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I.

POLICIES FOR ECONOMIC GROWTH
GROWTH WITHOUT INFLATION

by Maurice Allais (*)

This paper presents, from a synthetic point of view, first a technical analysis of the link between prices and money in a national framework, and a comparative assessment of the main characteristics of the gold standard, a system of fully flexible exchange rates, and the gold exchange standard introduced by the Bretton Woods agreement; and second, some constructive suggestions for national policies intended to promote growth without inflation and for a reform of the international monetary system.

I. Money and Prices in a National Framework.

The history experience shows that real economic growth is compromised, if not stifled, by price deflation. A moderate increase in the price level, of the order of 1% per annum, appears to be a reasonable desideratum. This means that the rate of growth of the supply of money should be 1% above the rate of growth of real gross national product. This is a necessary, sufficient condition for steady growth with monetary stability.

Experience and analysis combine to indicate that there are three features of the credit system which are particularly open to criticism. These relate respectively to the fluctuating nature of the creation of money, and the fundamental instability which this engenders in the distribution of income.

1) Experience proves that the global amount of deposit money in issue is extremely sensitive to the economic situation, and this effect, in conjunction with any variations in desired money balances which may occur, makes for instability of the economic system.

2) A banking system has a degree of potential instability which is all the greater the further the coverage ratio departs from unity.

3) The credit system alters the distribution of income. The state denies itself access to an important source of revenue, the resulting gap being covered by taxation. Secondly, the optimum allocation of resources is distorted, since some costs are generated without any counterpart activity. Finally, there is a bias to deflation in the system, depositors being exempted of the cost of their cash balances, insofar as these balances consist of deposits.

For these three reasons, the present organisation of the credit mechanism whose origins must be wholly traced to accidental histor-

(*) The text below is nearly the abstract of a detailed study which was circulated during the Congress of the Mont Pelerin Society, and which will shortly be published by the Center of Modern Economics, Rikkyo University (Tokyo, Japan) under the title: «Growth without inflation». — 9
cal events must be considered as irrational. In addition, a regular rate of increase of the means of payment is desirable. From these two points of view, a 100% money system appears as desirable. Such a system is perfectly feasible.

II. Money, Prices and Exchange in an International Framework.

1) The really fundamental aspect of the classical gold standard with fixed exchange rates is not the link with gold, but the immutability of exchange rates.

The choice between the gold standard and a floating exchange rate system reduces to a choice between exchange rate stability with no autonomy of internal monetary policy on one hand, and variable exchange rates with autonomy of internal monetary policy on the other.

To the extent that par values are maintained and a close relationship exists between the overall money supply and total liquidity, but there is a tendency for foreign exchange to account for an ever-growing share of total liquidity, the system of the gold exchange standard is structurally identical to the gold standard except there is a more rapid rate of growth of world liquidity than in the case of the gold standard. To the extent that par values may be altered and the link between the money supply and total liquidity does not obtain, the system is structurally identical to a system of floating exchange parities.

2) Whereas there is today a superabundance of paper liquidity, there is insufficient gold liquidity.

If the parities of the different currencies were maintained, if the present creditor countries implemented appropriate price policies designed to maintain their casting balance of payments surplus and further increase their gold reserves, while the United States attempted at the same time to keep its gold reserves at their present level, the western world, and the United States in particular, would be driven to deflation.

3) It is possible and indeed probable that a great country such as the United States can allow its exchange rate to find its own level freely, without damaging consequences, for the law of large numbers is in itself a guarantee of stability. But the smaller the economy, the greater seems to be the possible danger of freely fluctuating exchange rates.

A system of flexible exchange rates with some regulation of the seasonal or random fluctuations appears to be preferable to a system of freely fluctuating exchange rates.

4) In any system in which settlements of balance of payments deficits and surpluses are, or may be, made in gold, there is no way of stabilizing both the general price level and the price of gold.

Present day difficulties are due in large measure to the error of American policy in assigning two incompatible objectives to its monetary policy, the maintenance of prices at a steady level, and the maintenance of the gold parity of the dollar.

5) The general movements of prices due to the linking of currencies to the precious metals have always been moderate by comparison with those shown by the record of the past fifty years since gold ceased to function domestically as money.

The result of the linkage of currencies to the precious metals, and to gold in particular, has been — to the extent that the link could be maintained — a definite stabilizing influence. The origin of the monetary crises of the 19th century was not, as has too often been argued, the application of the gold standard. The basic reason for them was always abuse of credit.

6) There is no justification for supposing that a fixed price of gold is a necessary characteristic feature of a system in which gold is used.

7) The natural regulatory parameter in balance of payments matters is essentially the rate of exchange. The only result of an attempt to balance the balance of payments by acting on the level of prices or on the interest rate is to create even greater difficulties than those whose solution was sought.

The proponents and the adversaries of the gold standard, in fact, are doing battle over minor issues. Neither camp has been to see that the big problem is the issue of fixed exchange rates.

III. Suggestions for Steady Growth without Inflation.

1) The following propositions for structural reform are put forward as a means of ensuring durable rather than intermittent growth.

A) Prohibition of the granting of short, medium and long-term credits by banks and related institutions not covered by borrowing over at least a term of equivalent length (100% money).

B) Increase of the money supply by the state at a rate fixed each year by law at a figure one percent higher that the rate of growth of real gross national product in the preceding one year period, increased by the rate of growth of the coefficient K of the quantity theory identity MV = KPO if this rate cannot be neglected.

C) Incorporation of the supplementary revenue corresponding to the growth of the money supply into the budget resources, the fresh money being put into circulation through the medium of public expenditures, with taxation diminished by the overall amount of money creation involved.

2) Proposition (A) would put an end to the creation of money via the credit mechanism, an institutional arrangement which is the result of accidental historical circumstances. The right to mint money would be the prerogative of the state and the state alone.

Proposition (B) should set the rate at which money is created sufficiently high to promote growth of real gross national product.
Proposition (C) would ensure that the nation as a whole receives the benefits of newly created money instead of dispensing them among a limited minority only.

If the reforms (A) and (B) were introduced, notable inflation and recession would both be banished for ever. Real gross national product would grow regularly, and this growth would be the maximum compatible with the other data of the economy.

3. The fundamental objective of the propositions is to regularize economic growth, avoiding both inflationary overheating, the deflationary slowdown which is its inevitable sequel, and the alternating spiral by which one succeeds the other to the detriment of the overall performance of the economy.

IV. A Plan for Reforming the International Monetary System

1) The major aims to be secured by a reform of the international monetary system are as follows:
   (a) to enable each country to devote its internal monetary and budgetary policies to the achievement of full employment, growth and price stability;
   (b) to enable all countries to liberalize their trade by dismantling tariff barriers and eliminating quantitative restrictions and other obstacles to trade the greatest possible extent, without being hampered by problems of balance of payments equilibrium.

These aims can be fully achieved only if the autonomy of internal monetary policy is given priority over the maintenance of fixed exchange rates.

2) To improve the present system substantially without major disturbance, and in conformity with both the spirit of the International Monetary Fund rules and their essential provisions, the principle of rigid exchange rates needs to be interpreted more flexibly. At the same time, specific precautions must be taken to deal with any future situation of insufficiency of liquidity in terms of gold, in a system essentially based on gold. The following amendments to the International Monetary Fund articles of agreement could suffice to achieve these aims.

(a) Amendment to section 5 of article IV, concerning Changes in Par Values of Currencies:

«Each participating country may freely change the par value of its currency by up to 2.5% of the previous years par value, downwards (upwards) if its reserves have diminished (risen) substantially, without having to prove the existence of a fundamental disequilibrium.»

(b) Amendment to section 3 of article IV, concerning exchange based on parity:

«The margin of 1% by which the maximum and minimum rates for spot exchange transactions undertaken on the territory of a member country may differ is henceforth set at 2%. At the request of any member country, this margin may be set at 5%.»

(c) Amendment to section 7 of article IV, concerning uniform changes in par values:

«Should the value of the combined gold reserves of the participating countries fall below 20% of the overall value of their combined money supply, valued in a common unit (including sight deposits), the participating countries undertake to raise the price of gold i.e. to lower the par values of their currencies by 1.5% per annum until such time as the figure of 2% has been reached again.

Should the value of the combined gold reserves fall below 15% of the value of the combined money supply of member countries (including sight deposits), the annual increase in the price of gold will be set at 2.5% for so long as this situation lasts; and furthermore, the Fund may, subject to a decision to this effect by a majority of the votes cast, declare a general lowering of the values of its members' currencies which is binding on all members provided that the modified parity so declared shall not increase the value of members' combined gold reserves to above 20% of the value of their combined money supplies.»

In all other cases, the provisions of sections 7 of article IV are maintained unchanged.»

3) The first amendment would allow the damaging consequences of the principle of rigidly fixed exchange rates to be attenuated, but enable its advantages to be preserved to the greatest extent possible. The result would be that indispensable adjustments would no longer be made only following earlier violent disequilibria and a situation of major crisis. Large, sudden changes would be replaced by relatively slow and gradual modifications.

The second amendment would enable the value of a currency to be defended more efficaciously against erratic fluctuations and at the same time facilitate gradual changes in parities. Last but not least, it would enable countries which wished to do so to pursue a moderate policy of flexible exchange rates.

The third amendment reflects the twin facts that on the one hand, the International Monetary Fund rules put gold at the centre of the international payments system, at the same time as the industrialised countries display a continued and growing propensity to hold a high proportion of their reserves in the form of gold. This dual characteristic implies that the rate of growth of value of the overall gold stocks of member countries should be rapid enough to avoid any risk of a generalised deflation. A further advantage of the automatic nature of the provision of this amendment is that changes in the value of gold could be interpreted as implying any loss of prestige for the currency of any of the participating countries.

4) In one sense, these propositions may appear to be compromise between divergent points of views, but if there is a compromise, it is a consistent and viable one, and it is not open to any of the major criticisms which have been levelled at the plans which have been put forward up to now.
It is also a compromise which conforms to the general principle that in all cases in which reforms are necessary, a gradual evolution of institutions is to be preferred to a major upheaval.

3) The suggestions for the reform of the international monetary system are associated with those made in respect of internal monetary policy, although either group of propositions could be implemented separately.

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Riassunto — L'autore si pone come obiettivo di formulare alcune proposte di riforma riguardanti sia i sistemi monetari e creditizi interni dei singoli paesi, sia l'assetto monetario internazionale nel suo complesso. Secondo l'autore questi due ordini di riforme sono strettamente associati fra di loro ma potrebbero anche essere realizzati separatamente. Gli elementi di instabilità insiti nei sistemi creditizi moderni suggeriscono infatti l'opportunità di mutamenti radicali nelle modalità di creazione della liquidità interna; parallellamente l'attuale assetto dei pagamenti internazionali, fondato sul sistema «a cambio aureo» giusti-
MONETARY AND FISCAL POLICIES
FOR ECONOMIC GROWTH IN A FREE SOCIETY

by James M. Buchanan (*)

1. Introduction. — During the neo-classical era, when much of the
formal structure of economic analysis was resolved, economists tended
to neglect economic growth as an explicit objective for policy. Was
this the gross and glaring oversight that the recent rediscoverers of
growth now claim? Were the neoclassicists negligent in their failure
to carry forward and to develop the nascent classical interest in, and
emphasis on, economic growth?

There are two apparently contradictory answers to these questions.
The neo-classical economists were, for the most part, interested in de-
fining appropriate policy objectives for a free society, whereas the clas-
sical economists, although ambiguous, were fundamentally interested in po-
licies aimed at the wealth of nations. The neo-classical shift away from
the classical growth emphasis was a continuation of the rejection of mer-
cantilist thought patterns. A second answer is quite different. The
growth objective is implicitly included in the neo-classical emphasis on
efficiency. Growth takes place to the extent that markets are allowed
to operate efficiently.

These two possible answers are apparently contradictory, but some of
the difficulty vanishes when one particular misunderstanding is clari-
fied. The place of policy objectives, generally, in a society of freely
choosing individuals must be examined briefly. As overall objectives
for economic policy, «growth» and «efficiency» stand on the same
ground. In an instrumental sense, neither of these is an appropriate
policy standard. How is «efficiency» defined? How is «growth» de-
finable? Normally, we define output as that which individuals choose,
and we measure efficiency in terms of this criterion. Hence, markets
are judged to be operating efficiently to the extent that even are allowed
freely to choose what they will choose. This is all there is to it, and the
orthodox efficiency objective becomes equivalent to the more meaningful
goal of widening the range for individual choice (1). Much confusion
has been spread by misguided attempts to derive efficiency criteria from
non-individualistic sources.

With «growth» this confusion is much more general. In one mean-
ingful sense, an «optimal» rate of growth is that rate which results
from the choices of individuals in a market order. But it is not possible

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Virginia.
(1) For treatment of several of the points made here, see Olson J.
Suits, The Goals of Economic Policy, Henry Simon Memorial Lecture (Uni-
for an economy to be reorganized in such a manner as to generate a rate of growth in excess of that which emerges spontaneously from market choice of individuals? I do not want to argue here on the empirical answer to this question. Let us suppose that organizational changes are possible which could generate a higher rate of economic growth than that which is produced in an efﬁciently-operating market order. Will such changes be desirable in a free society? An aﬁrmative answer can be provided here only if it is conceptually possible to derive, from the choice of individuals as participants in political process, a general agreement on some institutional rearrangement that will produce the indicated results. On several occasions, I have attempted to derive such a conceptual agreement, and I have not been successful. I cannot retrace the analysis in this paper; I shall simply assert that the alleged external economies involved in growth-inducing behavior of individuals do not hold up under careful analytical scrutiny. This amounts to saying that, in my opinion, several notable economists, who have at least tried to examine the problem, have been wrong. These include such names as Pigou, Meade Baumol, and Graaf.

For many of the modern growth advocates, such a search is, of course, a waste of time. They are quite willing, and ready, to impose external criteria that will dictate «target» rates of growth, and the derivation of policy changes from voluntary agreements among individuals becomes wholly unnecessary. The mere fact that these advocates have been influential in shaping much modern thinking on economic policy demonstrates that the confusion here is much deeper than is that with respect to efﬁciency.

II. If that rate of growth emerging from the spontaneous operation of the market is deﬁned to be «optimal» in some sense, how can monetary policy be organized so as to promote this result? The answer has already been suggested. Growth and efﬁciency become attributes of the same process, and both can be furthered to the extent that markets are made to work better rather than worse. This suggests that monetary policy should be evaluated in terms of its effect on economic efﬁciency, itself an unorthodox approach. Monetary policy should aim at providing predictability in the value of the monetary unit. This, and not the level of employment or some target rate of growth, should be the instrumental objective for macro-economic policy, generally considered. Such predictability, which can be provided via monetary-fiscal policy instruments, can substantially reduce the range of uncertainties faced by decision-makers in the market. And there seems to be no question but that such a reduction would dramatically improve the efﬁciency of market performance. The analogy is the weather. The agricultural economy becomes more and more efﬁcient as the science of meteorology becomes more exact. In a genuine sense the average level of prices, which, in turn, reﬂects the state of aggregate demand, describes for the individual business man the «economic weather» within which all of the necessary uncertainties of business decisions arise. Improving predictability in the state of this «weather» reduces the range of uncertainties to those which can, and must, properly be confronted by the decision makers in the economy. The prospective producer of shirts should expect to face uncertainties, and to take risk, concerning his ability to market his product in competition with other ﬁrms in the same industry, concerning the overall demand for this product versus other consumer’s goods, concerning the availability and prices of resources. But his decision task is substantially assisted to the extent that successful macro-economic policy provides him with some insurance as to the expected average level of prices in the economy.

III. To this point, questions concerning the place of an economy in an international order have not been raised. Discussion has assumed, implicitly, that national economies are closed. In the real world, national economies are always open, to some extent and in varying degrees. It is necessary to see if this modiﬁes the general conclusions about the goal of macro-economic policy. Consider a situation in which a national government, through monetary-fiscal policy, successfully insures a high degree of predictability concerning the value of the national monetary unit, measured in terms of domestic purchasing power. For the businessman who operates in the international rather than the domestic market, the «economic weather» remains highly uncertain. For his purpose, a regime that deliberately fosters uncertainty in the domestic purchasing power of money in order to generate greater predictability in the international purchasing power of money may be preferable. Historically, national governments have tended to satisfy these preferences of international traders much more readily than they have those of domestic traders. The persistent defense of ﬁxed exchange rates can be interpreted only on some such basis as this.

If, in fact, there should exist some international arrangement or agency that could, in some way, insure global predictability in the average level of prices of internationally traded goods, a strong case can be made out in favor of national macro-economic policy that aims directly at insuring maximum coordination of the domestic economy and the international economy. If no such agency or arrangement exists, relatively little is gained by attempts to geared national policy to unpredictable international events. The dominance of balance-of-payments objectives in modern national macro-economics policy cannot be justified on predictability criteria. In the world economic organization as it currently exists, increased predictability concerning domestic price levels would surely improve the effcacy of market institutions, both domestic and international.

IV. Predictability in the value of the national monetary unit is a more general objective for policy than stability. Gradually increasing, gradually declining, or predictably oscillating price levels are all ac-
results here should not be exaggerated, but the direction of the difference seems clear.

VI. The argument here was basically correct, but, over the decade since it was first seriously advanced, precisely the reverse policy combination seems to have emerged as the standard pattern for macro-economic policy, at least in the United States and in Great Britain. We observe, commonly, easy budgets and tight money, rather than its converse. This combination tends to reduce the rate of economic growth relative to that achievable under alternative policy mixes due to the upward pressures placed on interest rates.

This growth-retarding combination of instruments is explained by the political economy of macro-economic policy. In democratic political structures, the politicians seek to minimize adverse voter reaction. When faced with the necessity to restrict private outlays, they will tend to select indirect instruments, those of monetary policy, and to allow the explicit manipulation of these instruments to remain in the hands of non-political bureaucrats, the central bankers or monetary authorities. When faced with the necessity to expand private spending, politicians will tend to select the direct policy instruments, those of budgetary policy, and they will claim credit for their usage (3).

VII. Relatively, macro-economic policy will be biased against economic growth in a democratic political structure. This conclusion, in itself, need cause little concern since growth, per se, need not be of major significance, and the bias may be of slight effect. Within the limits of this biased policy mix, variations can still exist that can exert further influences in the rate of economic growth. Even under a regime where easy budgets and tight money is characteristic, effects on growth depend on the way in which budgets are eased. When deficits are to be created, taxes may be reduced or public expenditures may be increased. The relative effects on economic growth are evident. Tax reduction releases funds for spending in the private sector, including investment outlay. Some new public expenditures may, of course, take the form


of capital formation, but public investments, especially in developed economies, are not likely to promote growth to an extent comparable with private investments. A budgetary policy that incorporates tax reduction will tend, relatively, to produce a higher rate of growth than will a policy that incorporates expenditure increases.

Which of these directions will tend to characterize democratic process? On balance, deficits will probably be created more often by expenditure increases, although both the analysis and the empirical record are cloudy here. The 1964 tax cut in the United States confutes the expenditure-increase hypothesis, but this may well have been a unique experience. The response depends critically on the state of public attitudes concerning the proper sphere of government. It now seems likely that the post-1966 policy mix will not be patterned on that of 1964 in the United States. Emphasis will probably be placed instead on major expansions in spending programs, the bases for which have already been put on the books by «Great Society» legislation.

VIII. Much of the above discussion about the effects of monetary-fiscal policy combinations on the rate of economic growth is equally relevant in a setting with false objectives and in one where appropriate objectives are adopted. In much of the world today, national policies are geared to employment, not to price-level objectives, and price-level stability is sacrificed, more or less deliberately. The institutional conflict between simultaneous achievement of high-level employment and price-level stability provides the basis for arguments in support of inflation, arguments that have effectively been translated into policy.

As I have suggested, to the extent that inflation in the price level is predictable, markets can be organized with reasonable efficiency, although there will necessarily be some adjustment costs. To the extent that inflation is unpredictable, the growth-generating potential of the market system is generally reduced, especially if unanticipated inflation continues over long periods of time.

Even here, however, the viability of market forces should not be underestimated. If allowed free play, market organization can produce substantial growth in the face of continued and unanticipated inflation. The situation becomes wholly different, however, when and if the attempt is made to inhibit markets by direct controls, a justified by the inflation itself. It is this latter policy combination that is observed in many countries at the present time. Long continued, this policy mix can only serve to inhibit severely the rate of economic growth in such countries.

Under a monetary-fiscal policy that generates inflationary pressures, that increase demand beyond the productive potential of resources, national governments are trying to prevent prices from increasing by the imposition of varying degrees of coercive controls over wages and prices. «Incomes policies», «price-wage guidelines»: these command current attention in the national economic presses. Fortunately, these policies are almost wholly ineffective until and unless the coercive power of the government is introduced more fully than has heretofore been the case in many nations. To the extent that these policies are effective, however, and to the extent that coercion is introduced to make them so, serious reduction in the efficiency with which the market performs its coordinating task must result.

This is widely acknowledged. Yet it is precisely this route that threatens not only the post-war growth record in developed countries, but, also, the very organizational principles upon which market order is founded.

This is, I think, the uniquely relevant result of the Keynesian emphasis. The macro-economic emphasis has created intellectual confusion such that we stand in danger of sliding, unwillingly, inadvertently, even further into neo-mercantilism. In the name of correcting neo-classical policy mistakes (which should be acknowledged), the modern macro-economists commit even more damaging errors. Failing to possess the essential vision of market order that should characterize the economist, they see no effective alternative to the centrally managed, manipulated economy. They simply do not understand that the effective operation of market processes provides the best source of generating high-level employment and economic growth, and that monetary and fiscal policy devices are useful only to the extent which they can promote, not retard, the power of organized markets.

