the effects of even relatively minor transactions will spread throughout the economic system. Add to this the sensitivity of the price system as a continuous measurement device of the diverse wants, needs, hopes, ambitions, fears, greed, and other motivations of humanity, and you have a lever that can move the world.

Political Considerations

In contrast to the lack of attention given to the economic consequences of various public financing schemes, the political considerations of taxation have been handled with both dispatch and imagination. The growing proportion of total production being consumed by the government is evidence of the effort devoted to solving the political problems. Corporate America has been conscripted as the chief tax collector for both income and sales taxes, while the banking industry has been drafted to play a major role in collecting the property taxes on mortgaged real estate.

The capacity for tax resistance has been minimized by skillful placement of the collection point. The bulk of personal income taxes are *withheld*. Purchase transactions cannot be completed without payment of the sales tax. Property taxes are normally included in monthly mortgage payments. In most jurisdictions, seizure and sale of property for nonpayment of taxes is a simple and expeditious process.

While the historical record gives us every reason to assume that the government would be able to overcome the political resistance to increased taxation, there are several conflicting forces. On the one hand, most of the easy sources of funding have already been exercised, perhaps to exhaustion. On the other hand, the knowledge and will to resist further burdens seems to be on the rise.

The root of the public financing problem is that man-made law cannot abolish natural law. Enactment of government taxes can affect the distribution of economic goods, but legislative fiat cannot create economic goods. Instead, taxation unavoidably lowers the return on productive activity. Disregarding any disincentive effect, the reduction in the return, when compounded over time, must reduce the total

pool of available resources because a *substantial potential quantity will never be created*. Resources which are not created cannot be diverted to government use. Even the most advanced political skills cannot alter this reality.

The Public Interest in Private Enterprise

Our examination of the dilemma of public finance would seem to indicate that in terms of equity, taxation is fundamentally unfair. The public enterprise is unable to determine what demand is, much less serve it. No bona fide exchange takes place. Individuals do not get what they pay for in any reasonable sense of the word. There is, in short, no defensible standard that is consistently employed in taxation other than convenience for the government.

Even convenience is unsustainable in the long run. The defenseless and the subservient have already been taxed, probably close to their capacity to pay. The strain on the economy's limited resources has become apparent. There is the very real possibility that any further attempt to raise revenues by increasing the tax rates will be counterproductive. Public enterprise has always been less feasible than private enterprise. The government must now face the prospect that this relative lack of feasibility is being replaced by an absolute infeasibility, particularly with regard to the potential for additional revenue generation.

So, if public finance is both unfair and infeasible, what are the public policy implications? Expansion of the government's role must be ruled out. Replacement of public by private enterprise seems warranted.

The specific means for achieving the privatization of public enterprise must follow in the wake of a more widely spread recognition that such a step would be beneficial. The future viability of our economic system may well depend upon the speed with which such recognition takes place.

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