Such modern macro-economists now command the worldwide attention of politicians. This fact we ignore at our peril. Our task, as members of the Mt. Pelerin society, is to see that the thinking is kept straight somewhere, that sound analysis survive in spite of all. It is, in one sense, a tribute to Henry Simon's that so much of what I have said in this paper he said, much more eloquently, more than twenty years ago.

JAMES M. BUCHANAN

Riassunto — Questo articolo prende in esame gli argomenti a favore di chiare politiche promotorie di sviluppo e conclude che queste non si giustificano in base alle regole standard di efficienza. Tuttavia, lo sviluppo viene promosso nella misura in cui riesce a far funzionare i mercati in modo più efficiente e a questo scopo, una previsione riguardo al valore del denaro è un elemento vitale.

Ciò presuppone, si analizza in relazione fra gli strumenti di politica monetaria e quelli di politica fiscale. La combinazione di «facile denaro» e bilanci rigidi è promotrice di sviluppo, ma l'esperienza insegna che questa combinazione è politicamente difficile da raggiungere. Nella serie degli strumenti di politica fiscale, è dimostrato che le riduzioni delle aliquote delle tasse promuovono lo sviluppo più che gli aumenti della spesa.
MONETARY AND FISCAL POLICY
FOR ECONOMIC STABILITY AND GROWTH

by Gottfried Haberler (*)

Introduction.
Many modern theorists would approach a problem like this by counting "targets" and "instruments." There are two targets — stability and growth, and two instruments — monetary and fiscal policy. In general, if the number of targets is equal to the number of instruments, the policy problem is soluble. Unfortunately, things are considerably more complicated. Monetary and fiscal policy are not simple undifferentiated tools, but complexes of measures. Stability and growth, too, are complex, to some extent interrelated phenomena. It will therefore be necessary to discuss the meaning of the terms. Furthermore, we have to identify the economic environment or type of economy for which we wish to investigate the monetary and fiscal policies most suitable for the attainment of stability and growth.

I shall assume a modern, substantially free enterprise economy of the Japanese-U.S.-Western European type—but an economy with a fairly large public sector and a government budget of something like 25 per cent of Gross National Product (GNP).

I make this latter assumption not because this is an ideal state of affairs guaranteeing a maximum rate of growth. It is certainly no such thing. I choose this type of economy as a framework for two reasons. This is the economic environment we live in and it gives fiscal policy the great weight it now has—making it, for better or worse, a powerful instrument for influencing stability and growth. To illustrate the second point, let me mention that if in 1931 or 1932 before the bottom of the Great Depression had been reached, the American Government had tried modern anti-depression fiscal policy and had granted a 50 per cent cut of the individual income tax, it would hardly have arrested the downward movement of the economy, because at that time the yield of the income tax was but a minute fraction of aggregate expenditures. Today, such a step would be sufficient to turn a recession into a runaway inflation—so much larger is the size of the public sector relatively to the economy as a whole and so much greater the weight of the income tax compared with total expenditures.

Meaning and Measurement of Growth.

Economists, policymakers and the public at large have become growth conscious. While twenty years ago, in the heydays of the "Key- (*) Department of Economics, Harvard University, Cambridge, Mass.

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nalian revolution, employment and stability largely monopolized the attention, emphasis has shifted to the problem of long-run growth.

Economic growth is usually defined or measured by the long-run increase in GNP per capita or the increase in output per manhour. The interpretation of such figures, their reliability and accuracy and especially the international comparison of such figures relating to different countries, raise, of course, a host of very intricate economic and statistical problems.

These difficulties are especially great when comparisons are made between countries in different stages of development—mature industrial countries and less developed ones. In the less developed countries, statistics are generally poor and GNP figures are apt to give excessive weight to industrial production neglecting unduly the contribution of agriculture, especially of subsistence farming. Comparisons between capitalist and communist countries raise special problems.

I shall not deal with these problems of interpretation and measurement. As far as the Ldc's are concerned, Peter Bauer and Herbert E. Frankel have dealt extensively and convincingly with these issues; Abram Bergson and Warren Nutter have done the same for comparisons between the U.S. and Russia. Let me only say that GNP has to be comprehensively defined. It is, of course, not identical with industrial production and certain 'imponderables' have to be taken into consideration, such as freedom and range of consumer choice, leisure and improvements in quality, working conditions and quality of public service, etc. The difficulties of interpretation and measurement are greater when an attempt is made to make absolute comparisons of GNP per capita at a point of time as between different countries, than when comparing rates of growth over time.

While preoccupation with growth in popular discussion, formal theories of growth and extensive measurement of the rate of growth are a fairly recent development, economists have always been concerned with growth. Adam Smith and John Stuart Mill have both been concerned with growth. Adam Smith's great book, *An Inquiry into the Nature and Causes of the Wealth of Nations*, would not have been falsely labelled had he called it *The Economic Growth or Development of Nations*.

It is very often said, especially by Keynesians and modern interventionist-protectionist writers on economic development, that *neoclassical economists* of all description — members of the *Cambridge* School, *Austrian* School, *Lassanne* School, or however one chooses to group them — were and are not interested in growth, that neoclassical economics is entirely concerned with static efficiency, value and price formation and has nothing to contribute to the explanation of growth (1).

Such assertions are in reality entirely unfounded and very superficial. It is true that economists late in the 19th Century compared with the early classical period have become much more specialized and that some neoclassical writers were preoccupied with problems other than growth. Much of the neoclassical theory is static; formal dynamic growth theory is a comparatively recent development and was first cultivated on Keynesian lines (e.g., Harrod-Domar models). It is, however, not true that the static nature of his theory debars a neoclassical writer from saying anything useful on growth. *Comparative statics* is a perfectly legitimate method of dealing with problems of development and growth, at least in first approximation. Some neoclassical writers, e.g., Bühn-Bawerk, A. Marshall, Schumpeter, had a lot to say on growth. And in recent years, a number of writers have taken the trouble to spell it out in great detail and in formal mathematical terms, the growth implied in the neoclassical system. (See, for example, Professor J.E. Meade's *A Neo-classical Theory of Economic Growth*, 1st edition, London 1961).

Economic Stability.

Economic stability, too, is a complex concept; the meaning in which stability can be said to be an objective of public policy has to be carefully specified. It goes without saying that each business firm is conscious of the importance of stabilizing its activities as far as possible. This is part of its endeavour to minimize the cost of production and to maximize its profits over the long run. Steady employment of the labor force and continuous utilization of equipment minimize cost of production and maximize profits. Internal arrangements such as multiple shifts, holding of inventories, maintaining standby equipment, etc. go a long way to guarantee continuous, uninterrupted activity, that is to say, stability. Diversification through mergers and acquisitions are other measures directed at the objective of maintaining a *stable* level of activity.

Needless to say, despite all efforts, complete stability is rarely attained. Individual firms wax and wane and occasionally break down. The same is true of individual industries. Output and employment change and occasional lapses from full employment are unavoidable. There is such a thing as *frictional* unemployment which is often estimated at 3-4 per cent of the labor force, but actually must be assumed to change over time according to circumstances. These types of instability are unavoidable; they cannot and should not be removed by monetary and fiscal policies.

The type of instability that financial (2) policies can be expected to classical economics could be closely paralleled by quotations from Friedrich List's criticism of the old classical school.

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(1) It is interesting to observe that the present-day criticism of neo-

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(2) When referring to monetary and fiscal policy together. I shall use the word "financial" policies.
mitigate or possibly eliminate are what we call the business cycle in the broad sense, especially the downswing or contraction phase of the cycle, cyclical depressions for short.

Here is not the place to go into the theory of business cycles or business cycle policy. Fortunately, this is hardly necessary. It will be sufficient for our purposes, I hope and believe, to formulate a few broad propositions on which the great majority of modern experts can agree, notwithstanding certain issues that are still controversial.

Business cycles are broadly based movements of expansion and contraction. Their basic characteristics are these (3).

The length of the cycles varies from more than one to ten or twelve years; the movement is very pervasive, affecting almost all branches and aspects of the economy; during the upswing, GNP and its principle subdivisions (especially industrial output) rise, during the downswing they decline; employment and unemployment move with output—unemployment, of course, in an inverted fashion; aggregate effective demand (money times velocity of circulation, MV for short; money national income; aggregate expenditure) fluctuates parallel with real output and employment.

The parallelism of money flows and real flows (output and employment) means that the business cycle has a monetary aspect or element. It does not mean that it is necessarily caused by monetary factors; in other words, it has a monetary element but is not necessarily a purely monetary phenomenon in the causal sense. Few modern experts would subscribe to the thesis that the cycle is a purely monetary phenomenon. But it is not too much to say that the upswing has an inflationary element and the downswing a deflationary element. We may go a step further and say that the proximate cause of the real cycle (i.e., the cycle of output and employment) is fluctuations in aggregate monetary expenditures (effective demand). It is perfectly compatible with this statement to assume that the mechanism that brings about the alternation of expansion and contraction of aggregate effective demand may be basically non-monetary—for example, that it is an interaction of multiplier and accelerator and an innovation mechanism as described by Schumpeter. Money does, however, play at least a permissive role in the sense that either the quantity of money or its velocity of circulation adjust to the real forces. However, money can and actually often does play an active role in the sense that measures of monetary policy bring about or intensify expansion or contraction of the business cycle.

A further general characteristic is that investment fluctuates more violently than consumption and, related thereto, that the cyclical amplitude of production of durable goods and of producer goods is greater than that of nondurables and consumer goods.

For the U.S., it has been definitely established that agricultural production has no cyclical pattern. Prices of agricultural products, and farmers' income on the other hand, did fluctuate sharply in a cyclical fashion, at least until government policies of rigid price supports for agricultural products were introduced in the 1930's. The same is probably true of other industrial countries.

Most experts believe that the business cycle is the result of an endogenous process, i.e., that there is an economic mechanism which produces cyclical fluctuations. Nobody would deny, however, that the actual cycle is often profoundly influenced by exogenous forces. The most important force is government finance, especially wars and war inflation. In modern times, conscious policies to counteract the cycle by financial policies have become very important. But despite the fact that governments have become cycle conscious, government financial policies often accentuate the cycle or otherwise create instability, and that not only through expenditure variations forced by war and defense exigencies.

In many less developed countries endemic inflation, even in peacetime in an exogenous force which often swamps the endogenous cycle altogether.

Inflationary and deflationary forces impinging on a country from abroad, operating through shifts in imports and exports and the balance of payments, are from the point of view of each country an exogenous factor. Even large countries are influenced thereby. In small countries, international developments usually dominate the domestic cycle.

Business Cycle Policy.

Actual business cycle policy as well as the views of economists concerning such policies have undergone great changes in the last 30 years.

Formerly, it was widely held that little could be done about depressions once the downward movement has started or a boom has got under way. The only effective anti-depression policy, it was thought, is a policy to prevent the boom. Once a boom is allowed to get under way, the depression becomes unavoidable; it can perhaps be somewhat alleviated but to try to prevent it altogether would make things worse and lead to a more severe depression later.

It was, however, soon realized, even by those who regard depressions as the unavoidable consequence of real maladjustments created by the boom, that depressions feed on themselves—that is to say, that vicious spirals of deflation often go way beyond what may be necessary to correct the maladjustments created by the boom. The late Professor W. Ropke and Professor Albert Hahn spoke of a secondary deflation. From there it was a small step to realizing that the secondary deflation usually is, or may be, quantitatively much more important than what might be called the primary or essential function.

or character of a depression—namely, the elimination or absorption of
the "real maladjustments" created by the preceding boom.

Today, the emphasis has definitely shifted from preventing a depre-
sion by somehow manipulating or moderating the upswing, to counter-
acting a depression once it has gotten under way. That does not mean
that no attempt should be made to influence the upswing. Everybody
agrees, in principle, that inflationary excesses which sooner or later
threaten every business cycle upswing should be restrained. Naturally,
views diverge when and where the inflationary danger starts. But it is
fairly generally agreed that there is no strict correlation between the de-
gree of inflation during the upswing and the severity of the following
depression. Sometimes very severe depressions follow periods of only
mildly inflationary upswings and periods of high inflation are rarely fol-
lowed by severe depressions.

The severity of depressions seems to depend much more on policy
mistakes and developments during the depression, than on the degree
of inflationary excesses or on the magnitude of the alleged "real mal-
djustments" that may have characterized the preceding upswing.

Concerning the instruments of anti-depression policy, there exists
general agreement on basic issues. Easy money policies and expansion-
ary fiscal policies are the basic prescriptions. Under the influence of
Keynesian thinking, expansionary fiscal policy was at first taken as
synonymous with government deficits brought about by ad hoc increases
in government expenditures ("public works"). Later, it was realized that
budget deficits can be brought about by collecting less in taxes
as well as by increasing expenditures (4).

The position of the modern "laissez-faire" liberal economists can per-
haps be stated this way: If fiscal policy is used to counteract the con-
traction of effective demand in a depression or recession (the difference
between depression and recession is only one of degree), it is better
to reduce taxes than to increase government expenditures. In other words,
it is better to let the individuals do the spending than to impose the
pattern of spending by government decree (5).

Furthermore, the liberal economist will wish to reduce the scope
for ad hoc decisions of the government by favoring so-called "automatic
stabilizers" as compared with "discretionary policies." Milton Fried-
man, in a number of important papers, has made that point forcefully
and convincingly. He has pointed out that fiscal policy measures, changes
in expenditures as well as changes in tax rates, are subject to un-
avoidable lags. There is first the "diagnosis" lag. The government
must decide whether a change is necessary, i.e., whether a recession has
started. Secondly, it must persuade Parliament to accept its decision
and, thirdly, after a decision to change expenditures or taxes has been
made, it must be carried out. Decisions concerning monetary policy
(changes in the discount rate or open market operations) can be made
quicker in most countries because central banks can act without asking
parliamentary approval. But monetary measures seem to have a fairly
long operational lag; it takes a while until a change in interest rates or
in the quality of money influences spending.

The consequences of these lags may be serious. Suppose the cyclical
recession we wish to counteract is short, say, 10 months (the average
of the postwar recessions in the U.S.). If then anti-recession measures are
not taken very promptly, their effect may well come too late to relieve
the recession and instead overstimulate the succeeding upswing, that is
to say, the policy may be destabilizing rather than stabilizing (6). Since
to act "promptly" may well have to mean "before the recession has
actually started (if the lag is longer than the duration of the recession),
a fully effective stabilization policy requires not only correct prompt
diagnosis that the turning point has been reached, which is not easy,
but correct predication that it will be reached at a certain time in the
future. Economic reporting of current economic developments has been
greatly improved in the last twenty years, but reliable forecasting of
cyclical changes is still, and probably always will be, at least as uncertain
as forecasting the weather.

If anti-depression policy relies on the so-called "automatic" stabil-
izers, it is not subject to this difficulty. What is meant by automatic
stabilizers is that in a modern country with a large public sector when
during a recession economic activity slackens, a deficit in the government
budget is automatically created by the joint effect of falling tax receipts
and rising expenditures for unemployment benefits and similar relief
measures. Hence, if taxes and expenditures are set at such a level that
the budget balances over the whole cycle, a deficit will automatically
appear in recessions and a surplus during the upswing. Or if there is
a secular increase in the public debt, the deficit will be larger in recession
periods and smaller in prosperity years. This will tend to counteract
the cyclical swings without forcing the authorities to rely on prompt
diagnosis and correct forecasting.

(4) It is interesting to observe that one of the first places where this
was clearly stated is not in any of Keynes' writings or that of any Keynesian,
but in Economic Stability in the Postwar World, Report of the League of
Economists on Economic Depressions, Part II. League of Nations, Geneva,
1945. The leading spirit of that Committee was the late Alexander Loeveday, who was a member
of the Mont Pelerin Society.

(5) There remains the question which taxes should be reduced. Some
observers on that problem will be made later. Another question which
might be raised is whether dollar per dollar an increase in expenditures is
not more effective than a tax remission, (a) because expenditures can be
pleased and (b) because the taxpayer may not increase his spending by the
full amount of the tax remission. These and other questions of finer
detail will not be discussed here.

(6) To give a concrete example: In the U.S. the argument is currently
(December 1966) used by some people that it is too late to raise taxes for
the purpose of curbing inflation; the expansion is drawing to an end and
if a decision were made now to raise taxes, the effect would come too late
to restrain inflation, it would accentuate the coming recession. (I am discussing
here the logic of the argument and not its actual merits and possible ulterior
motives, such as avoiding a tax rise in an election year).
This ideal picture is, of course, a far cry from actual reality. No government has yet wholly relied on automatic stabilizers and there are always emergencies, such as the war in Vietnam or a defense build-up, to disturb the picture. The operation of the automatic stabilizers is, however, a fact which has lightened the burden of discretionary policies. These considerations could be indefinitely expanded and refined. They lead to the following broad conclusions which are, I believe, widely accepted: it is fairly easy to prevent by monetary and fiscal policies serious and long-drawn-out depressions from developing. But a complete and full smoothing of moderate cyclical swings in the order of magnitude that we had in the postwar period in western industrial countries is not possible except by much more drastic measures than comparatively mild monetary and fiscal policies. It would require putting the economy under permanent inflationary pressure, trying at the same time to hold down inflation by a multitude of controls, incomes policies, as it is called in Europe, or "price caps for non-inflationary wage and price behavior", as it is called in the U.S. These policies of high pressure and creeping inflation imperceptible shade off into the system of "represed inflation", the most reprehensible and dangerous form of inflation.

Stability and Growth: Possible Conflicts.

Nobody will deny that preventing or alleviating severe and long depressions, anything like the Great Depression of the 1930's or even the 1929-32 depression, at the same time raises the long-term rate of growth. To that extent, the promotion of stability and growth go together.

Speaking of the Great Depression, it must be added that without truly horrendous policy mistakes it would never have gotten as severe as it did, and many of the measures actually taken in the 1930's, whether really effective in the technical sense of alleviating the depression or not, were certainly not conducive to long-run growth. The depression could, however, easily have been greatly alleviated and shortened by monetary and simple fiscal policies (T). (On the combination of monetary and fiscal policy from the point of view of growth, some observations will be made below).

Going now from one extreme—preventing or curing severe depressions—to the other extreme—smoothing out even wild fluctuations and maintaining employment continuously at a very high level—it seems to me clear that a point will be reached where the objective of stabilization becomes incompatible with the objective of maximizing long-run growth. Or putting the same thought in a different way, running the economy for a long time under forced draft so as to keep unemployment at extremely low levels—"high pressure system"—will result in lower long-run growth than if occasional lapses from full employment are permitted. The high pressure system is what economists call a state of "overfull employment". The reasons why this system is not optimal from the standpoint of growth are the following: overfull employment will cause inflation. Even if it is only creeping inflation, it will provoke governments to introduce more and more direct controls. It is not necessary to explain to this audience why direct controls, even if for some time they may suppress the symptoms of inflation, are not conducive to stimulating productivity and growth.

Apart from growth reducing inefficiencies introduced by government controls, it is a fact that during business cycle upswings and prolonged periods of high level activity, wastes and inefficiencies increase. Labor discipline diminishes, absenteeism and excessive labor turnover increases, sloppy work, bottlenecks and short supply and delivery of parts and material reduce efficiency and cause work stoppages (8).

Furthermore, the idea which played a great role in earlier business cycle theories, that "real maladjustments" develop during the prosperity phase of the cycle, while not sufficient to explain prolonged depressions or to justify a hands-off policy in a depression (let the depression run its course), has probably enough validity to make an occasional pause advisable although it means a temporary drop in the growth rate.

For all these reasons, it would seem that occasional lapses from full employment (defining full employment itself not as literally 100 per cent employment but allowing for "frictional" unemployment) are in the interest of maximizing long-run growth. During these periods of slight slack, real maladjustments are corrected, labor discipline tightened, numerous inefficiencies eliminated, and thus cost of production reduced.

How long these spells of readjustment and tightening should be is, of course, a delicate question of judgment.

Inflation and Growth.

Some will say that all the talk about business cycles is obsolete. There is no more business cycle. In the second half of the 20th Century, the only threat to stability is inflation.

It is, of course, true that there has been a lot of inflation in the last 25 years. Most less developed countries, with very few exceptions, live under almost permanent inflation. And even in the industrial countries there is continuous inflation since, say, the middle 1930's, in the sense that prices, whether measured at wholesale or by cost of living, present the picture of an ascending staircase, periods of rising prices being interrupted not by periods of price decline as before 1933, but

(8) Increasing inefficiencies often do not find expression, or find only insufficient expression, in productivity figures (output per manhour). The reason is that at the end of a business cycle upswing output per manhour is increased by another factor, namely, by the coming into operation of new machinery and equipment.

at best by periods of uneasy stability. The U.S. enjoyed such a plateau of fairly stable prices from 1958 to 1964. During these 6 or 7 years wholesale prices remained stable while consumer prices rose by something like 1.2 or 1.3 per cent a year, which is regarded as tolerable, in view of the fact that quality improvements probably offset the slight rise in the index. Since the beginning of 1965, wholesale prices have gone up by a little more than 4 per cent per annum (at a somewhat accelerating rate) and consumer prices by 2.5 to 3 per cent. This is still considered moderate for an expansion period of unprecedented length and is less than prices have risen during the same period in any other important country.

The problem of inflation is unquestionably a real one although it is, as far as the U.S. is concerned, not quite so dramatic as it is often pictured.

The existence of an inflationary trend, however, does not make the business cycle obsolete. Attempts at stopping inflation almost always lead, at least temporarily, to increasing unemployment and slower growth. In other words, the business cycle in the basic sense of alternating periods of expansion and contraction in real output and employment — contraction at least relatively to a rising trend in production — is still there. The difference from before the Great Depression is that the real cycle is milder and the price cycle plays around a more steeply rising long-run price trend (9).

I shall not discuss at any length the question whether inflation is good or bad for growth, because it has been discussed exhaustively. It can be shown, I believe, that rapid, prolonged inflation is bad for growth and even mild inflation, as we find it in developed countries, is bad in the sense that ideally it is always possible to specify a policy which would avoid inflation and result in quicker growth. Concretely, if money wages could be made flexible and the upward wage push eliminated, and if government expenditure could be reduced, it would be possible to have lower interest rates, more investment and hence faster growth without inflation. Real wage levels need not, of course, decline in a growing economy: It would be sufficient, roughly, that money wages on the average do not rise faster than productivity (10).

(9) Whether there was a secular inflation during the 150 years or so before the Great Depression is a matter of interpretation. Each major war — 1812, Civil War, World War I — raised the price curve to a higher level and after each war prices fell, but failed to return to the prewar level. But in between these peaks, there is an underlying trend visible. Since World War II, the picture is different. There was no price decline to speak of since 1968.

(10) For reasons which cannot be discussed here, this is only approximately true. I do believe, however, that if wages rise parallel with productivity only slight changes, up or down, in the price level would be required to maintain equilibrium. To that extent, the «incomes policy» approach to inflation (or «guidepost policy» as it is called in the U.S.) is correct. Where that policy goes wrong is the assumption that the desired behavior of wages

Actually, it often happens that a certain amount of inflation appears as the lesser evil, because the choice of methods of stopping inflation may be restricted. Let me describe as a concrete example a situation which frequently arises in less developed countries where the problems of inflation appear, so to speak, in crude and magnified form, easier to make out, than in developed countries.

Suppose inflation is due to large government deficits plus rapid credit expansion for the private sector. If then monetary policy is used to put the brakes on inflation, the private sector will be starved while public extravagance continues. Investment will fall and the rate of growth slacken. Moreover, labor unions have become used during inflationary periods to obtaining large annual wage hikes and although these wage increases were to a large extent only nominal, unions will not quickly adjust to non-inflationary conditions. Hence, wages may continue to be pushed up faster than would be compatible with tolerable levels of unemployment.

Under such circumstances, resumption of inflation may well look as the lesser evil. Economists call this, euphemistically, a policy of the second best, a policy of the lesser evil would be a better description.

In the developed countries, the alternatives usually do not appear in such an extreme form. But basically the dilemma posed by inflation is the same.

Monetary and Fiscal Policy Compared.

Either monetary, or fiscal policy can be used to stop inflation (11). The short-run effects, including those on employment, will be pretty much the same. But the long-run effects on growth can be very different.

This stems from the fact that monetary measures (increases in the discount rate and restrictive open market operations) fall primarily on productive private investment, while fiscal policy can be manipulated in such a way that it impinges wholly or primarily on private consumption and unproductive government expenditure.

The first part of this statement needs to be qualified to the extent that monetary policy may restrict consumer credit and private housing credit. Furthermore, local government expenditures may be restrained by a credit squeeze.

The impact of a restrictive fiscal policy depends on whether government expenditures are reduced or taxes raised. As to expenditures, it (and prices) can be brought about by government decree or persuasion. I have discussed these problems at greater length in the last edition of my pamphlet, Inflation: Its Causes and Cures, American Enterprise Institute, Washington, D.C., New Edition, 1968.

(11) I need not here dwell on the fact that successful fiscal policy measures, too, have monetary implications. Concretely, the expansion of the quantity of money has to be stopped either by monetary or fiscal measures. For details see my pamphlet on Inflation quoted in the preceding footnote.
should be kept in mind that not all government expenditures are unproductive.

The incidence of taxes is a very complicated problem. But it is generally assumed that the basic income tax, excise taxes on consumption goods and sales taxes tend to reduce private consumption. The corporate income tax and the higher brackets of a progressive income tax, on the other hand, fall mainly or largely on saving and investment. Hence from the point of view of stimulating growth additional taxation imposed for the purpose of curbing inflation should take the form of surcharges on the basic income tax and excise taxes or sales taxes. Vice versa, when the purpose is to counteract deflationary tendencies and to stimulate the economy, from the growth standpoint monetary policy is indicated and, if fiscal policy is used, the corporate income tax and the higher brackets of the individual income tax should be reduced.

The proposed selective tax changes are anything but popular. The politically feasible choice may be between monetary policy measures on the one hand and on the other hand uniform percentage across the board increase of the individual income tax (in all brackets) and of the corporate income tax. The precise impact of such a complicated tax change is difficult to estimate. But most people would surmise that on balance it would favor investment over consumption and therefore be good for growth.

There is one further point to be made in this connection. The problem of inflation very often presents itself in the form of a growing deficit in the balance of payments (12). Balance-of-payments difficulties stemming from the point of view of the internal economy; or expressed differently, internationally the threat of inflation usually manifests itself much earlier than it would in a closed economy. It is for this reason that it is often said that the existence of many independent currency areas is a bulwark against inflation so long as countries keep their currencies convertible. The international aspects of the problem cannot be further pursued at this point. I confine myself to saying that the choice between monetary and fiscal policy as a weapon against inflation will be affected by considerations. Concretely, many experts feel that from the balance-of-payments standpoint, monetary policy is to be preferred, because the rise in interest rates which it entails would have a favorable effect on the international capital balance; in other words, may attract capital imports and/or restrain capital exports, thus offsetting a deficit on current account.

The theoretical possibility of manipulating and mixing fiscal and monetary policy in such a way as to influence the balance of payments has received a good deal of attention in recent years. I personally believe

that the effectiveness of this approach — «operation mix» — can be easily over-estimated. The reason is that under inflationary conditions, unless the inflation is very mild indeed, international capital flows are not likely to be very sensitive to comparatively small changes in interest differentials.

**Structural Tax Changes.**

The different impact of different taxes on consumption and investment has other implications. Suppose the problem is not to counteract inflation or deflation; in other words, suppose monetary equilibrium exists and the problem is to change the tax system in such a way as to stimulate growth. On the basis of what has been said before, the answer is a shift in the tax system, namely, an increase in the basic income tax and/or sales and excise taxes, compensated by a decrease in the corporate income tax and the higher brackets of the income tax — a decrease in progressivity. There can hardly be any doubt that in many countries highly progressive income taxes plus a heavy tax on corporate income are inimical to saving, investment, innovation and growth.

Furthermore, more specific tax measures have been used to influence consumption, saving and investment: investment credits deductible from corporate taxable income, lower income tax rates applicable to the saved portion of individual income, etc.

**Concluding Remarks.**

The present paper has been kept on a technical economic level. Monetary and fiscal policies were discussed from the point of view of economic stability and growth. Broader, philosophical problems were not raised.

Thus the question of «equity» of the tax system or equity of the whole financial system, comprising monetary and fiscal policy, were deliberately ignored.

There is the still more basic question why should economic growth be an objective of government policy? Why not let the question be decided by the actions of the individuals and the forces of the market? We do not wish to interfere with the freedom of consumer choice. Can that principle of non-interference in the individuals' decisions concerning the pattern of their consumption not also be applied to the individuals' choice between consumption and saving which determines the level of investment and hence help to determine the rate of growth? The individuals' choice between consumption and saving is, of course, not the only one that affects growth. Choices concerning education, resources spent on scientific research and engineering, etc. are equally important. Concerning each of the these and others, the same question could be asked — why not leave all these choices to the individuals? Why make it a business of the government?
No comprehensive treatment of these issues is possible here. I con-
fine myself to a few remarks.

First, I decided to discuss the problem of stability and growth in
the framework of the present western societies with their large public
sector. The existence of a large government budget makes it virtually
impossible for public policy to remain neutral with respect to growth.
For better or worse it will have an impact on stability and growth. It
is quite possible, or even probable, that the financial policies that were
suggested above as growth-promoting do no more than partly offset
growth-retarding effects of other government activities. In other words,
they may well, on balance, bring the total government impact on eco-
nomic growth closer to a neutrality than it was before.

Secondly, I doubt whether the government should remain neutral
with respect to growth, even if it could. We surely wish to preserve
freedom of consumer choice. But even in that area certain limitations
are unavoidable and are generally accepted. Let me only mention re-
strictions of certain types of consumption (alcohol) by non-adults, re-
strictions on the use of narcotics, drugs, etc., compulsory education, and
so on. No doubt present practices go much farther in restricting
consumer choice and prescribing certain expenditures than most of us
regard as defensible. But it is a question of more or less. The radical
solution — no government influence at all — seems to me difficult to
defend and to be inconsistent.

When it comes to choices between consumption and investment, in
other words, between present consumption and future consumption, the
individualistic postulate, that all decisions should be left to individual
choices and market forces, must be more severely qualified than in the
case of choices between different types of present consumption. The main
reason is that in this case future generations, as yet unborn, are involved
who cannot speak for themselves. When decisions are made on what
types of goods should be produced for current consumption, it makes
sense (with the limitations mentioned) to let the market decide on the
ground that the market gives everybody the same weight dollar per dollar
provided, of course, that we accept the existing income distribution (as
modified by the existing tax system and welfare policies). When future
generations, and for that matter the younger generation (children) are
involved, the situation seems to me radically different.

But it would lead too far to pursue this matter any further.

GOTTfried HABERLER

Riassunto — L'articolo illustra il problema della promozione della sta-
bilità economica e dello sviluppo mediante una politica monetaria e fiscale
in una economia moderna — del tipo Americano-Giapponese-Europeo — che
è organizzata principalmente sulla base di una libera impresa ma in cui il
governo adopera il 55-70 per cento del reddito nazionale per i propri sco-
pi. L'autore in primo luogo discute brevemente il significato e la misura
dello sviluppo economico. Egli esamina in seguito i diversi tipi di instabilità e
conclude che le fluttuazioni econo-
miche dette e i cicli rappresentano il problema della stabilità per le polit-
iche finanziarie. L'autore fa una di-
nistinzione fra cicli non molto accen-
tuati e cicli di profonda depressione. Il primo tipo è caratteristico del dop-
oguerra. Le forti depressioni possono
essere evitate abbastanza facilmente
mediante la politica monetaria e sono,
con ogni probabilità, una cosa del pas-
sato. Le fluttuazioni poco accettabili,
d'altra parte, potrebbero essere com-
pletamente soppressi con una drastica
regolamentazione dell'economia. Si so-
stiene che ciò non favorrebbe lo svil-
uppo a lungo termine, perché signifi-
cherrebbe inflazione e renderebbe l'e-
conomia incerta e rigida e provochi-
rebbe eccitanti controlli da parte del
governo. No dura che esiste un con-
sitto fra politiche di stabilizzazione
troppo ambiziose ed il raggiungimento
del massimo sviluppo a lungo termine.
L'autore analizza brevemente il pro-
blem della inflazione in relazione alla
stabilità economica ed allo sviluppo
discutendo gli effetti rispet-
tivi della politica monetaria e fiscale
sullo sviluppo. Dal punto di vista di
una promozione dello sviluppo, è me-
glio servirsi di una severa politica
fiscale (bilancio con saldi attivi punt-
to che di una politica monetaria seve-
ra (alti tassi di interesse) per
combattere l'inflazione, perché i saldi
attivi vengono ottenuti mediante tasse
su consumo o, ancora meglio, median-
te una riduzione dello spese pubbliche.
Infine l'articolo tocca il problema del
perché lo sviluppo dovrebbe interes-
sare la politica del governo. Perché il
tasso di sviluppo non dovrebbe essere
determinato dalle decisioni degli in-
dividi riguardo al risparmio, agli in-
vestimenti, alla proporzione di reddito
dedicata alla ricerca, all'istruzione ecc.? L'a. ammette che i governi che
assumono per i propri usi o per la
rispostazione il 25% o più del red-
dito nazionale, come fanno ora tutti
gli attuali governi occidentali, non
possono restare neutri nei riguardi
dello sviluppo. Operazioni governative
di quell'ordine di grandezza riducono
il tasso di sviluppo. Pertanto, se la
politica fiscale e monetaria è condotta
in modo tale da accelerare lo sviluppo,
è probabile che l'influenza globale del
governo sullo sviluppo si avvicini alla
neutralità più che non nel caso in cui
la politica monetaria e fiscale venga
attuata senza particolare riguardo al
suo influsso sullo sviluppo.
ON MONETARY POLICY FOR GROWTH

by Clarence E. Philbrook (*)

The size of the grain of salt I swallow with «Monetary Policy for Growth» will reveal that a certain fraudulence pertains to my talking about the subject at all.

One must presumably still discuss «Monetary Policy»; but, without hazard of weeding superficiality, that which the policy is «for» cannot be so readily incorporated in a word— unless that word be some equivalent of «the least poor hope for the realization of the ends of man». Banal though it be to reassert that any one of our many sub-values must be limited in realization by its containment in a matrix of ends, the need for strenuous reiteration appears unlimited. Not that clear verbal denial of the assertion is rampant. Where the context specifically refers to «policy» in general, the point is to be found more or less on every hand, perhaps of late rendered mysteriously more free of the stench of philosophy by being expressed in terms of a «trade-off among values». Doubtless too, many discussants suppose they are giving due attention to these considerations as they repeat the statement that such and such value must be realized «to a maximum degree consistent with» each of a restricted list of favorite ends. Nevertheless, such has been the dominant treatment of the subject of «growth» that I am tempted to say that the earnest of «being in touch» with the mainstream of thought is disassociation from serious moorings in the complex of means and ends. It is in so far as I create expectation of treating the subject in this spirit, that the word «fraud» comes to mind. If the topic is given its currently respectable connotations, my thoughts are largely devoted to urging the undesirability of a monetary policy for growth.

The distinction I shall press is one between (a) monetary policy to cause growth and (b) monetary policy to permit growth. Measured by volume, surely most discussion takes for granted that the policy is to cause growth, not merely to permit it. The question of technical possibilities of promoting growth has received the most attention; but the question of exactly what is the end sought would seem properly to claim priority.

For the «mature» economy—by and large apparently meaning countries with known technology and tastes for productive effort similar to those of Western Europe and the United States and still eschewing central control of population growth, this is of course a matter of how much of the current product shall be devoted to capital accumulation in all forms. The fact that there is no identifiable optimum rate of growth of product through capital accumulation has been «discovered» by writers on growth, after such disregard of initial criticism that the

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respected issue seemed almost fresh. True, the ill wind of "cold war" did blow good to somebody—namely, whoever wished to discuss policy on the basis of "national objectives" rather than the nature of the good society, and fateful to pull out of that hat a particular needed growth rate for, say, the United States, requiring forced-draft capital accumulation. And it must be confessed that those who try to conceive the good society cannot easily deny respectability to such an approach to life in the face of a rival social-economic system not obviously weaned away from its original intention to eradicate capitalism. It may indeed be that I am speaking to no purpose, or at least to future generations, if I say what is intended to be relevant to societies which manage to live in largely nonviolent relations. Nevertheless, I shall speak as if to such societies. In so far as growth enthusiasts speak of the peaceful-society problem, obvious considerations render mysterious the facility with which they advocate assuring a particular, relatively high growth rate. In the weighing of present consumption versus future, any present sacrifice for a capital increment adding ever so little to annual product will over sufficient time give rise to a greater sum of consumption possibilities than was sacrificed, if the future is not discounted. By such a criterion we in the United States should of course regret that growth theorists had not arisen to help force our ancestors of 1850 to greater frugality.

If we adopt forced-growth enthusiasm, then, we open one more sphere of government action in which no definitive judgment of success is available. One man's opinion of the right forced rate of growth is as good as another's. There is no way of really settling a dispute, but merely uneasy compromise lasting only till shifts of power, whims of the voter, and politicians' discernment of personal advantage dictate change. It is not assumed here that all such conditions in the political process are avoidable; but the aim of constitution-making should be to minimize, not embrace them. As opposed to embracing this one, the libertarian reasserts the program implicit in his tradition: the appropriate amount of capital accumulation is that amount made possible by the wishes of men, as individual persons, to save. (On other grounds this amount will pertain to a "full employment income").

Closely related things could be said of growth-induced changes through changes not describable as capital accumulation. For example, to force the sacrifice of leisure (require longer hours of work) for the sake of greater product would be on all fours with causing greater saving, from the standpoint of men's utility calculus—assuming that employment problems are properly met. That governments in developed economies do no such thing (but indeed more likely the opposite), while yet avidly sponsoring growth, only testifies to the spontaneity of insistence on freedoms where the issue is obvious, and to the strength and devious working of the growth mystique.

Thus I am urging that forced growth, whether by monetary policy or any other policy, is no part of the good society. To permit growth is a different matter; and notoriously monetary discussion has purported to have much to say on this score. Adoption of the aim to permit growth implies belief that (a) some rate of growth is anticipated which is appropriate, definable, and determinate, although by no means necessarily predictable or even measurable after the fact and (b) there are at least some market forces working in favor of the realization of this rate—forces which, however, may encounter obstacles capable of being approximately removed. Monetary policy conceived as permitting growth implies that some of the obstacles can be removed by some appropriate treatment of aggregate demand.

For the basis of a liberal criterion of the "appropriate" rate of growth we must of course resort to the basic conception of the person in equilibrium with respect to the apportionment of each of his available means among all sources of satisfaction as he conceives them. Apportionment of each means between income-earning and non-income-earning ("leisure") uses, by each decision-maker, determines the amount of each means which may be considered appropriate at any given time for the use of the market economy. Apportionment of wealth according to marginal utility principles—that is, in accordance with the tastes of persons and the returns contemplated from its market use—fixes a proper amount of capital. Treatment of time and energy in the same manner determines a proper amount of labor, encompassing all human exertion, to be supplied by each person and in that sense a proper total for the economy under the given circumstances. Thus is derived a conception which, in a libertarian view, yields the only defensible meaning of "full employment," either of capital or of labor. To the conception of a proper growth rate, in this libertarian view, it is scarcely even a step. Clearly "full employment" of capital and of labor at each moment would be the literal ideal. Conditions permitting growth in the right degree, then, are simply conditions such that, should any person for any reason whatever wish to place another unit of wealth or of time or of energy in use by the economy, there is available a mode of action by him alone which will set off a reaction that achieves its end.

Without commitment to any particular program, one may assert that discussion of monetary policy has suffered from what amounts to effective isolation from the basic picture of equilibrium in a free economy—more specifically, from failure to remain mindful of the role which we must assign to money in the process of the individual's apportionment of his means. Among the means of the typical person in the sketch above is whatever amount of money he has. As a means, it is subject to apportionment between income-earning and nonincome-earning ("leisure") uses, again with respect to relative marginal utilities as affected by a number of things including the returns to be gained by permitting some of it to be used by business men for capital purposes. (This is of course the characteristic act of apportionment of cash balances contemplated by Keynes, under the head of trading between money and bonds). In the case of the money means, discernment of equilibrium requires attention to an additional act of apportionment—this time within the sphere of "leisure" (non-income-earning) uses;
namely, between utilities of consumption goods and services other than money-services, and the satisfactions available in diminishing degree from a cash balance in real terms (1). The amount of retained money means necessary to strike the utility balance in this sphere is of course influenced heavily by the rate at which money flows into the money-marriage pool—that is, by money incomes; and, by the same token, so is the degree of change in it, if any, necessary at any time to maintain that balance. And we may think of producers’ money pools as production-good inventories treated according to principles of marginalism and therefore determine as to size. In sum, we may look at the equilibrium pool of money means, and so at the rate of flow of a total of existing money, as determined in the total apportionment of means by individuals in the light of utilities affected by productivities (2). The notion of appropriateness of the magnitude of a money flow has thus the same source and validity as apply to the flow of offered productive services.

The upshot is that only one unexceptionable thing can be said about the monetary conditions necessary for full use by the market economy of the means which men wish to inject into it. It is a dreadfully familiar thought. The populace are constantly sending batches of dollars in one direction and batches of productive services in another. These are to meet and, so to speak, mutually validate their repeated trips through the economy. The only requirement for validation is that the batches of offered dollars, and the sum of prices of units of productive services (however much the average of these prices may have adjusted in the process) shall be equal. (This statement takes for granted the process of adjustment of relative prices). It can, then, be said noncontroversially that for a particular batch of dollar offers (aggregate demand) there is a particular appropriate equilibrium set of prices of productive services; and, for a particular set (level) of these prices, there is a particular, appropriate aggregate demand, hence rate of flow of dollars.

What constitutes paying due respect to these noncontroversial propositions is of course the content of that aspect of monetary policy on which I am now concentrating, namely, the criterion of a proper size for aggregate demand. Let us remind ourselves of the gradations of attitude on this score.

(1) Integration of the treatment of money balances of consumers into the leisure-income calculus ought not, I should think, create issues, even if one is inclined to press a view of them as something like a production-good inventory in that they facilitate exchange and so help in obtaining the wants of goods. It may suffice here to note that many of our «leisure» uses of resources (for example, time, energy, and capital for eating and sleeping) also contribute to our ability to produce income.

(2) Perhaps I may here express again over the fact that textbook authors have so frequently made no effort in monetary discussion to distinguish between the notion of determinateness and the notion of constancy—thus managing to dispose of the quantity theory in a few pages which explain that quantity theorists assume (output and) the velocity of money constant and therefore could of course idiotically conclude that the price level varies directly with the quantity of money.

Merely for exposition, we may conceive a certain theorist who is in fact a straw man, although no few textbooks might well leave the impression that he stands for historical persons. He is totally unconcerned with the magnitude of aggregate demand in money terms. For the most popular validation problem, he has but one solution: «inflation, money, let wage rates fall ». He is innocent of even the need to analyze whether aggregate demand in money terms might fall enough to frustrate validation of any increased amount of productive means.

If we build into our straw man a certain deviation toward soundness (one which Don Patinkin does not quite care to deny the neoclassicals but which he says they seem always on the verge of missing), we are less far from historical persons: however intuitively, our now less unreal man takes into account the fact that downward price movements impart to a given amount of money a larger wealth value, the apportionment of which offers a force to avert a frustrating degree of decline of aggregate demand.

If we then give him credit for taking account of the metallic standard contemplated by the relevant men, our straw theorist becomes real enough for serious discussion. The mining of metal means that, as the populace offer for validation larger amount of productive means, they simultaneously have, and normally send out, some additional dollars to work toward validating them. Further, in so far as validation still must rest upon downward price responses, the rate of increase of money means will tend to undergo an increase to which no significant limit can be assigned, as more resources are devoted to mining according to the rate of value of the money means (3).

Were the additional money means injected always of such amount as to validate at initially prevailing prices the increments of productive means, we should have a type case reasonably called «neutral money». Approximately, it would correspond to a case of constant money wage rates. Once this type of validation is set forth, there looms the great divide between attitudes toward what constitutes a proper criterion of the magnitude of aggregate demand.

Both before and after Keynes many sane men have reasoned in the following manner. The very reason we take interest, beyond curiosity, in the level of aggregate demand in money terms—why we bother to go even so far as to advocate «neutral money» in my sense—consists importantly in conceding somewhat to a presumption against reliance on downward price response. If some of the need of such response is to be removed—as under «neutral money»,—why not a bit more relief? Were aggregate demand so manipulated as to tend toward validation

(3) Thus exercises in the possible impossibility of unfrazed growth with a given quantity of money are, while stimulating, not really of the essence of the problem of policy in a semi-sane society. It may be added that only strenuous effort appears adequate to prevent students ‘forgetting these familiar metallic-standard consideration and thus losing perspective on the options of policy. Cf. Don Patinkin, Money, Interest, and Prices (New York: Harper & Row, 1965) pp. 260, 261.
at a constant commodity-price level, then, as technology advanced, some relief would be added by a tendency for money wage rates gradually to rise. But, added some analysts, such validation would by no means always obviate need of downward particular-price response. Why not, then, free our productive services entirely from that tyranny of the market which might sometimes force reductions in some of their prices? Let never a wish to inject another unit of a productive service into the economy face any doubt that additional dollar offers, to demand it at the current price, will simultaneously or in advance be there to meet it. (Here we have a form of the thought basic to a thing that apparently every student today e knows: that the sole means of growth is a prior increase in aggregate demand in money terms). Indeed, if we press the procedure with bold generosity, we may be dangling bait that will entice repeated error of calculi to the disadvantage of leisure uses and thus be contributing, by a benevolent Machiavellianism, at least an element of growth—as long, at any rate, as men do not catch on to what we are doing. Furthermore, such validation may enable us to have nearly proper growth without ever admitting to labor unions and to minimum-wage advisers that we are deluding on our social instructions to them, namely, e Get whatever real wage your collective power permits; e at least, again, it will enable us to do so as long as those objects of our high respect are foolish enough to trust us.

That one must now for respectability advocate, as minimum overvaluation, an aggregate demand assuring a constant price level, is not without its oddities. That the name of Keynes has somehow operated in the direction of strong overvaluation through aggregate demand strikes me as positively droll. For, where he was discussing what he would like to have aggregate demand achieve, the lead he provided was not unpromising. Apparently lost is awareness of what Keynes declared to be an acceptable policy—albeit the declaration itself was foggy to a degree such as would surely bring, in the case of a less charismatic author, a curt letter from the editor. Just after a statement that stability (in Australia) would have to be sought by means which would e maintain investment at the critical level e (and so, on his grounds, would operate through management of aggregate demand), occurs the assertion, e...the maintenance of a stable general level of money-wages is, on a balance of considerations, the most advisable policy for a closed system... e (General Theory, p. 270). True, on the next page he expresses a mild preference for e allowing wages to rise slowly whilst keeping prices stable. e (Just how to apply this policy e in the long period e as recommended, together with his approved policy of stable wage rates in the short period, Keynes does not say). We need not, however, regard him as rejecting stable money wage rates, especially since he ends by saying, e But no essential point of principle is involved. Perhaps we could help restore sanity under the slogan, e Back to Keynes’ conservatism! e.

Clearly, nevertheless, the urge to painless validation of growth has got out of hand. The criterion for aggregate demand has lost all sig-

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pages cited above). One hardly need speak of the less "modern" theorists such as J.M. Clark who called for a board of wise men. The thought is clear in the "modern" "discoveries" of "Iaws" relating wage rise to the level of unemployment as cause. It is left in no doubt by Samuelson. And so on.

What comes through less clearly is, what to do about it. The proposition points with complete clarity to the conclusion that, unless we vitalize the responsiveness of prices of productive services—the discipline or "tyranny" of demand,—we are but pawing the air with respect to full-employment in a free society. Some refreshment is to be found in the fact that A.P. Lerner says, in effect, if price response to demand is what is lacking, then we cannot stop short of injecting it. Even his objectionable scheme of government-forced response to excess demand or supply of labor has a certain appeal, at least on grounds of virility, in relation to the feeble suggestion of a board of wise men to exercise moral suasion (5). On the other hand, it is rather frightening to find a Samuelson, normally so able to go the extra mile to draw the resultants of sets of vectors, drawing the vectors clearly enough but then dropping his pen, explicitly leaving this particular resultant as an open question (6).

Actually, as a rule one fact, if mentioned, is touched with such delicacy that we scarcely feel its presence. It is that the most troublesome vector consists in the force of the prescriptions given the sellers of productive services—that we have a case of good learning of bad teaching. Evidently the social well-being requires that economists cease to become disoriented whenever logic points to unpopular prescriptions.

The question of what combination of devices can best give rise to the chosen behavior of aggregate demand has been neglected here, and not wholly without intention. The fact is that, having spent my teaching life in large part purveying notions favorable to what I thought was a good program of active management of aggregate demand in money terms, I find reluctantly forced to reenact the question of whether it is desirable to engage in such management. On this ground my steps feel uncertain, for I am inured to thinking it sane to cut loose from the gold standard and fixed exchange rates, frankly manufacture money through the government according to a very specific, consti-

tutional criterion, including provision for growth by Federal budget deficits. I have looked kindly upon Friedman's version of such a program—a regular growth in the money supply,—although not conceding that a constant-price-level policy would fail, given those conditions essential to the success of any free-society policy toward demand. But my commitment to active management may suffer a marked decline.

I now toy with the thought of accepting a charge which no few persons would be glad to hurl at me. I have accused some "modern" economists of living in the past—in a past of the nineteen-thirties, in an economy sinking in sack in depression and rendered near-helpless at least in part by hopeless and conflicting forms of "help"—in times when it was at least understandable if one supposed carelessness of the real-wage meaning of a money wage left scope for monetary Machiavellianism, to trick workers into full employment. But am I myself, and others who look toward a well-planned management of aggregate demand perhaps living in the past in a different respect?

The past of which I think was different from the present (at least wenumen have thought it was) in at least two crucial respects. That is, we could conceive of (a) a society's arriving at a sane monetary program and (b) our trusting a government faithfully to carry out the agreed program. Both these processes are in large part a function of the degree of social consensus, not only on technical analysis but especially on what constitutes a moral society—perhaps we should say, consensus on the latter in the light of the former. On this score, as many have noted, the tower of Babel has risen high, until that hideous strength renders all but impossible effective communication about crucial matters, among a critically large proportion of the crucial members of the society. The condition suggests a world in which the slate has been wiped clean of all ancient prescriptions, a world in which the social contract has to be written de novo in its every jot and title. Any one of myriad conflicting possible clauses could conceivably help form the basis of a society much better at least than chaos, provided the other clauses were selected with a proper view to this one; but the task would be totally hopeless. In the field of monetary policy where so large a part of the acceptability of each of several policies consists in its very acceptance, this imaginary construct seems to me especially suggestive.

And this thought brings me to my brink of apostasy. In that past in which I have lived, at least the range of policies that might be taken seriously was not enormous. A constant-price-level policy would have found great support, and a stable money-wage approximation would not have been violently different from conceptions which large numbers of persons would find acceptable; and agreement upon some one policy might seem thinkable. The basic presuppositions have, however, been called into question in many ways, and the means of


(6) "A Brief Survey of Post-Keynesian Developments," in Robert Lekachman, ed., op. cit., p. 240. Doubtless it does no good to protest that Samuelson's statement of what "conservatives" would say (Treat labor rough) is terminologically too flawed to do any good as harm. Surely to liveliness of writing style can justify so describing a program intended to be kind to those who labor by withdrawing support from those who would monopolize job opportunities.
Hienamento — La politica monetaria non può avere per scopo lo «sviluppo» ma, come ogni politica generale, e i fini dell'uomo. Non esiste alcun calcolo collettivo che indichi «quanto» sviluppo si debba avere in un dato periodo; e i limiti posti dalla collettività danno ai politici un grande controllo supplementare sulle categorie inferiori della popolazione. La soluzione liberale classica offre una determinata risposta conciliabile con la libertà; politica monetaria non per «causare» lo sviluppo, ma per «permettere» tale sviluppo quale rimetterà quando gli uomini individualmente saranno in grado di procurare un uso inteso a favorire lo sviluppo, quale essi individualmente desiderano, di qualsiasi porzione delle loro risorse. Qui la questione principale diventa quale serie di livelli di domanda aggregata in termini monetari debba essere sperimentata. Esistono molti gradi di libertà rispetto a questa serie. Perché nessun livello di domanda aggregata monetaria — non imposta con quanta rapidità esso possa salire — realizzerebbe i desideri del budget individuale se non sarà rispettato questo «sine qua non» di un sistema di prezzi; che i prezzi di fornitura di servizi produttivi in media si adattino alla domanda aggregata attraverso l’addattamento di ognuno di questi alla particolare domanda ad esso attinenti; e, data la prontezza di adattamento, un vasto raggio di livelli di domanda aggregata consentirebbe il successo. Molti di tali prezzi economici liberali classici abbiamo fatto concessioni alla riluttanza verso l’adattamento dei salari monetari inteso ad insinuare il tasso di sviluppo della domanda aggregata di denari. Ma (a) così facendo, dato che nessun specifico criterio di domanda aggregata di denaro sembra idoneo ad essere elevato a dog...
A THEORY OF INCENTIVE TAXATION
IN THE PROCESS OF ECONOMIC DEVELOPMENT

by Günter Schmölders

Only recently writers on taxation agreed to include economic growth in the goals which can serve as criteria of a rational tax policy. Policy, in this instance, is far ahead of theory; not only the obvious contributions of various modern tax systems to economic development (1) but also the conscious adaptation of modern tax policy to the requirements of economic growth — even at the expense of some hitherto predominant principles like equity and fair sharing of the tax burden — are indicators of the lag of theory behind practice. The former has every reason to close the existing gap by catching up with the events; only a sound theoretical basis for growth taxation can make possible a fiscal theory to point to long run improvements in taxation and establish criteria by which tax policy can be judged in the decades ahead.

Let me first define the scope and potential of any growth-oriented tax policy. Basic doubts about the suitability of taxation for fostering economic development remain even in modern literature on public finance. It is argued that there could be no doubt about the paralysing impact of taxation on development and therefore only the incorporation of government spending into the analysis could possibly result in a favourable overall impact of public finance on economic growth (2).

Although some scepticism about any global impact of taxation on growth seems amply justified, the argument might be pushed too far if it is used to confine tax policy to the goal of minimizing the growth-retarding effects of taxation. It is by now well-established that growth-retarding aggregate effects can be balanced, even overcompensated by the growth-stimulating effects of taxation in certain sectors. Not only the experience with postwar growth in Germany but also the lessons of other successfully developed countries and regions demonstrate the further impact of tax policy (3).

I. Before we discuss in detail the scope and potential of incentive taxation oriented towards economic development, we have to deal with a few elementary restrictions imposed on the realization of every tax policy. The proposition is generally accepted in fiscal theory, that the


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more accurately a specific tax is being tailored to the existing ideals of «equity» and «ability to pay», the more difficult its correct and unequivocal assessment will become. The more monetary aggregates like sales, income, wealth, or even characteristics of the individual's economic situation are used for the determination of the tax base, the more advanced abilities, skills, and motivation are required on the part of both revenue officials and tax payers. A high standard of rational reasoning and abstract thinking is inevitably needed to put such complicated taxation mechanism into smooth operation.

Training the mind for rational reasoning and the capacity for abstract thinking, however, vary considerably between countries in different stages of socioeconomic development; these factors, therefore, account for considerable differences — from country and from time period to time period — in the ability of societies to absorb and sustain various forms and degrees of closely tailored taxation.

Let us try, then, to spell out more precisely our hypothesis about the degree of absorption a specific tax is able to reach in the behaviour patterns of the public, or as we might term it, its degree of enforceability. Almost any tax must invariably reckon with a certain quota of fraud and tax evasion. As soon as this percentage, however, surmounts a given mark the original concept concerning the desired distribution of the tax burden is endangered; revenue authorities are no longer capable of controlling and metering out the actual tax burden. Therefore, it may happen very easily that an income tax designed to closely fit the taxability of the individual gradually fades away into a rough and vague approximation to this perfect scheme; the actual tax payments then depend on circumstances like misgivings about tax cheating, lack of personal relations with the revenue office, and advanced knowledge of evasion techniques and legal loopholes.

If such symptoms emerge and short term measures do not bring about any remedy, the government in introducing this tax has simply overestimated its enforceability, misjudging the taxability of its citizens or the efficiency of its tax administration or both of them. Misjudgments of that sort have been very frequent in the past; in most cases they were the result of transplanting the tax system of a highly developed country too rigidly into a society of a lower economic level without sufficient regard to the peculiarities.

In a situation like this three reactions are to be observed (4). The first one is surrender, or the complete withdrawal of the tax, the government openly acknowledging to have been misled in designing the concept in the first place. More often we find an attempt to defend undefendable ground. In the long run this will inevitably end with the government tolerating a certain gap between the legal obligation to pay taxes and the actual tax-compliance; in other words, it means that the state allows its citizens to only partly fulfill their obligation and thus to grant extra tax privileges contradicting original intentions.

The third possibility means resorting the line of defense by introducing «object-bound» assessment criteria, often on the basis of «signes extérieurs» or other easily identifiable symbols of the individual's economic position. This procedure, of course, is nothing than a thinly disguised retreat from the principle of individual assessment towards a more approximative and coarse method of taxation, performed in the vague hope of increasing the degree of overall enforcement of the tax in the years to come. An income tax, for example, will most certainly turn into a luxury tax as soon as in shaping the technical procedure the income of an individual is being estimated in accord with the level of consumption displayed. Frequently nothing remains of the original personalized tax except the label.

II. Let me now, for reasons of clarification, turn to the situation in Spain (5). This country is presently undergoing an accelerated process of industrialization. Its highly «modernized» system of taxation had to be abolished because both administrative efficiency and taxability of the Spaniards had been grossly overestimated. The traditional gap between legal tax liability and actual tax compliance was further widened by the adoption of «better» tax laws from higher developed countries during the tax reforms of 1957 and 1964. These tax laws stated that any calculation of profits was to be done by using the accrual method which would have rendered a very personal and individualized tax assessment. Actually, however, the assessment of income and yield taxes (6) of Spanish self-employed and professionals are fixed by tax commissions — which by the way partly consist of representatives of the tax-payers themselves — the bases of assessment being the size of the mechanical equipment used for production, the number of persons employed or other conspicuous characteristics of the enterprise.

It goes without saying, that an assessment on the grounds of such external features will, at its best, render an approximate measure of that shop's capacity for production, whereas the actual production, sales or even the business profits just cannot be assessed by this method. E.g., the number of employed workers is by no means necessarily in close relation to the actual volume of production. The differences in the degree

(4) BURKHARD STÜMPFEL, Sozialökonomischer Wandels und die Durchsetzung der Besteuerung, in Finanzarchiv, N. F., forthcoming.

(5) The empirical data on which the subsequent paragraph are based have been collected by the Cologne Center in Empirical Economics (Forschungsstelle für empirische Sozialökonomik — Prof. G. Schmolder, University of Cologne) — with financial support of the Foundation Volkswagenwerk. The sample covered a representative cross-section of the main urban population (1023 respondents). The services of DATAP S.R.A. Estudios de Mercados Opinion, Madrid, in conducting the survey are gratefully acknowledged.

(6) «Impuesto sobre los rendimientos del trabajo personal» and «Impuesto sobre actividades y beneficios comerciales y industriales».
of modernisation and the productivity of labor existing between progressive and more traditional firms of one branch may be large to the extent, that the production of older units is hopelessly outworn, whereas modern units are being extremely undervalued.

If it is already rather hazardous to assess the aggregate "turnover" by using external features, the residual quantities "income" or "net profit" are all the more difficult to rate correctly on such a basis, since they represent the surplus of gross income over production costs. It hardly needs mentioning that in a modern economy two enterprises of the same line and size may differ greatly in their profits, no matter what criteria are used as a measure. The profit percentage of total sales may range from zero to twenty per cent or more, and even the same firm may show ups and downs of such percentage over any period of years.

The failure of the present Spanish taxes is reflected in the following table containing answers of self-employed businessmen and professionals to the question:

"Considering that business conditions vary from year to year, your income in one year might be for example ten per cent lower than in the year before. Would you then have to pay the same amount to taxes or would your tax burden be smaller?" (Table 1).

### Table 1

<table>
<thead>
<tr>
<th>The tax-burden explained</th>
<th>Number of cases</th>
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<tbody>
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<td>Remains the same</td>
<td>In reduced proportion</td>
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<td>per cent</td>
<td>per cent</td>
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</tbody>
</table>

A second question started out from the opposite assumption: "If your income would grow by ten per cent, it was asked, "would you then have to pay the same or a higher amount of taxes" (Table 2).

The answers to the first question suggest that about two-thirds of the independent tax-payers in Spain do not see any connection between their actual tax burden and a possible decrease in their income. The fact that the answers to the second question were less conclusive most probably results from the emotional implications touched upon in this case: hardhitted adversaries of taxation do not like to admit that there is such a fairly easy way lowering their relative tax burden.

### Table 2

<table>
<thead>
<tr>
<th>Taxable group</th>
<th>Remains the same</th>
<th>Is raised</th>
<th>Don't know</th>
<th>Number of cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
<td></td>
</tr>
<tr>
<td>Entrepreneurs</td>
<td>42</td>
<td>40</td>
<td>8</td>
<td>100</td>
</tr>
<tr>
<td>Professionals</td>
<td>46</td>
<td>44</td>
<td>10</td>
<td>100</td>
</tr>
<tr>
<td>Self-employed and businessmen</td>
<td>59</td>
<td>30</td>
<td>11</td>
<td>100</td>
</tr>
</tbody>
</table>

My suspicion that in the present state of socioeconomic development in Spain a taxation scheme based on bookkeeping was bound to fail, is confirmed by a quick glance at the technical design of the sales-tax of June, 1964 (7). In this case the tax liability was to be apportioned by employing the same external features that had already been used for the profits tax; strange as it may seem, the actual turnover as it appears in the bookkeeps had to be passed by because a realistic assessment was impossible.

The result of such strategy is of course multiple tax burden of a few bases and numerous distortions of otherwise economical business decisions. If, for instance, the number of persons employed serves as an indicator for simultaneously determining both the sales tax and profits tax, it is highly probable that human labor will be exploited to a great extent, either by introducing longer working hours or by increasing the amount of work per hour; on the other hand, such taxation must work as a barrier against any increase in the number of employees and, consequently against economic growth.

These consequences, however, may partly be compensated by the relatively low taxes levied upon the highly modernized, productive and well-paying companies. Since the basic tax liability is derived from some sort of fictitious "average company", taxation will endanger the capital substance of marginal firms only. On the other hand, it may measure out extra incentives and liquidity to establishments with high earning power enabling them to expand at a faster rate than would be attainable if a regular profit tax could be properly enforced.

This peculiar type of tax assessment according to external signs of size and success contains a number of aspects, which just do not tally with the general aim of social welfare policy. If, however, this procedure is restricted to the group of independent businessmen exclusively, the mere welfare argument does not weigh as heavily. As far as taxing the em-

(7) "Impuesto sobre el tráfico de las empresas."
employees is concerned, the Spanish habit of levying income tax at the source takes to a certain extent into account the personal ability to pay as well as individual tax exemption. But we should realize that this considerable difference existing between the taxation of the self-employed and corporations on the one hand and of dependent labour on the other hand does not lack a specific, hidden logic when it comes to the alternative of income redistribution versus economic growth: The employed, being the primary object of social welfare in industrialized countries, are being taxed according to their individual ability to pay, whereas the group of the independents, viz.: the most important actors in economic decision-making, are subject only to a tax of «cost» character with specific effects on the improvement of the overall economic structure. Entrepreneurs with above-average earnings receive reward, incentives, and help for expanding their business activities by being able to fall back on their «tax savings». Considering that this tends to force the weaker firms out of the market, we may conclude that social welfare aspect must give way when it comes to taxing the independents leaving to them plenty of leeway to determine their productive contribution to the economy. In contrast, the employed workers being tied to fixed working hours and a certain age of retirement, can be reached more comprehensively by a redistributive type of taxation without impairing the goal of a growth-oriented fiscal policy.

III. The enforceability of an individually tailored income tax, therefore, seems to depend on certain historic conditions, including a specific «tax mentality» as on a number of very specific socioeconomic conditions of the countries concerned as well. After thus outlining the boundary conditions within which any effective tax policy will have to operate, we now turn to a more detailed discussion of its scope and potential for influencing structural chances leading to economic development.

Obligation to pay taxes is almost as universal as compulsory school education and conscription. Practically everybody can be made liable to taxation, and therefore amenable to a certain economic pressure by the government. In contrast to transfer payment to private enterprises which generally are incompatible with the basic rules of free economies, the manipulation of the existing financial relation between government and citizens called «taxation» is generally accepted. However, taxes and transfer payment have one thing in common: both can be described as a similar method of influencing economic behaviour indirectly, namely through a variation of the data relevant for decision making even if both refrain from any direct control of these decisions.

As far as incentive taxation is concerned, this guiding influence can operate through two different mechanisms:

(i) The income effects; taxation is in a position to indirectly channel disposable capital away from growth- lagging to growth-intensive sectors by granting selective exemptions.

(ii) The announcement effects; a growth-generating behaviour can be revoked by the desire to escape taxation, i.e. to avoid the taxable fact altogether. Many writers confuse the objective of a growth-oriented tax policy to stimulation of saving out of the current income (9). Since the lower income groups are presumed to have a higher marginal rate of consumption than the upper, tax policy — according to this approach — can be content with trying to reduce highly consumptive incomes; furthermore, as the impact of taxation on work is far from being conclusive (10) the only sure path is for taxation to cut down consumption as much and saving as little as possible.

In contrast to this macro-economic approach, behavioral analysis of incentive taxation attempt to separate the quantities «total consumption» and «total savings», at the same time to ask for the growth-generating productive behaviour of tax payers or beneficiaries of tax exemptions respectively. Sectoral tax exemptions meet their growth objective only under the conditions, that there is sufficient motivation to spend the additionally disposable amount for productive investment, and that the desired investment would not otherwise take place regardless of the additional incentive from taxation.

An example of an indiscriminate application of a policy based solely on income effects is to be found in the Philippines, where a very wide range of enterprises have been classified as «new and essential» and accorded tax exemption, with no clear stimulus to private net investment (11).

A growth-oriented tax policy relying more on the announcement-effects follows a different path: on the extreme end of their scale we find taxes which are imposed not with the purpose of collecting them but to persuade people to behave in a certain way to avoid them. Less extreme are taxes which are fiscally quite lucrative but contain certain exemptions granted under the condition that a certain action is taken, as for instance the income taxes of most modern states. If such tax-freeing behaviour is not originally intended by the legislator, these provisions can be considered «loopholes»; otherwise, they reflect the


pragmatic, if not openly admitted, decision between the alternatives «equity versus efficiency».

IV. To look for the most promising strategic points of intervention into the economic structure for tax policy we have to analyse the process of economic growth, i.e. to separate its different components. It may prove useful to distinguish between two sectors of economic behaviour: the enterprise-sector and the household-sector. Entrepreneurial decisions relevant for economic development are, above all dispositions about production and investment (including research and product development); whereas the most important growth-relevant decisions of the private household is its *occupational choice* (including the decisions with regard to education) and local mobility (12).

Obviously no growth-oriented tax policy can dispense of a further classification of both the enterprise and the household sectors. The entrepreneurial sector is composed of several subsectors among whom Rostow (15) distinguishes

«(i) Primary growth sectors, where possibilities for innovation or for the exploitation of newly profitable or hitherto unexplored resources yield a high growth-rate and set in motion expansionary forces elsewhere in the economy.

(ii) Supplementary growth sectors, where rapid advance occurs in direct response to — or as a requirement of — advance in the primary growth sectors; for example coal, iron and engineering in relation to the railroads. These sectors may be traced many stages back into the economy.

(iii) Derived growth sectors, where advance occurs in some fairly steady relation to the growth of total real income, population, industrial production or some other overall, modestly increasing variable. Food output in relation to population and housing in relation to family formation are classic derived relations of this order.»

The sectoral «point of gravity» of economic development, i.e. the «key-industries» whose entrepreneurs are most crucial for the rate of economic growth of the subsequent years, change frequently. During the rise of today’s industrialized countries this key-role was at first taken over by the cotton-textile industry together with food processing industry, later on by railway construction, and coal and steel industry, finally — in the mature economies — by the automobile industry (14).

Before we discuss more specifically the possible effect of tax policy on the economy during various stages of its development, some impulses emanating from the «leading» sectors have to be described more clearly. Hirschman distinguishes mainly two kinds of intersectoral influences on the economic structure: «Backward-effects» and «Forward-effects» (15). The so-called backward-effects are the adaptive reactions caused by the additional demand for materials, machinery, services etc.; even demand-induced changes on the labour-market, i.e. the increase in the quality of the labour force as the consequence of industrial employment fall into this category.

The «forward-effects» consist in the quantitative and qualitative increases of output in a particular sector, i.e. the additional linkages resulting for the economy from efficiency gains in one sector. The enormous stimulus resulting from the construction of transatlantic railroad initially quite unprofitable in the United States for the economic development of the western states may serve as an example.

The «key-sector», even if it can reliably be identified, may not in all cases serve as the main target of growth-oriented incentive taxation; tax preferences may not always have the desired effects on investment. Particularly in developing countries even very profitable activities remain frequently unutilized or underutilized; economic growth does not only depend on the potential economic linkage of the target sector with suppliers and customers but also on the degree of adaptability with which the newly created market and profit chances are utilized by the private decision-makers. On the other hand — this being another boundary condition — it is very well possible that the rate of expansion and the efficiency of the key-sector are already sufficient without fiscal intervention to cause the desired chain reaction in other sectors. In other words, the impact of tax interventions on the highly important sector may sometimes be smaller than the impact on another, strategically less important sector which would not develop without public assistance. Thus American railroad construction in the last decades of the 19th Century would not have been, in spite of its decisive importance for economic development, a suitable target of a growth-oriented tax policy: private initiative thoroughly seized upon this sector and guaranteed intensive growth. During this period massive promotion e.g. of the chemical industry whose development lagged behind Europe, would have been more appropiate.

This argument touches upon the goals of any growth-oriented tax policy. If a sector’s importance for the development process yields only a first approximation for the determination of the benefits of tax exemptions, i.e. if the expected effect of the measure is only one criterion for the choice of the target sector, many priorities of taxation in the process of economic development have to change as soon as the intended alternations in the behavioural patterns of the decision-makers are effected. Thus, a successful development policy plays only the role of a pace-setter;
once certain new enterprises are established and investment and production decisions necessary for their existence and expansion have become daily routine, public promotion and financial protection can be dispensed with. The same applies if there are sufficiently many imitators grasping the newly demonstrated opportunities (10). As a general rule, a further influx of entrepreneurs will result automatically once a small number of enterprises makes good profits. The promotion of a sector once it has been integrated into the economic structure can be discontinued, the more as particularly young branches of production use to grow very fast in the first years and decades of their existence until a certain degree of saturation of the market is reached (17). Needless to emphasize that the withdrawal of temporary tax advantages does not necessarily lead to the shrinking of the respective sectors, as we can learn from the theory of educational tariff protection (18).

V. Some concluding remarks may show, on the basis of empirical data, the sensitive to tax stimuli of a group of German smaller entrepreneurs and professionals. In summer 1983, the Cologne Center for Research in Empirical Economies under the direction of the author analyzed a group of some thousand German self-employed by modern methods of survey research. A whole battery of questions aimed at ascertaining the degree of utilization, on the part of the self-employed, of tax privileges explicitly offered to them by the tax law. Interestingly enough, more than half of them (54%) were either unable or unwilling to name any such privileges, quite a few answers reflecting emotional issues (like 'compared to 'Big Business' we have absolutely no possibilities to alleviate our tax burden'). A minority (14%) of respondents enumerating concrete examples mentioned the possibility of saving taxes by fixing working expenses at their highest, supporting the hypothesis, that reducing the liability may become a goal of its own, in the pursuit of which the economic principles of profitability and liquidity may be overruled by what might be called «conspicuous consumption camouflaged by business expenditures». Due to a rather low capital input yielding only a small basis for tax reducing arrangements within their professional sphere, professional people preferred tax privileged private savings (life insurance, savings through building and loan associations or under the Federal Government's bonus scheme) to «manipulating» working expenses.

On the whole, professional people appeared to be better informed about and to take more systematically advantage of tax privileges and loopholes than businessmen, especially than small traders and craftsmen. Although part of the differences may be due to the better general education and training of professional people facilitating better understanding of the complicated tax laws, the main factor seemed to be their generally higher incomes. A higher income demands better protection from taxation, thus stimulating its recipient to overcome the complexity and difficulties involved either in his own looking in the tax laws for possible loopholes, or in consulting a tax expert, whose advice yields better profits with rising incomes.

This result of our empirical study emphasizes anew the doubtfulness of an economic policy operating with global tax privileges which are not only used more systematically by the upper income brackets but largely fail even to fulfill their original purpose, namely to provoke the most productive economic decision. This example demonstrates that the problem of enforceability is not confined to tax compliance; even non-fiscal goals of taxation, insofar they are pursued by tax privileges, can be jeopardized if tax privileges do not reach their intended recipients because they presuppose a too high degree of economic rationality and abstract thinking.

Turning finally to economic decision of the private household, the problem of occupational choice and local mobility has to be mentioned as a particular target of any effective development policy. If economic growth asks for a certain preparedness of a population to give up its present way of living and working in favour of different, more profitable conditions (19), a growth-oriented tax policy would have to try to influence these forms of mobility. In contrast to the many writers in the field of taxation who elaborately discuss the effect of taxation on the work-effort on the basis of assumptions about «rational» behaviour, the above noted empirical data collected in four countries (20) suggest that there is hardly any indication of considerable incentive or disincentive effects of progressive income taxation; as George F. Break paraphrased Mark Twain, disincentives seem to be «like the weather», they «are much talked about, but few people do anything about them».

Conclusion.

An economic policy aiming at influencing economic decision-making (21), has to be defined in a threefold way: in respect of the targets of such policy—entrepreneurs on the one hand, the households on the other hand, both groups to be divided in subgroups —, in respect of the desired behavioural effects, and finally in respect of the measures to be taken. Whatever policy is chosen, the final criterion of every measure are the induced changes of actual behaviour.

(19) G. SCHMÜCKL, Der Beitrag der Verhaltensforschung zur Theorie der wirtschaftlichen Entwicklung, op. cit.
(20) See footnote (10).
Global aggregates like «total saving» and «total consumption» have not been discussed in the preceding chapters because their real role in concrete situations of economic development is by no means clearly established (22).

In contrast, the application of a development typology based on historic experience of successfully developed countries permits the discovery of «strategic variables» or bottleneck-sectors which, in a concrete situation, limit economic development; in other words, a tax-wise induced change here may have a more stimulating effect for economic growth than any variation of global aggregates. This approach consciously leaves behind the «capital-pool» concept which explains economic stagnation by the scarcity of a capital and other resources (23). Rather, a growth-oriented tax policy as advocated in this paper starts out from the behavioural theory of economic development: development is the task to combine existing but misdirected resources and to induce people to achieve this combination. The implications of this approach are obvious: the belief that successful development policy can mainly be based on the husbanding of scarce resources such as capital and entrepreneurship is abandoned, while the route becomes clear for the concentration on behaviourally relevant «inducement-mechanisms» and «pressures» (Hirschman). A whole field of research lies before us in the task to define the role of incentive taxation in this process (24).

The Breakdown of Added Value in Manufacturing Industry

<table>
<thead>
<tr>
<th>Medium and small enterprises</th>
<th>Major enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Added value (%)</td>
<td>100</td>
</tr>
<tr>
<td>Net earnings</td>
<td>30.3</td>
</tr>
<tr>
<td>Personnel expenses</td>
<td>54.6</td>
</tr>
<tr>
<td>Cost of financing</td>
<td>11.2</td>
</tr>
<tr>
<td>Rent, taxes and imports</td>
<td>5.6</td>
</tr>
<tr>
<td>Depreciation</td>
<td>5.3</td>
</tr>
</tbody>
</table>

As shown by an analysis in the Economic White Paper for 1964, the increase of the added value was largely due to contributions from capital. As result of investment into plants and facilities sparked by technological innovations, the productivity of labor showed a sharp increase. (See the following table).

<table>
<thead>
<tr>
<th>Year</th>
<th>Growth rate of gross added value</th>
<th>Due to Capital Accumulation</th>
<th>Due to Increase in labor</th>
<th>Due to technological Progress</th>
<th>Due to Interactions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964-65</td>
<td>16.9</td>
<td>9.0</td>
<td>3.1</td>
<td>1.0</td>
<td>3.8</td>
</tr>
<tr>
<td>1965-66</td>
<td>22.1</td>
<td>11.1</td>
<td>3.9</td>
<td>2.9</td>
<td>4.2</td>
</tr>
</tbody>
</table>

Remarks: By using the cross-section data for every year, we measured the Dougall function, and calculated those figures on the basis of the results of the measurements.

Günter SchmölDErS

Köln Universität.

Riassunto — Un certo grado di sviluppo socio-economico è una condizione necessaria, se non sufficiente per l'applicazione di qualsiasi tassa generale sul reddito.

In molti paesi sovietizzati tale condizione è fondata dall'essere garantita, a i contribuenti, per esempio in un paese parzialmente industrializzato come la Spagna, non risentono, nel loro carico fiscale, cambianti corrispondenti a quelli che si verificano nel loro reddito personale, in considerazione della tassa sul reddito ovviamente ha cessato di essere tale per divenire soltanto una imposizione grossolana basata su indizi apparenti di ricchezza, quando addirittura non riflette le relazioni personali del contribuente con il funzionario delle tasse o l'abilità del contribuente nell'elaborazione fiscale. Per quel che riguarda la tassazione a titolo di incentivo, fattori quali l'attuazione del contribuente verso le tasse (neutralità fiscale) e la "cultura politica" hanno un ruolo decisivo. Vi sono due meccanismi per attuare una tassazione avvente scopo di incentivo: 1) lo spostamento di capitali disponibili da settori di lento sviluppo a settori di sviluppo intensivo.

Nel caso in cui la mancanza di informazioni renda impossibile la valutazione dei redditi della tassa, si può: 2) cercare di influire sul comportamento dei lavoratori, di coloro che investono, dei ristabilirchi, squeryandò degli effetti determinati dall'annullamento della tassa, per es. per provocare cambia- menti stimolando lo sviluppo di certi settori di strumenti con drastici eccessi senza riguardo alla loro incidenza e nello stesso tempo ostacolando investimenti meno utili mediante l'applicazione di tasse proibitive. Un cambio discriminato da una tassa in es. possibili strategici che limitano lo sviluppo economico generale può avere un effetto più stimolante di ogni variazione di aggregati globali qual è il «riversamento totale» o il «crescita totale» provveduto da tassazione la cui incidenza rimane sconosciuta.

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II.

OLIGOPOLY IN A FREE SOCIETY
OLIGOPOLY AND THE FREE SOCIETY

by Fritz Machlup (*)

The theme of this article calls for a combination of economic theory, economic policy, and political theory, and, alas, of highly controversial chapters of each of these areas. I am conscious of the difficulty of the task and of the risk that I shall displease many by both my conclusions and my ways of reaching them.

Conjectures on Conjunctions and Sequences.

I shall resist my propensity to define the words featured in the title and denoting the main concepts of my essay. I can safely omit definitions, assuming that my readers know what is meant by oligopoly and what by a free society. But it is appropriate to spell out why the two are joint subjects of inquiry. Obviously, the choice of this topic implies a curiosity about certain hypotheses according to which oligopoly and free society stand in some sort of relationship.

These relationships cannot be direct, cannot be perceived with visual observation, cannot be demonstrated by logical proof, and cannot be verified by experimental or statistical methods. This means that the hypotheses linking market positions of enterprises and the scope, degree, and durability of various kinds of freedom in society are very general, speculative statements of probable conjunctions and sequences. To say this is not to downgrade the significance of such hypotheses. Indeed, practically all statements about economic and political interrelationships are of this nature — and some of them are of paramount importance to the quality of our lives.


Before I can start formulating any of these hypotheses, I must make a few distinctions. For there are several kinds of oligopoly and several kinds of freedom, and what may hold for some need not hold for all. For example, there are small-business oligopolies and big-business oligopolies; and there are uncoordinated, coordinated, and organized oligopolies. I doubt that there are many relations between uncoordinated small-business oligopoly and any kind of freedom in society. Such relations can arise only where the existence of oligopoly makes itself felt and becomes sufficiently manifest to elicit political reactions. This is unlikely to occur except in instances in which decisions by a few can effect the welfare of many; and this may happen

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in case of «big business» and in cases of combinations among small business. We conclude that in hypotheses concerning freedoms in society oligopoly can figure only insofar as it occurs through organized (or at least coordinated) group of small and medium-sized business firms or in the form of very large enterprises.

The freedoms that may be affected are mainly economic freedoms. These are freedoms that consist in the absence of restrictions on, and interference with, certain kinds of action regarding prices, outputs, sales, wages, employment, capitalization, investment, merger, reorganization, relation, and other business affairs. There exists, however, a distinct association between economic and political freedoms: reductions in political freedoms, and sometimes, even in intellectual freedoms. The nature of the associations among different kinds of freedom has been shown by others and need not be elaborated upon here.

Five Propositions.

We are now ready to formulate a few propositions relating oligopoly and the free society.

1. Oligopoly positions may lead to prices that deviate substantially from the competitive norm and are insufficiently responsive to changes in conditions regarding cost and demand; they are apt to induce an inefficient allocation of productive resources and an unsatisfactory performance of the market economy; this, in turn, may lead to widespread disaffection with the free-enterprise system and the free society.

2. Oligopoly positions may give some private individuals or groups more power of influence than is consistent with the high degree of economic freedom regarded as essential in a free society.

3. Oligopoly positions, by affording (or appearing to afford) power or large influence to private individuals or groups, may destroy the image and credibility of the free-enterprise system, weaken popular loyalty to it, and increase the appeal of ideologies hostile to the maintenance of a free society.

4. Oligopoly positions, having created apprehensions, anxieties, jealousies, and antagonisms of various sorts, induce governments to adopt regulations of business that are not only inefficient (both in their operation and in their effects upon business conduct) but also inconsistent with some economic freedoms.

5. The same apprehensions, anxieties, jealousies, or antagonisms may induce governments to adopt measures attempting to prevent the emergence or strengthening of oligopoly positions or to dissolve those that have grown up; some of these measures may be inconsistent with some economic freedoms.

A Variety of Views.

It is worth noting that only the first of these five propositions states the possibility of economic effects of the exercise of «oligopoly power»...
viation of the price from that which would prevail under pure competition was an inverse function of the number of firms in the market. Unfortunately, the simplicity of the theory was obtained by excessively simplified assumptions: that all suppliers were equally large, offered a perfectly homogeneous product, had identical cost conditions and practically unlimited capacity to produce, held rather naive ideas about the conduct of their competitors and continued to hold these ideas after being shown that they were wrong.

Even if this theory was not directly applicable to any concrete situations, it had heuristic, and, especially, pedagogic value. Critics have often complained that this theory misled us into believing that selling prices would always be higher if the number of sellers declined, and lower if the number of sellers increased. Well, if all other relevant conditions remained unchanged, this conclusion would probably hold in spite of all the counterfactual assumptions of the theory. The point is that other things are likely to change too when the number of sellers in the market increases or decreases, and that the concomitant changes may counteract the effects of the change in numbers.

One of the simplifying assumptions, that all firms in the industry were of equal size, was then dropped in favor of special assumptions concerning the «structure» of the industry. Crude indices of concentration were devised to express some features of the size distribution of firms. These were primitive figures giving the percentage of the total output or capacity of the industry that was controlled by the largest three, four, or five firms. The underlying theory was that the prices of the product would be higher the greater the share of the total market that was controlled by three, four, or five largest firms. The number of firms supplying the rest of the total output was disregarded, and so were the relative sizes of the largest firms (1). Refined «summary indices of concentration», taking account of these important factors, have been proposed only in the last few years.

A Digression on Indices of Concentration.

In order to show how deceptive the crude «indices of concentration» can be, we may compare several alternative size distributions of an industry and the relative shares the three and four largest firms have of the total productive capacity. Let us assume that these different structures are actually alternatives attainable through mergers and dissolutions:

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. 1</td>
<td>30%</td>
<td>40%</td>
<td>50%</td>
<td>60%</td>
</tr>
<tr>
<td>No. 2</td>
<td>20%</td>
<td>30%</td>
<td>40%</td>
<td>50%</td>
</tr>
<tr>
<td>No. 3</td>
<td>15%</td>
<td>20%</td>
<td>25%</td>
<td>30%</td>
</tr>
<tr>
<td>No. 4</td>
<td>10%</td>
<td>15%</td>
<td>20%</td>
<td>25%</td>
</tr>
<tr>
<td>No. 5</td>
<td>5%</td>
<td>10%</td>
<td>15%</td>
<td>20%</td>
</tr>
<tr>
<td>No. 6</td>
<td>2.5%</td>
<td>5%</td>
<td>7.5%</td>
<td>10%</td>
</tr>
<tr>
<td>No. 7</td>
<td>1.25%</td>
<td>5.6%</td>
<td>8.75%</td>
<td>12.5%</td>
</tr>
<tr>
<td>No. 8</td>
<td>—</td>
<td>2.5%</td>
<td>5%</td>
<td>7.5%</td>
</tr>
</tbody>
</table>

100 % 100% 100% 100% 100% 100%

The concentration index for the three largest firms is the same — 75 per cent — for four constellations, A, B, C and D, which are different in several other respects. The concentration index for the four largest firms is higher in constellations A and E — 90 per cent — than in the cases B, C, or D, where it is 89 per cent. Does this indicate that there will be less competition in constellations A and E than in B, C, and D? Perhaps so. But it is worth noting that, by the three-firm index, A, B, C, and D are «alike» and, by the four-firm index, A ranks with E, while B, C, and D look alike.

Other analysts would give more weight to the relative positions among the largest firms. They might say that A affords more competition than E, because the three largest suppliers are more, nearly equal in market influence, and both A and B are more competitive than C and D, where the biggest firm has no real match.

Some of these theories were invented by lawyers and judges engaged in antitrust litigations. There is a strong conviction among certain «antitrust experts» that mergers among smaller firms, by creating larger enterprises more nearly equal to the leading ones, would increase competition in the industry even though the number of independent competitors were reduced (2). The idea, presumably, is that the largest firms take the separate supplies of several small independent firms less seriously than the combined supply of a combined firm.

There is, in my opinion, not a shred of evidence, empirical or theoretical, in support of this notion. I do see some theoretical evidence supporting the contrary. For what matters in this business of «industry structure» is the ease of arranging for concerted action of cooperation among individual suppliers. The leading firm or firms can more easily generate a spirit of cooperation among a few firms of respectable size than with a whole school of small fry. Even in the absence of any agreements or understandings, the demand facing a large firm will seem less elastic if the competitors share not only the market but also the attitude of oligopoly with its inherent restraints and inhibitions. The demand facing a partial monopolist is what remains of the total demand after all the small producers have disposed of their supply; the rest demand for the production of the big is, therefore, more elastic.

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(1) Other factors neglected were competition from abroad and from other industries supplied substitutes. The neglect of these important factors would vitiate any comparisons among different industries. But, if nothing else is intended than an evaluation of the effects of potential changes in the structure of a given industry, the factors that remain unchanged can sometimes legitimately be disregarded.

(2) In a decision about a merger between two banks in New York, the court found that the merger narrowed the gap between the second and third largest banks and thereby improved the competitive structure and intensified competition for the three leaders. United States v. Manufacturers Hanover Trust Company, 240 F. Supp. 997 (S.D.N.Y., 1965).
than it would be if some of the small were combined into an oligopolistically competing firm. Price will be lower if the estimated elasticity of demand is greater. (This argument presupposes however, that there are no differences in the quality or marketability of the product associated with the size of the enterprises. It also presupposes that there are no serious economies or diseconomies of size. If qualities or costs are different, there is little that can be said a priori.)

Some recently proposed refined indices of concentration, which reflect the relative positions of the largest firms (thus making the situation in F, C, and D in our example look different from one another) and also the existence of many small competitors in the industry, still do not yield results fully indicative of the degree of competition that is afforded by high elasticities of the demand for the outputs of the "dominant" firms. The *Herfindahl Summary Index*, developed by Orris C. Herfindahl in an unpublished doctoral dissertation, is the sum of the squares of the relative sizes (or market shares) of all the firms in an industry. (3) This index is supposed to repair the shortcomings of the crude indices of concentration, but it exaggerates, in my opinion, the market power of the largest firms in that it gives too little weight to the "atomic" competition of very small competitors (4).

It ought to be possible to design indices of concentration that correspond more closely to the implications which market structures may have upon the degree of competition within the industry. Of course, no index constructed from nothing but relative sizes or market shares can tell the whole story, which really involves a great many factors of a qualitative nature.

**Prices Reflecting Added Costs and Risks.**

If prices under oligopoly are in general higher than prices where sellers are too numerous and too small to have any separate influence on the market, they are still, like most theories of oligopoly, lower than prices set by a monopolist. Only in rare instances could competing oligopolists manage to maximize their "joint profits" by charging the full "monopoly price".

However, this theory holds only under the assumption that costs and risks are equal in both situations, that is, whether several firms share the market or whether a single firm has the whole market to itself. This assumption may not be fulfilled. There may be instances in which the risks of "rocking the boat" are so high that oligopolists keep their prices above the price that would maximize their joint profits. And there may be instances in which the arrangements for the enforcement of peace among the competitors or arrangements for maintenance of "orderly marketing" (that is, limited competition) are so expensive that price cannot be below the potential monopoly price. One of the most common achievements of competing oligopolists is to find other ways of competing than through price concessions. Competition in some of these forms may be quite harsh, but it will not always provide benefits to the buyers. It may result in higher costs of transportation, packaging, advertising, selling, and other things that do not confer equivalent benefits on the customer. From the point of view of competing sellers, there are many substitutes for price competition. From the point of view of economic welfare in a market economy, there is none: only through price competition do the buyers gain all that sellers give up.

**Price Inflexibility.**

The theory that oligopoly prices are less responsive than polyopoly prices to changes in cost and demand has been advanced in several formulations and supported by various arguments. Some of the arguments have been rather weak, others valid only in certain circumstances and not in others; but, by and large, the theory has withstood most critical attacks. Statistical tests have probably been the poorest support for the theory. This is not surprising, since the testees had to resort to many poor proxies for the strategic variables. They took indices of concentration as measures of oligopoly power; they took actual price movements for price flexibility (regardless of the strength of the causes for the movements); they took price movements over time in lieu of potential price differences at the same time; they took different industries in lieu of the same industry in different circumstances; and they used defective data (for example, list prices, in lieu of prices actually paid) and manipulated them in unappropirate ways. With all these faults, there still remained an impression that "there may be something to it"; but this impression may be the result of some more convincing, theoretical arguments.

One of these is "the case of the kinked demand curve", which has been incorporated into most textbooks of economics. It rests on the assumption that an oligopolist expects his competitors to follow suit whenever he reduces his price, but not to match his price increases. The resulting high elasticity of demand (large losses of sales) at higher prices and low elasticity of demand (small gains of sales) at prices lower than the prevailing one can explain why the oligopolist would not want to change his price even if his costs went up or down. The
case is plausibl e, but rather special and therefore not acceptable as paradigmatic of all kinds and forms of oligopoly.

There is no need to fall back to a special case, for in practically all positions of oligopoly (other than the belligerent type, engaged in a price war) sellers have a strong incentive to leave prices unchanged. Whenever competitors' reactions have to be reckoned with—whether they have to be guessed at without any clues or can be anticipated with little uncertainty, whether they are in the form of retaliatory price changes or other disagreeable counteractions (perhaps only in the form of social disapproval)— an oligopolist will want to defer spontaneous price actions as long as possible. Only under the provocation of drastic changes in his costs or in his sales will he make such decisions.

The same results can be inferred both from models of static marginal analysis and from models of mathematical game theory. Marginalist and game theorists may be rather condescending regarding each other's techniques of reasoning, yet their findings are pretty much the same on this point. Game theory, too, suggests that each player will minimize his largest possible losses by abstaining from aggressive actions on prices.

Unresponsiveness of prices to changes in cost and demand makes for an inefficient allocation of productive resources and thus will downgrade the performance of a market economy. Several arguments, however, claim offsetting advantages of oligopolistic price maintenance. They have to be considered before a verdict is reached.

Stability, Innovation, and Growth

What most arguments against the charges of price inflexibility and allocative inefficiency have in common is that these charges are based on purely static analysis and are irrelevant in an economy subject to fluctuations, given to evolutionary change, and exhibiting secular growth.

Oligopoly and Stabilization.

Whether inflexibility of particular prices mitigates or aggravates cyclical instability of the economy has been a controversial question. One group of theorists contends that the resistance of some prices to react to increases and reductions of effective demand deflects the impact fluctuations and concentrates it on prices in more competitive sectors of the economy; in addition, it causes output and employment to fluctuate more than they would with greater flexibility of prices. The opposing group contends that the stabilization of certain strategic prices reduces the volatility of aggregate demand and thus the extent of cyclical expansions and contractions of economic activity.

Both these theories have survived because each is a logical conclusion from the underlying sets of assumptions, and both sets of assumptions are 'possible.' There is no easy way to ascertain which of

the assumptions are 'more probable' at particular times, places, and with particular institutions. If aggregate demand can be effectively controlled by monetary and fiscal policies, then oligopolistic price inflexibility will be chiefly a nuisance, shifting the incidence of sectoral changes onto other sectors. If aggregate demand is not controlled by the authorities, but largely influenced by events in particular sectors of the economy, the price maintenance for strategic products can make a contribution toward the stabilization of economic activity.

My own view of this matter is that society ought not to rely on selected private individuals, responsible to no one, to regulate or regularize aggregate demand. A free society ought not to confer on powerful business executives a role either as destabilizers or as stabilizers of its economy.

Oligopoly and Innovation.

The role of oligopoly in promoting innovation in products and techniques of production has been another bone of contention in economic literature. Strictly speaking, it is not oligopoly as such, but rather the large firm sheltered from unrestricted competition, which is given credit for its contributions to technological progress.

The argument is easy to comprehend. To invest in innovative activities takes money and ability to lose money. Small firms under the constant pressure of unremitting competition cannot afford to risk money in developing new products or new techniques. They cannot support research laboratories, pay development costs, establish pilot plants, engage in market explorations, enforce patent rights and licensing agreements, and all the rest. These things a large firm can do and is willing to do for it may anticipate that the profits from this investment in innovation will not be eaten away too soon by competitors who imitate the novel products and techniques and lower prices to the level of incremental costs.

The patent system is supposed to give innovators this sort of protection from competition. Under present conditions, however, only large firms already in positions not exposed to unrestrained competition can afford to undertake the innovative activities which eventually lead to patents affording additional security against price competition.

The question is not whether the argument is right or wrong, but whether it is correctly applied or greatly exaggerated. A good deal of exaggeration is no doubt involved if it is held that technological progress cannot be had except at the price of allowing strong oligopoly positions to be built up and to endure. In the first place, even a 'perfect' competition does not imply that imitators would appear in the market within a few weeks after each successful innovation; innovators have enough time to cash in on their less expensive ventures even if they cannot count on the inhibitions and self-restraint of 'rival oligopolists.' Secondly, there is plenty of scope for innovations of modest financial dimensions, and therefore within the means of smaller firms. Thirdly,
if it is true that very ambitious and risky projects cannot be undertaken except by large organizations protected from eager and unrestrained competitors, then there is still the possibility of having such innovative projects financed either cooperatively or governmentally. The thought of socialized research is no longer so horrifying after almost twenty years during which about two thirds of total expenditures for research and development in the United States have been financed by the government.

The main point, however, is a sense of proportion on this question. No one with sound judgment proposes any policies to transform all industries so radically that anything approaching perfect polyopoly replaces the present oligopolistic positions. All that the advocates of a competitive order propose is to replace strong by weaker market positions that is, by positions more effectively exposed to competitive inroads and less sure of cooperative restraints on price competition. This does not mean the end of industrial research and development induced by the profit incentive.

**Oligopoly and Growth.**

Innovation through technical progress is one of the contributors to economic growth, but there are, of course, others. While oligopoly cannot be credited with any contributions to the increase in the labor force thought it might be good if parenthood were oligopolistically restrained claims have been made to the effect that oligopoly facilitates capital investment.

These claims rest on the following arguments: (a) Oligopoly positions enable firms to maintain a higher rate of profit, which increases the aggregate ability to save. (b) Oligopoly positions raise the expected returns to investment, hence, the marginal efficiency of capital. (c) Oligopoly positions prevent large fluctuations in profits and thus reduce the uncertainty that attaches to the expected outcome of investment decisions. With more funds available and higher returns more likely, total investment will be greater and the rate of growth enhanced.

Plausible as all this sounds, it is beset with flaws. It is by no means certain that aggregate profits would be higher in an economy of universal monopolies and oligopolies than in an economy of universal polyopoly; still less, that aggregate profits would be higher in an economy in which some industries had much control over their output, others little, and some none, compared with an economy in which no industry had such control. If we mean by total profits the sum of the normal returns to capital, of all rents (of natural and artificial scarcity) as well as of profits in the narrower sense of the word (that is, the excess over all costs and rents), then it is rather difficult to figure out how this sum would be affected by some industries acquiring a greater measure of control over their output. Under certain assumptions, this total may be increased in the short run but reduced in the long run.

Under some assumptions the effect would be nil; this should be clear if one considers that an undetermined portion of the increased earnings of an oligopolistic industry is usually absorbed by increased wages.

The effect of oligopoly control upon the marginal efficiency of investment is also doubtful. While a given lump of productive capacity may earn more in the hands of firms capable of maintaining higher prices, their investment-expansion demand will be less elastic. For they will have a better estimate of the effects of overproduction and may be more astute in restraining total expansion. I said may, because certain forms of oligopoly induce the deliberate construction of excess capacity. This may mean more investment, but also more useless investment, and the effect on the rate of growth of the economy is questionable. (In an economy with chronic underemployment and demand deficiency due to oversaving, the effect may be positive; otherwise, it will surely be negative).

The third point, claiming a reduction of uncertainty in the profit expectations of strongly oligopolistic industries, raises questions of a different, perhaps more fundamental nature, questions which relate to the role of profits in a market economy. According to a liberal (libertarian) economic philosophy, profits are not seen primarily as sources of saving nor as accelerators of the economic growth of the national or regional community. Instead, profits are seen as indicators of demand for particular products insufficiently satisfied by the output produced. Profits, in the sign language of the market economy, say More of this product is wanted, and losses say There is abundant capacity for the production of this product. Private entrepreneurs are to understand these signals and to accomplish the corresponding transfer of productive resources. Any attempt to perpetuate profits, stabilize profits, and avert losses by means of control over the output of the entire industry, sabotages the free-market system.

**Oligopoly, Profits, and the Market Economy.**

The claim that oligopoly power secures maintenance of positive profits and averts losses in the industries in question is, in effect, equivalent to the claim that the leaders in these industries have embarked on the destruction of the free-market order. Where large firms have grown by good management and internal expansion and in the process have reached a size that is associated with a large measure of control over the total output of their industry, the exercise of this control is incidental to their growth; in this case it would be too harsh to charge the possessors of this power with an intent to destroy the competitive market economy. On the other hand, such a charge will have to be sustained where firms deliberately seek to increase their influence over the market by arranging the take-over of going concerns in the same industry, by organizing competing suppliers into cartels (or similar schemes of cooperation), or by persuading the government to compel suppliers to abide by rules which reduce competition.
This may be the place for me to comment on the concept of "excessive competition," which seems to have particularly wide currency in several countries. From the point of view of an individual firm, all competition is excessive, in that profits would be higher and the lives of the managers easier if competition were restrained. From the point of view of an advocate of a well-functioning free-enterprise, free-market economy, excessive competition does not exist. There will ordinarily exist some industries with excess capacity, built up when the demand for the product was actually larger or the increase in demand overestimated. These industries should now have negative economic profits, because the value of unused capacity is nil (apart from anticipations for future use), and the competitive price of the product cannot cover any part of the cost of excess capacity (5). If a price is maintained which still covers any portion of this cost, this price does not serve its function as part of the steering mechanism of the free-market economy. To maintain loss-averting and profit-securing prices in an industry where productive capacity is abundant, it is to vitiate the role of profits. Oligopolistic stabilization of profits, far from securing the stability of the system, promotes its degeneration and eventual destruction.

EXCESSIVE PERSONAL POWER

Several times in the course of this discussion, the words "power," "influence," or "control" have been used. The reference has always been to the productive capacity and the production volume of an industry and to the prices prevailing in its markets. In the following section the reference will be to people.

Market Power and Personal Power.

In the political philosophy of liberalism the market economy is regarded as a system steered by impersonal forces. The "dictates of the market" are not considered as dictates of any persons wielding power over others. This interpretation is possible as long as all economic power (influence, control) is so widely dispersed that one cannot attribute any drastic changes in prices, wage rates, employment, or supplies of goods and services to the actions of a few particular persons. Where no one person or small group of persons can be blamed for an unwise development concerning prices, incomes, jobs, or provisions, those favored by the development may accept it as a stroke of bad luck about which one may gripe but not feel mad at anybody.

Oligopoly positions, either big-business oligopoly or organized medium — and small — business oligopoly, give a few persons influence over supplies, prices, jobs, and incomes in entire industries. The decisions of a very few may affect very many, and these may feel aggrieved and resentful. They will no longer charge their disadvantage to "bad luck" but rather to the doings of "bad men" and to the "bad system" that allows these men to wield influence.

Personal Power and Economic Freedom.

That oligopoly power, where it involves personal power of a few over many, will invite mass antagonism against the system that permits or condones it, is perhaps clear. This antagonism is likely to lead to a gradual whittling away of some of the economic freedoms of the system, chiefly through the imposition of coercive controls by the government. It is worth noting, however, that apart from this threat of illiberal laws and policies adopted in response to public resentment of oligopoly power, the exercise of oligopoly power is per se an infringement of economic freedom.

Freedom is not, as some have said, the effective power or opportunity to do certain things, but the absence of any personal restraints and prohibitions against doing these things. Freedom of speech, for example, does not mean that I am capable of speaking but that no one will restrain me from speaking or punish me if I do. (I may be muted or hoarse, and therefore incapable of speaking, but still be free to speak). I am "free" to drink alcoholic beverages, even if I am too poor to buy them; on the other hand, I am not free to buy or consume these drinks under prohibition, even if I have enough money and enough thirst. Thus, freedom means that there is no one — policeman, sheriff, clamousman, gangster, or any one else having power or influence — who prevents me from doing what I, in the absence of his interference, would be able to do.

This digression on the meaning of freedom is relevant to our present issue: If I cannot buy a product because it is too expensive, I will still feel perfectly "free" to purchase it as long as I cannot blame a particular person or small group of persons for keeping me from doing so for example, by pricing the product out of my reach. If I can single out one or a few persons responsible for actions that keep me from buying what I would otherwise be able to buy, the loss of my ability to buy is converted into a loss of my freedom to buy.

This conception of lack of opportunity into lack of freedom becomes much clearer in the case of the action of trade-union executives. If these men decide on a strike, or agree with employers on a large rise in wage rates at which only fewer workers are demanded, I may become "unemployable". My inability to find a job would normally have no connotation of "lack of freedom"; however, if I can attribute my failure to be employed to the power of a small group of men, I shall regard this as a deprivation of my freedom to work.

The freedom to enter any industry by setting up a new enterprise is one of the basic conditions of free enterprise. If government establishes

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(5) Strictly speaking, the competitive price could not even cover the capital cost (amortization and interest) of the used part of the productive capacity except where consumer cost in the light of some future demand for increased output is positive. Otherwise every part of the specific fixed capital has a zero value and its opportunity cost is nil.
obstacles against a new entry, an essential economic freedom disappears. If a group of cartelized oligopolists creates obstacles to keep outsiders out and insiders prosperous, the same economic freedom is abolished.

Oligopolists who establish quotas, divide the market, control output, sales, or exports are infringing on the freedom of others to produce, sell, or export. All these restraints of trade, voluntary or imposed, are clear violations of economic freedom. In many instances these restraints are not formalized but nevertheless effective, merely because of the power of a few to impose their will upon others.

**Government Intervention**

From an evaluation of oligopoly and the effects of oligopolistic behavior we shall now turn to an evaluation of government intervention against oligopoly and oligopolistic behavior. The discussion will again have to take account of political as well as economic arguments.

**Types of Government Policy against Oligopoly.**

Four types of government intervention against oligopoly and oligopolistic behavior may be distinguished:

A. Against the exercise of market influence afforded by oligopoly positions.

1. prohibiting oligopolistic behavior having *actually* *bad* effects,
2. prohibiting oligopolistic behavior having *potentially* *bad* effects.

B. Against the creation or maintenance of oligopoly positions.

3. prohibiting actions which *actually* secure oligopoly positions,
4. prohibiting actions which *potentially* help secure oligopoly positions.

The first two policies may be called *repressive*, the other two, *preventive*. Perhaps we ought to add a third kind and a fifth type: C5. Compelling business firms in oligopoly positions to exercise their influence to achieve *good* effects. This could be called *directive policy*. Since I cannot judge *good* behavior or *desirable* uses of market influence, I shall not discuss this kind of policy, but confine myself to repressive and preventive policies.

The first two policies may be called *repressive*, the other two, *preventive*. In a way, only the first of the four policies attacks oligopolistic behavior that definitely offends against some accepted standards of social or economic performance. The other three are one or more steps removed from the Bad Thing itself, and may therefore be characterized as anticipatory interventions. These interventions forbid actions that have potentially bad effects (No. 2), or forbid actions that create conditions which might enable someone to do something that may have potentially bad effects (No. 3), or forbid actions that may potentially be helpful in creating conditions which might enable someone to do something that may have potentially bad effects (No. 4).

The resort to anticipatory interventions is partly a matter of greater caution — like prohibiting the use, possession, acquisition, or sale of deadly weapons instead of only prohibiting murder. But it is also a matter of effectiveness in the enforcement of a legal prohibition, for it is much easier to prove possible than actual effects. No one questions that a gun can kill a man; but that it actually was the use of a certain gun that caused the death of a man may be difficult to establish beyond reasonable doubt. It is easy to show that a merger may be the first of a series of consolidations eventually creating an industrial climate in which suppliers restrain themselves in using price competition to increase their shares in the market and that such restraint may lead to prices at which quantities produced and sold are smaller than would correspond to the best possible use of resources. It is very difficult to prove that particular prices set by a firm for some of its products are such that its output is *unduly* restricted.

This difficulty of proving that an oligopolistic position has actually been exercised in a socially harmful way has long been recognized by the courts in the United States. It has led, chiefly through the development of case law, to the formulation of *per se* illegality of certain business arrangements. It became unnecessary, for example, for the prosecution of antitrust violations to prove that particular selling prices agreed upon by two or more suppliers were *unduly* high; price agreements and concerted pricing, were made illegal *per se*, no matter whether the prices were reasonable or not.

The same argument applies to the preventive interventions. It is difficult to prove that particular actions, say, certain mergers of business firms, create oligopoly positions; it is much easier to prove that such actions may potentially be a factor in the creation of oligopoly positions. Assume that there are fifteen suppliers serving a given market; a merger between two of them would hardly change the competitive situation substantially, but three or four such mergers could; hence, to be on the safe side, one may prohibit even the first of the mergers that might be prevented. Since mergers among competing firms have been the most active force in the establishment of oligopoly positions, to make *potential* reduction in competition, the criterion of illegality seems much safer than to insist on a proof that competition is actually reduced by the fusion between firms.

The preventive type of anti-oligopoly legislation has not been serious enough. The danger is not so much against firms that grow in size and influence through internal expansion, that is, through construction of new productive capacity rather than through acquisition of existing capacity from other firms. There have been some proposals to limit the size of firms regardless of the methods by which it is achieved, but such policies have evidently been considered too costly in terms of economic freedom and in terms of economic efficiency. This suggests that we look into the costs, that is, the undesired effects of government intervention against oligopoly.
Preventive Interventions, Economic Freedom, and Efficiency

Let us first consider the undesired effects of preventive interventions. In the case of internal growth of firms the arguments against prohibition of expansion are overwhelming.

If a firm has succeeded in satisfying its customers so well that the demand for its products continuously increases, it would be difficult to justify a veto of the construction of capacity to produce enough to meet the demand. If a firm intends to add to its lines of products, convinced that it can produce and sell them more efficiently than other firms, a governmental veto of such expansion would seem rather unreasonable. If a firm develops a novel product and sets out to create both the productive capacity and the market for it, it would seem out of the question to keep the firm from doing so. Finally, if a firm finds the advantages of vertical integration so attractive that it undertakes to construct facilities to produce materials which it has hitherto purchased, or to fabricate or process some of its products which it has hitherto sold, it would be hard to defend a prohibition of these investments.

In all these cases the firm would grow in size: absolutely (measured by value of assets, number of employees, and volume of sales) and probably also relatively (measured by its share in particular markets). Presumably its influence in its markets would increase and its oligopolistic position be strengthened. None the less, there is little public support for a "limitist" approach that would try to keep firms from becoming more influential or powerful as long as their growth is the result of their creating new productive capacity.

The balance of the arguments seems to change for many whenever the growth of firms into large and influential businesses is due to acquisitions of already existing capacity. Several of the arguments, however, remain applicable to growth by merger, or external expansion, and the ultimate judgment depends on a delicate weighing of probabilities.

Assume a firm has been satisfying its customers and finds the demand for its output increasing while another firm in the same industry has been losing sales and losing money. If the productive capacity of the unsuccessful firm could be more efficiently used by the profitable concern, why should the take-over be prevented? Would it not benefit almost everybody concerned — stockholders, workers, management, and consumers — if a merger allowed the productive facilities of the losing firm to be operated by superior methods to produce a product preferred by the market? To be sure, competition would be reduced as the competing supplier disappears. The output from his plant, however, would not disappear but rather be produced at lower cost and of better quality. This should more than compensate for the decline in competition.

Assume a firm intends to add a new line of products and finds that it could do this best by taking over the business of an existing firm. Why should there be an objection to a merger? If the stock or the assets of the old firm seem to be worth more to the new owners than to the old, is this not an indication that the economy stands to benefit from the shift of resources to new management? Assume, finally, that a firm seeks vertical integration in order to rationalize its production program, and sets out to acquire existing plant for the production of materials needed in its production or for processing or fabricating some of its products. Why should this be vetoed in the name of preserving competition?

Some of these questions can be answered by submitting good reasons for vetoes. But the three types of merger just described may be judged rather differently. The second, or conglomerate, type of merger is often entirely exempted from the economists' criticism and the lawyers' attack, because the probability that it reduces competition is slight. The third, or vertical, type of merger is criticized and attacked chiefly when a rather special condition is found to be present, namely, when the acquisition may deprive some competitors of easy access to needed inputs or outlets. For, in this case, these competitors may become dependent on the facilities and cooperation of the integrated firm and this may compel them to refrain from uninhibited competition in the markets.

It is the first, or horizontal, type of merger where the suspicion of significant injury to competition is strongest. One need not deny that instances may exist in which the harmful effects of the reduction of competition are more than offset by the beneficial effects of the transfer of resources into more competent hands, with facilities being used more efficiently and consumers being served better. But one may question that these circumstances occur frequently enough to be taken as the rule rather than the exception.

Since the most likely net effects of merger depend so much on the circumstances of each case, it may seem reasonable to let each case be decided on its merits, and allow or disallow mergers according to the judgment of the net benefits or net injury to economic welfare. Yet, to leave such decisions to administrative or judicial discretion is the least desirable policy from the point of view of the rule of law and the scope of freedom. The effects which a change in the structure of an industry is likely to have on the degree of competition can neither be measured nor estimated with any good claim to reliability. Let me refer to my discussion in the section on "Oligopoly Pricing", where I showed how little is known about the implications which industrial structure may have for the pricing of the products. Ignorance is not a good basis from which to judge the merits of the case.

Alternatives to such arbitrary ad hoc decisions would be to forbid all mergers without exception, to abstain from all interventions against mergers, or to devise rules of thumb which can be applied with a minimum of discretion and a minimum of injury to economic efficiency. Prohibition of all mergers would be too costly in terms of efficiency. Complete freedom of merger would probably be less costly than outright prohibition, but economically more costly than reliance on "repressive policies" and politically more costly than a policy of complete laissez faire. As I said before, complete laissez faire in the establishment and exercise of oligopoly positions reduces the credibility of the free-enterprise, free-market economy and creates a hostility to the system likely to lead
to much more serious government interventions, if not to complete subversion.

These considerations favor the formulation of rules of thumb that would allow certain mergers and prohibit others. These rules should use objectively ascertainable criteria, which, as much as it is possible, divide situations of high and low probability of mergers leading to strong oligopoly positions. I must admit that I am not ready to propose such rules.

**Repressive Interventions, Economic Freedom, and Efficiency.**

If the policy of preventive interventions were 100 per cent successful, so as to exclude the formation and maintenance of strong oligopoly positions, there would, of course, be no need for repressive interventions. Interventions against the exercise of oligopolistic market influence are demanded only where preventive interventions do not exist or do not work well.

Prohibitions of oligopolistic behavior with actually injurious effects on the economy can be both oppressive and ineffective at the same time. They can be oppressive in the methods used for investigation and prosecution of allegedly unlawful behavior, and yet ineffective in proving that the effects are actually injurious, in enjoining firms from continuing or repealing the condemned activities, and in discouraging others from engaging in similar activities. It is difficult to say whether legal prohibitions of this kind are more distasteful because of their ineffectiveness, because of the randomness of prosecution and conviction, or because of the loss of freedom associated with the enforcement of laws that leave so much discretion to prosecutors and judges.

Prohibitions of potentially harmful behavior are not subject to this condemnation provided they are explicit about the kind of activities that are per se unlawful. Only such explicitness can exclude discretionary decisions about supposedly actual results of the offensive activities. The trouble is that the list of potentially harmful activities by business firms can never be executive. The possibilities for variations and combinations are so great that business practice can always be ahead of legislative amendment. Moreover, a fast rate of change in legal provisions is undesirable from several points of view, including some that are closely connected with economic and political freedom. If there is an escape from this dilemma, it can be only through a skillful formulation of the law, covering possible loopholes and circumventions of the prohibitions without leaving too much discretion to those who have to interpret the law.

A long and expansive list of per se unlawful behavior will be vulnerable to criticisms charging unreasonable limitations on business conduct. Any one of the many necessary prohibitions may forbid dozens of innocent and socially beneficial actions for one socially harmful action. Is this not an intolerable burden on business and an excessive cost in terms of restricted freedom of action and enforced inefficiency and waste? The cost may certainly be considerable; but it has to be compared with the cost of the alternative anti-oligopoly procedure, of prohibiting harmful actions, with all the uncertainties involved in the difficulty or impossibility of proving or disproving injury to the economy. I submit that the cost of forcing businesses to abstain from a large number of actions deemed potentially harmful and therefore per se unlawful is still much smaller, in terms of both freedom and efficiency, than the cost of legal prohibitions of injuries which can neither be proved nor assessed except by arguments leaving excessive scope to discretion.

**No Interventions: Laissez Faire.**

Once more let us ask whether we would not be best advised to avoid the cost of both preventive and repressive interventions in the form of per se or ad hoc prohibitions, and to take our chances with laissez faire. I raise the question again because I am seriously concerned about the fact that several of my friends have taken a position in favor of laissez faire and in opposition to the antitrust laws.

I agree with them in their belief that abolition of all trade restrictions and of many other government interventions restraining competition, domestic as well as foreign, would do much to prevent the establishment and maintenance of strong oligopoly positions. I go so far as to say that, with completely free trade and without any other governmental interferences with competition, I would propose that we take a chance and see how we can manage without any anti-oligopoly laws. I see some reasons why even then the government had better intervene to prevent lapses from competition, but there is no point arguing about such iffi speculations. The question is whether we should provide for government intervention against private restrictions on competition in the world in which we live, that is, in a world in which public restrictions on competition are serious and evidently irremovable. To this question my answer is affirmative.

This answer does not imply a belief that government intervention can abolish oligopoly. It can perhaps prevent some of the growth of oligopoly through merger and the more conspicuous forms of cartelization and business cooperation. With more moral fortitude than we can muster, intervention might also reduce oligopoly by dissolving giant corporations that control many establishments which could without serious loss of efficiency be controlled by separate firms. But this is generally regarded as too ambitious a program for the moment. So-called realists tell us that a policy of preventing cartels and similar arrangements which limit price competition, and a policy of preventing mergers which potentially reduce competition are all that we can reasonably insist upon at the present time.

My arguments in support of anti-oligopoly policies were presented in the earlier sections of this article. For political as well as economic reasons I consider that our society can remain freer by promoting avoidable forms and instances of oligopoly and oligopolistic business behavior than by leaving them free to restrain competition.

__FRITZ MACHLUP__
**Riassunto** — Il rapporto fra l'esistenza di forti posizioni di oligopolio in economia e la sussistenza di una società libera si basa su postulati sia politici sia economici. Le posizioni di oligopolio possono causare una distribuzione inefficiente delle risorse ed un comportamento insoddisfacente dell'economia di mercato; possono dare ad individui privati o a gruppi più potere o influenza di quanto sia tollerabile in una società libera; possono distruggere la «credibilità» del sistema della libera impresa; possono costringere i governi ad adottare regole d'affari inefficienti e dannose alla libertà; e possono far sì che i governi si imbarcano in politiche repressive e dirigiste che distruggono la libertà economica. L'ipotesi che le politiche di prezzo oligopolistiche contribuiscono alla stabilità regge solo a certe condizioni, mentre ad altre condizioni può essere vero il contrario. In ogni modo, la società non dovrebbe dare ai dirigenti degli affari il ruolo di stabilizzatori della economia. La controversia che le innovazioni e il progresso tecnologico dipendano da posizioni di oligopolio è un'inerogareazione assurda. Un indebolimento del potere di mercato oligopolistico non limiterebbe né ridurrebbe sostanzialmente la ricerca industriale e lo sviluppo. L'idea che l'oligopolio promuove lo sviluppo economico non è valida, dal momento che l'oligopolio può cambiare ai massimo le direzioni dello sviluppo.

In conclusione, il costo sociale della lotta contro il potere dell'oligopolio può essere notevole ma sempre inferiore a ciò che costerebbe il permettere la continuazione e lo sviluppo di tale potere.

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**THE CHANGING PROBLEM OF OLIGOPOLY**

*by George J. Stigler (*)*

Oligopoly is a fairly modern word — it began to be used generally by economists as late as the 1930's — but the form of organization to which it refers must be as old as civilization. An industry is oligopolistic if it contains only a few firms, — more than one (which would be a monopoly) but not the large number necessary to insure the existence of free competition. Thus defined, oligopoly is obviously a very common form of organization even in so vast an economy as the United States possesses; it ranges from A (aluminum) to Z (zipper).

I shall attempt to describe both the changes in the ruling attitude of economists toward oligopoly in the present century and the changes in public policy in the United States toward oligopoly. By selecting only the two topics, the economist's views and the course of public policy, I do not wish to imply that public policy towards oligopoly in the United States has been formed by economists. Certain economists have had a substantial influence upon public opinion and hence on public policy, but many other forces are at work in fashioning public policy in the United States.

Let us begin with the economists. Sixty years ago, and even forty years ago, most American economists would have accepted the following three elements of an economic philosophy of the organization of industry:

1. The society should rely upon competition to achieve its main economic goals (such as efficiency and progressiveness), with infrequent intervention by the state where special ends were desired. The intervention might be to ration goods in wartime, to give extra safety devices to industrial workers, etc.

2. The society should socialize or regulate the industries which, because of economies of scale, were unavoidably monopolistic in structure. These industries were the traditional public utilities: transport, communication, electricity, etc.

3. The society should strengthen competition in industries with a small number of firms by prohibiting collusion and at times by increasing the number of rivals. The number of rivals might be increased by trust-busting (dissolutions), or by techniques such as removal of tariff barriers.

This philosophy rested partly on technical economic theory. For example, economic theory demonstrated that monopoly led to an inefficient allocation of resources among industries, and this same theory

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suggested that a few rivals (oligopoly) are likely to take account of their joint influence upon markets and act in a more or less monopolistic manner. The philosophy rested partly also upon the widespread desire for a decentralized (and hence private) economic system with wide freedom and responsibility for the individual.

Today the majority of economists have lost much of their faith in each element of this philosophy.

The first element of the philosophy — the main reliance upon competition to produce an optimum allocation of resources — has been impaired by three kinds of developments.

(1) The standard of performance expected of the economy has risen greatly. For example, the competitive system was once judged efficient because it pushed resources out of declining industries by imposing losses on the owners of the resources: today the system is often criticized for achieving the new allocation of resources too slowly.

(2) The decisions of private firms are guided by their (private) costs and returns, and much (including numerous reputations) has been made of the possible differences between private and social costs and returns. As a familiar example, a company may dispose of waste materials by throwing them into a river, — ignoring the costs which the pollution puts on other parties. Immense resourcefulness has gone into inventing and detecting differences between private and social costs.

(3) The ability of individuals to act in their own interest is questioned over a widening range of expenditures. Drugs and charges for installment credit, issues of new securities, the safety of banks, and the probity of merchants are all deemed too complex for the typical person to judge.

Confidence in the working of competition is accordingly now at a low level.

The second element of the traditional economic philosophy — the social control over natural monopolies — never had theoretical or empirical underpinnings comparable to that of the policy of competition. But it was widely believed that the impartial expert public commission could avoid the worst abuses (discrimination in prices, exorbitant prices) of the natural monopolies.

Also time has dealt harshly with this hope. Economists have become more distrustful of the capacities of regulatory commissions that at any previous time in this century. The Interstate Commerce Commission is widely considered to be backward-looking, and to have contributed to the decline of railroading. A host of commissions (the Federal Power Commission, the Maritime Commission, and the Texas Railroad Commission are examples) are deemed to be captives of their industries, in the sense of identifying the public interests with those of the particular industry. Nor is the distrust limited to commissions: few economists would describe the American agricultural program or the oil import system or the sugar quota system as anything except the triumph of special political interests over general economic welfare.

And despite the alleged success of the Tennessee Valley Authority, no one wishes to see important industries socialized.

The third element of traditional economic philosophy — the encouragement of competition in oligopolistic industries — ought to have declined in favor out of simple inconsistency. If competition is losing favor, and regulation is dubious, why regulate to get competition? Oddly enough, antitrust policies (like free trade and motherhood) have remained above controversy, and in particular the opposition to cartels continues strong. Most economists have strong reservations on dissolution of large companies, but this has always been true. Perhaps the most precise way to describe the majority attitude of economists is to say that they continue to believe that antitrust policy is desirable but are much less confident that it is important.

Before we consider what philosophy economists have developed to replace the traditional reliance upon competition, let us turn to the actual course of public policy in the United States in dealing with oligopoly.

When the Sherman Act, our basic antitrust statute, was passed in 1890, most economists and most non-economists believed that an industry with a modest number of firms could be tolerably competitive. The dominant firm, the near-monopoly, posed the basic problem with which the Sherman Act sought to deal. Nevertheless the prohibition on contracts or conspiracies in restraint of trade was directed against joint action by a few oligopolists as well as against cartels of a substantial number of firms.

The courts proved willing, and even eager, to strike down explicit agreements to fix prices, divide markets, and boycott outsiders. Even parallel actions which fit a pattern of conspiracy have sometimes been sufficient to lead to conviction under the antitrust laws.

Unless the oligopolist has been a company with a dominant share of the industry, however, the Department of Justice has not requested the courts granted a remedy of literal trust-busting, that is, of dissolution of the oligopolist into two or more firms. Even in the case of a wholly dominant firm (such as United Shoe Machinery, International Business Machines, and Aluminum Corporation of America) the remedy of dissolution has not been granted, or even always requested. The antitrust laws have not been directed to the elimination of existing oligopolies.

With moderately diligent search it would be possible to collect 100 or 200 verdicts on the effects of the American antitrust policy, verdicts given by lawyers, economists, politicians and businessmen. I have made no such inventory of opinions but I suspect that the average opinion would be that the policy has slightly retarded collusion but has had no significant effect upon the degree of concentration in major industries.

I believe that this average opinion does not give full weight to the effects of our antitrusts policy. The subject is too complex to be discussed in passing, but on the basis of preliminary quantitative mea-
spectrum of the effects of the antitrust laws (which will appear in the Journal of Law and Economics), I believe that the Sherman Act substantially reduced the amount of effective collusion and had at least a modestly deterrent effect upon concentration.

One fairly new antitrust law, the Celler-Kefauver law of 1950, poses a paradox in the American policy. This law forbids mergers where the effect may be to lessen substantially the competition in any market. The same courts that refuse to dissolve existing monopolies have shown astonishing alacrity in enforcing this new law. The government has not been able to find a case so implausible that the courts would refuse to prevent a prospective merger or undo a recent merger. The most recent government victory was against two local grocery chains in Los Angeles (United States v. Voo's Grocery Company, 86 F. Ct. 1480 [1956]). The two chains had 7.5 percent of the Los Angeles area business, and overlapped somewhat in the neighborhoods in which they had stores. The Supreme Court was much impressed by the decline in the number of single-store enterprises from 3,505 in 1950 to 2,500 in 1963. On the record, no large company in America will be allowed to merge with another company in the same industry unless the latter company is failing.

The paradox of policy consists partly in the uneven treatment of old and new oligopolists. It consists even more in the fact that merger is only one route to oligopoly, and the other main route is completely ignored. Voo's Grocery Company was forbidden to get 3 percent of the Los Angeles grocery business by merging with Shopping Bag, but if Voo's grew to 20 percent of the market by opening new stores, no whisper of governmental disapproval would have been raised. And economic theory says that if large chains are more profitable than small, they will eventually dominate whether mergers take place or are forbidden.

Despite the great vigor with which the new anti-merger law is being enforced, antitrust policy is losing pride of place in the governmental relations with business. The federal government is moving in the direction of a sort of forcible partnership with the larger oligopolists (and monopolists). The public policy is becoming one of entanglement with business. We may document this trend first for a few prominent industries.

The steel industry is occasionally nationalized in Great Britain but I suspect that the American steel companies will soon be subject to more detailed regulation than those in Britain. In the last decade we have seen actions such as:

1. A lively, increasing concern with industry prices, and public efforts to influence these prices by exhortation, governmental procurement policies, etc.

2. An almost continuous public participation in wage negotiations between employers and union.

3. A drive of the industry for tariff protection, not yet successful but not yet concluded.

The automobile industry traditionally had few dealings with the federal government in peacetime. Now we may cite:

1. A law regulating the relations between automobile manufacturers and dealers.

2. The recent imposition of federal standards of safety in the product.

3. The recent, informal quota agreement with Canada by which it fulfills its protectionist goals without the use of high tariffs.

Other industries would be easy to add. The petroleum industry is at least as much public as private, what with state output quotas, national import quotas, regulation of shipments, special tax provisions, special contracts for drilling on offshore lands, etc. The non-ferrous metals (aluminum, copper, lead, zinc in particular) are an equally rich field for examples of the new partnership. I need not remind a Japanese audience that many products are protected by informal export systems obtained by threat of formal controls.

The «guidelines» for wages and prices which have been developed to combat inflation are a more general example of the growing entanglement. The government sets general rules for increases in prices and wages (or incomes) and—in the United States-seeks to enforce these rules on conspicuous industries. The rules are enforced by publicity, governmental procurement practices, antitrust prosecutions, subsidies, and any other instrument a resourceful politician can find. The two basic assumptions of this approach are: (1) large companies have the discretionary power to raise or lower prices, and (2) a selective, informal system of public intervention can bend this discretionary power to the vital public interests.

The policy of entanglement is not directed only to oligopolistic industries. For example, the savings and loan associations are not absolutely large enterprises (although they are few in number in most local markets), but they consider the federal government to be the source of their funds and the scourge of rival financial institutions. Nevertheless, the policy of entanglement is primarily one between government and the industries which are oligopolistic. Much of the legislative and administrative involvement of government is sought by business. Two types of business, however, are most successful in obtaining governmental aid. The one is a great industry with a good geographical concentration which yields representation in Congress: the farmers, the coal miners, the Texas and Oklahoma oilmen, once upon a time the silver miners. The other type has a few large firms which can support an extensive, high quality lobby. These latter industries are largely, in fact almost exclusively, oligopolistic in structure. The other side of the banknote is that it is easy and efficient for the government to extort, threaten, bribe, and regulate a few large firms. Many small firms can
be shepherded only by a large administrative staff, and then only with incessant trouble.

In some industries the displacement of the traditional policy of competition by that of entanglement has been completely open: thus the commercial banks are granted an exemption from the antitrust laws for the purpose of administering the « voluntary » program of restriction of foreign loans. As a rule, however, there is no open conflict between antitrust and other governmental policies: the antitrust policy is left to its shrinking relative role.

This is a wholly explicable development. Few believe in the ability of private enterprise, whether competitive or monopolistic, to provide the many special things a society wants. To hold prices constant at the psychological moment, to put a safety device on a car at the correct time, to test drugs fully for side effects, to settle a labor dispute promptly when there is considerable damage to the balance of payments—such things are not to be achieved by antitrust policy, certainly not this month. Because there is no reversal of this growing dissatisfaction with private enterprise, there will be no reversal of these formal and informal interventions in business. And because the government is now committed to helping all important parts of our society, every industry will go more often to Washington to get help or repel an attack by some other group.

The policy of entanglement of business and government is no policy at all: it has no principles or plan. The accidents, conveniences, and exigencies of the moment govern developments. Oil imports rise and Texans are aroused; a Canadian prime minister feels the need for more employment in automobile plants, or a young man catches the public ear with his charge that automobiles are unsafe.

The economists have joined in this movement towards entanglement of government and business, but have not provided any comprehensive new philosophy to replace the philosophy of competitive private enterprise. Indeed the economists presently lack the scientific knowledge necessary to appraise recent public policies. Let me give two examples of this ignorance.

1. It is widely believed that oligopolists raise prices in prosperous periods but refuse to reduce them when business conditions become worse. Yet no real factual basis exists for this belief: a wholly inadequate set of government price statistics are the sole support for the notion.

2. Influential economists in the Council of Economic Advisers believe that selective control of price movements in oligopolistic industries will allow the economy to operate at a lower level of unemployment while avoiding inflation. No satisfactory evidence or theory exists for this belief. I suspect that the official position which the economists have achieved in the national administration has weakened our status: the Council of Economic Advisers must say responsible things, and it is more responsible to the President than to the profession.

Nothing we have learned of either oligopoly behavior or of the capacities of public regulation has shaken my faith in the traditional philosophy of reliance upon competition,—even when the competition is attenuated because the number of rivals is small. The exactions of monopolists will in general be of a much smaller order of magnitude than the wastes which accompany political intervention in the production process. The performance of our essentially unregulated telephone industry bears favorable comparison to either the federal petroleum policies or the New York City subway policies. The performance of our colluding electrical equipment manufacturers—and I wholly approve of their conviction under the Sherman Act—was not so costly to the nation as our Merchant Marine or our television channel assignment policies. There is no other method of regulating business which has been so efficient and so free of gross waste as our antitrust policy.

Indeed the old position — the implicit position of classical liberal policy — that the monopoly problem is acute only when the state supports the monopolies, seems to me to be a basic truth. Even a modest program of antitrust therefore achieves much by inhibiting public policies to create monopoly.

The aimless drift of public policy carries it in every direction except the one I prefer—for the preferred position carries the insupportable burden of one-time acceptance. The present policies, which rest upon the doctrines of egalitarianism and democratic susceptibility to well-placed pressure groups, which combine responsiveness to public passions and private opportunism, face no serious challenge at the present time. Any strong group will get from the state some of what it wishes—surely enough to keep it from violent protest.

The only effective challenge to generous opportunism is a trenchant ideology and that is precisely what we no longer have. We dislike communism and are ashamed of private enterprise, but have only good intentions to put in their place. The problem of oligopoly, meanwhile, will be increasingly the problem of the industry in politics, not the problem of the monopoly in the market.

GEORGE J. STIGLER

Riassunto — Questo articolo illustra il cambiamento degli atteggiamenti degli economisti americani nel riguardo diunnedipopolio, dell'oligopolio e dei contratti del 1890 ad oggi. I cambiamenti più importanti sono: una diminuita fiducia nella concorrenza che nell'intervento statale ed una maggiore accentuazione delle imperfezioni del comportamento del mercato in regime di oligopolio. Oli economisti sostengono ancora le leggi antitrust ma attribuiscono ad esse una minor importanza e pretendono sempre più verso misure ad hoc per migliorare il comportamento del mercato. Seguendo l'intervento politico negli affari e specialmente nelle industrie oligopolistiche tenderà a diffondersi.
OLIGOPOLY IN A FREE SOCIETY

by David McCord Wright (*)

I. In our Western slang oligopoly is indeed a "hot potato". For too many people the notion of a free society is inseparably connected with that of "pure" competition. Others, not so dogmatic, will nevertheless point out that our Mt. Pelerin Society believes in the operation of the free market, and in a minimum of government planning and intervention. How then can we possibly come to terms with anything which so patently interferes with the operation of the institution upon which we so heavily rely?

But does oligopoly inevitably interfere with the working of the market? Well, first of all, what is oligopoly? Most people I believe would define it as the dominance of the market by a small group of competitors — three or more — who are aware of the fact that what policy they individually adopt will affect the policies of the others, and who hence allow for strategic repercussion in behavior.

Yet if we merely define oligopoly as small numbers we must at once see that it can cover many different types of market behavior. There can, for example, be a cartel, or some form of market leadership, or active competition under tacitly accepted "rules of the game", or a "big three" or more surrounded by a number of smaller firms. Again, we can look at the matter over time and ask if the same firms are so deeply entrenched that they continue to dominate, or if there is turnover in the make up of the ruling group. Finally we can look at actual behavior and see whether the particular industry is technologically progressive or not, what is happening to prices and output, and generally how the industry is behaving.

II. But some people are not willing to consider these variations. Professor Paul Samuelson, in the fourth edition of his economics, says "Even if it had no harmful effect on income distribution, imperfect competition could still represent an important economic evil" (p. 470) and in the discussion of oligopoly on page 489 has literally not one good word to say for it. Later editions contain even more dogmatic passages.

Now the writer so far from agreeing with this outlook is of opinion that we could as well talk of the "optimum" degree of monopoly, or oligopoly, as of the optimum degree of competition. Indeed I will try to show that oligopoly output can sometimes be greater than pure competition. The basic issue is a simple one: are we to talk in terms of maximum output from a fixed set of productive resources and knowledge, or are we to talk of a maximum rate of growth? The key to under-

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standing will be found if we return our analysis to Professor Edward Chamberlin's inexplicably ignored distinction between 'pure' and 'perfect' competition.

I developed the distinction between pure and perfect competition at a meeting in Italy last year but since so many of this audience were not there I take leave to repeat. According to Chamberlin pure competition means that each producer believes (or acts as if he believed) that acting alone has no influence on price. Diagrammatically this is expressed by a perfectly elastic individual demand curve for the firm, and the factual requirements for such a curve are (1) a homogeneous product - no reasons for buyers to prefer one seller rather than another (2) - sufficient numbers for the producers to disregard the repercussions their act will have upon the policies of others. But what is a sufficient number? Unfortunately we cannot be specific. A lot depends upon national culture, habits and that kind of things.

Turn next to 'perfect' competition à la Chamberlin. To him it means perfect knowledge, perfect mobility, that kind of things. « Monopolistic » elements - preferences by consumers, for example, as between sellers - are to him one form of imperfection but only a small part of the total. Far more important, in my opinion, are the necessary uncertainties of growth: the fact that for physical reasons we do not have and never can have perfect knowledge of how the pattern of consumer wants will change next year and so forth. The important imperfections derive, I submit, from the nature of the universe rather than the nature of the market. But let us hurry on.

It follows from our definitions that competition, à la Chamberlin, can be pure and imperfect simultaneously. He writes, for example, « The actual price of wheat approximates very inaccurately its normal price, yet the wheat farmer possesses not a jot of monopoly power. The market, though a very imperfect one, is purely competitive » (Chapter 1, The Theory of Monopolistic Competition). Actually, since completely perfect knowledge and foresight is never possible pure competition is always imperfect. We shall see in a minute that this conclusion is of the utmost importance.

Unfortunately for the development of a truly scientific economics, however, most economists, and economic text books, use the Joan Robinson terminology in which perfect competition simply means large numbers and imperfect small numbers, thus jumbling together the frictions of the market and the uncertainties of growth, and giving rise to such conclusions as the following, also from Samuelson (6th ed. p. 463): « Only when prices of goods are equal to Marginal Costs in the Economy squeezing from its scarce resources and limited technical knowledge the maximum of outputs. Only when each source of industry has had its rising MC equated to any other sources MC -as will be the case when each MC has been set equal to the common P -can the industry be producing its total Q at Minimum total cost. Only then will society be out on its production -possibility frontier and not inefficiently inside the frontier. »

And he continues: « Because Marginal Cost has this optimal property, it can with some care be used as a yardstick to detect inefficiency in any institutional set up ».

Now I submit that though Samuelson, in this case, is merely stating conventional economic theory, the quotation is quite wrong for a growing world.

III. The trouble is that, as already implied, the essence of the growth process is uncertainty. Failure to understand the uncertainty point leads to such naive ideas as that the purely competitive producer, in the real world, will blindly produce out to the intersection of marginal cost with present price. But this is nonsense. Just because the purely competitive producer thinks that acting alone he cannot change price, we cannot suppose that he must be so stupid as to suppose that price will not change. Of course not. The purely competitive producer sets his output today with reference to his forecast of what the price is going to be and the forecast may be wrong. A cotton farmer in an uncontrolled market knows that he cannot change price by himself, but he also knows that prices can fluctuate. So he guesses at the future price in making his productions plans.

If we deny the analysis just given, we must be tacitly defining the purely competitive producer as a brainless or ignorant peasant. And surely that would not be an economic optimum.

The conclusion we reach is that if the maximum rate of growth is to be our optimum, rather than the maximum output from a given endowment of factors and technology, then that form of competition is best which on average best enables the industry to form reliable and expanding forecasts of the future. Such a standard revolutionises the whole economic theory of optimum output and optimum types of competition.

IV. In my Growth and the Economy, Scribners 1965, I point out that it is only because of imperfections - à la Chamberlin - that the system can function at all. In Adam Smith's invisible hand big present profits induce people to expand output in that line until prices and profits are brought down to normal. The inference is that businessmen are dumb bells who go in expecting high profits and cut their own throats. I point out that this is a misinterpretation. The investor usually expects the price and profit to fall but what he hopes for is an interval of abnormal profit before the « gravy » is squeezed out. This interval is only possible because of frictions of adjustment - that is imperfections à la Chamberlin. Without such frictions there would be virtually no incentive to innovate.

One of the aspects of pure competition usually overlooked is that it cannot in any case be combined with the introduction of new Inventions for the man with a new invention has a non-homogeneous special product. As such he is a monopolistic competitor.

But leaving aside proofs by definition such as that one, it should be evident that what really determines the business man's decision to
Invest is his perspective of profit—his subjective estimate of how fast he thinks prices will fall, sales perhaps decline and profits slowly disappear.

In figure I diagram a simple case of profit perspective. The diagram is three dimensional. One plane shows time, one sales, and one forecasts of cost and price behavior. It is not that the investor does not hope better, but this is what he feels sufficiently sure of to use in making a final decision. It is this which he compares with the rate of interest in setting his final plan.

![Figure I](image)

The banner shaped area on the time plane represents the dwindling profit margin, as output increases, while the sales dimension shows a similar fall. The total expected profit is set by the volume of the pyramid. It is this perspective of profit which is the vital factor in the investment decision, and it should be noted that since it relates to the future it is always substantially subjective. It is what the business man thinks is going to happen, not what he knows must happen.

Now I submit that a group of large businesses can afford to take a longer view, and are less likely to panic than a hoard of small producers. One idea of course is that the small producer will keep producing even at a loss if demand drops. But with few resources to fall back upon he cannot keep at it long. The perspective of profit may become negative and the industry shuts down. If there are postenable wants involved, a considerable period of non-production may ensue.

On the other hand the monopolistic or oligopolistic business may see that the interruption is temporary. It will not (horror of horrors to the theorist) cut price, or cut price on a large scale. But it may keep producing in limited flow whereas the purely competitive producer may have shut down entirely. The presence of a protected zone of market power can serve both as an incentive to invention and as a stabilizer of the flow of output.

V. Professor Samuelson's indictment of oligopoly rests upon the assumption that if there are several producers (only) of the same product they will be led to adopt a live and let live attitude freezing prices and restricting production. The argument is logical if we are dealing with an unchanging world, but it does not apply to an innovating group in a growing society.

The flaw in the theoretical model of oligopoly is the assumption of the same product. This is precisely where the model fails. In the United State good manners of oligopolistic competition are bad to try to drive others out by a cut-throat price war but quite alright to try to gain the field by technological innovation. Product competition takes the place of the simple competition of the static purely competitive model. The result is that businesses no matter how large are kept on their toes by the possibility of being outsmarted through a more attractive product, unexpectedly released by a competitor. Also the total flow of output, thanks to productivity gains may be faster than if only pure competition had existed. Paraphrasing Professor Boulding, "Many people talk as if it they had rather ride in cheap stage coaches than expensive aeroplanes.

I have spent much of my time so far knocking down old prejudices so that we could consider the actual problem. My article leads to the conclusion that the simple fact of an industry's being divided between a few large firms does not, of itself, mean that output is being kept less than would have been the case under pure competition. We have got to look more closely than the simple model can do.

What the S. P. S. is opposed to, I submit, is not oligopoly but oligarchy. Our liberal standards lead us to oppose government by one closed group which excludes all others from a chance for power. We are not so naive as to deny that sometimes such groups can have high standards of social responsibility and, within their preconceptions, of justice, but we feel that over time such a society stagnates, and that its denial of opportunity to those born outside the charmed circle is immoral.

As a corollary of this principle we are suspicious of schemes for the overall cooperative or indicative planning of social output by institutes of businessmen, labor, and government. Schumpeter characterized such plans as the first step toward socialism. Appealing as they often are to business groups harassed by the anti-trust laws, and rational as they seem to the neo-platonist, most members of this society, I believe, would say that schemes of this sort end the relatively independent opportunity for economic experimentation which is the life blood of a true capitalist and open society.
But oligopoly as part of a dynamic process of adaptation, and with a "good manners" favoring technological development is a different story. So we ask the following questions:

How did the small group happen to emerge at the head of the industry?

Perhaps they did so because they were the most efficient managers, and because the nature of the industry called for large units.

Is the small group acting to exclude others?

Are they deliberately excluding entry, or is entry merely expensive for reasons that are not their fault? Would an ingenious new technological idea have a fair chance, or would they deliberately block and suppress it?

How are they acting toward each other?

Is there a "you scratch my back, I'll scratch yours" outlook so that they will not under-bid one another, even when they honestly can do a better and cheaper technical job?

The economic watch words of the Mt. Pelerin Society are turn-over, change, growth, development, and opportunity for the gifted and motivated man, wherever he finds himself, to make the most of his talents on reasonably independent lines. It is quite possible for an industry to be led by a few large firms and still meet all these requirements.

DAVID McCORD WRIGHT

Riassunto — L'oligopolio (regime di pochi produttori) di un prodotto più o meno identico è spesso trattato nel la teoria economica come un fenomeno isolato con un singolo insieme di caratteristiche. Ciò è un errore.

La teoria economica generalmente esamina l'oligopolio in termini di equilibrio. Questa procedura perde di vista l'essenza del problema. Il quadro appropriato è un sistema di perturbazione continua in condizioni di concorrenza pura ma non perfetta (Chamberlin). L'incertezza in tale sistema, è il problema di base e quella forma di concorrenza che meglio si accompagagna ad essa, darà il più alto tasso di sviluppo. L'esistenza di aree di potere di mercato, anche di natura oligopolistica, non è necessariamente nociva.

Per capire bene i modelli di comportamento, bisogna considerare i va- lori sociali ed istituzionali. Il castello, o tacito accordo, mirante al ristagno dell'iniziativa, è solo una possibilità. Negli Stati Uniti si è affermato un "galasso della concorrenza" in base al quale un ribasso dei prezzi, come tale, viene guardato con adeguo, mette l'abbandono dei prezzi mediano- re innovazioni tecniche o l'incrudescenza in un nuovo territorio mediante nuovi tipi di merci o tecniche, viene ac- cettato.

Il risultato è che nessun oligopolio, per quanto ridotto a poche imprese, se non riesce a trasformarsi in monopolio assoluto, potrà sottrarsi agli ef- fetti di cambiamenti insospetati e an- che le imprese più grosse sono sem- pre soggette ad un alto grado di con- correnza. Esse non possono ristagnare o formare comode coalizioni.

Per giudicare della desiderabilità economica di una struttura industriale non si possono semplicemente contare numeri ma bisogna chiedersi in quale quadro sociale di idee funzionano i piccoli e i grandi numeri.
III.

HOW PRICES SHOULD BE DETERMINED
HOW SHOULD PRICES BE SET?

by Armon Alchian (*)

How should prices be set? No one knows. God may know; but not care. One interpretation of this question is « By what competitive behavior should scarce resources be allocated among competing claimants and users? Who should have what and for what purpose? » Read this way, the question asks how society should be ordered; and what each person should be allowed to do. In another sense the question can be interpreted very narrowly and incompletely: Should price discrimination be allowed? Should prices be set by decree or by open-market competitive forces? Should collusive action by sellers or buyers be encouraged? But these, if pressed far enough, go back to the broader question asked first.

With that prologue let me pose the question anew. « What are the consequences of setting prices in various ways? » and also, « What conditions must exist if prices are to be set that way? » In this more general form of the question — as a sociologist might put it — « What are the cultural, political and economic consequences of various processes of allocating goods and what are the institutional conditions that must prevail if that allocation or process is to be realized? » In so far as you would prefer one or another kind for the society, would your preferred process depend upon the particular goods and the people involved? Would you want the same system to apply to drugs, books and shoes? For everyone, children, aged, literate, more informed? Do you prefer that the young cannot buy alcohol? That licensed doctors can buy morphine; while we unlicensed doctors can not? Do you think it desirable that Frenchmen and Englishmen have less competitive clash of ideas and options via television and radio than do Americans? That minority groups are less likely to get jobs in public utilities and in strong unions? That liquor store owners are a strong source of political support for politicians? That a strong patronage arm of the politician is the licensing board which issues licenses in various professions; radio and television stations are more likely to be awarded to ex-congressmen than any other class of people; college teachers will discourage weak students from continuing their education whereas a golf teacher will encourage the slow learner to keep trying? And do you prefer that doctors prohibit advertising and open competition for their services; that universities and schools assign students to schools nearest their residence, whereas those who eat out are not so assigned to restaurants; that public employees are less helpful to the public they serve than the employee of a selfish private employer? And that public government or non-profit employers

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are more discriminatory in their employment policies than private property employers? And that public services are more likely to be underpriced than are privately provided services? The list could be lengthened easily. What are your preferences — as if anyone really cares! More sensible is an understanding of why those phenomena occur. All are results of the pricing system used. However, the ability to use particular pricing tactics depends upon the property system.

Let me emphasize the fundamental fact that every question of pricing is a question of property rights. We could have asked «What system of property rights shall be used?». For the existing system of property rights determines the system of price-setting in the exchange or allocation of scarce resources. I am repeatedly impressed with how many apparently diverse questions come down to the same element — the structure of property rights to use of scarce resources. In fact, and this is a proposition I should like to emphasize as strongly as I can, Economics is the study of property rights. Without scarce resources there is no point to property rights. The allocation of scarce resources in a society is the assignment of rights to uses of resources in a society. So the question of economics or of how prices should be set is the question of how property rights should be defined and exchanged and on what terms.

I cannot present a theory of all the implications of various forms of property rights — as a means of deriving the implications of various ways of setting prices — i.e., of rationing scarce goods among competing users. But a general outline of the standard elements, with some examples, can be attempted.

Economic theory (which is a theory of society) postulates that behavior conforms to the hypothesis that every person has a convex utility or preference function with his goals and goods entering as substitutable variables. Eating, physical comfort, sex, honor, intellectual interchange, and marketable wealth are some of the goods, and among them substitution or tradeoffs occur. Each person is constrained to some feasible set — the set composed of all the achievable combinations of those goods. Typically in standard economic theory, the boundary of the feasible set is defined by one's marketable private property and market prices. Almost the entire development of mathematical economics has used that very special constraint and from it has come much of our current theory.

Goods controlled as private property are more likely to be exchanged (allocated) via a market clearing money price than goods not so controlled. The reason is simple enough. With private property, two persons may exchange rights to goods on whatever terms they mutually accept. The exchange of one good for several other marketable goods or for friendship or for charity or for whatever other service one wishes to contemplate is unrestricted. It is unrestricted in the sense that any person who prefers some other mixture or form of payment for the goods he sells can offer or ask for it. A seller can sell to pretty women rather than ordinary women if he prefers. He can accomplish that mixture by accepting a lower price from «beauties» in order to deal more with them. Or as a buyer he can pay higher wages or prices and get a choice of other characteristics in his employees or pay higher prices and get better quality. He can more fully discriminate. Prices will reflect the variations in preferences and quality of goods. This point, I think, bears repetition. In the open-market, property rights can be privately reshuffled and exchanged for whatever kind of mixture of other rights or goods that any two people can agree to. Any kind of mixture of components or goods can be suggested as the components of price. No one has to sell for money only; he can sell for very little money and ask the buyers to not smoke or not drink or to dress well or to perform little dances or to do any of large variety of other things. The buyer has his own tradeoffs or marginal rates of substitution among units of the various goods or activities for which he is asked as a condition of exchange of rights. If the two parties can agree on some mixture of services or rights to be made available to one party in exchange for some mixture from the other, we have a sale. Typically, with private property, one party transfers money and the other some nonmoney goods. But there is nothing to prevent someone from asking for less money and a bigger smile, or a pledge not to smoke — to name but two. The more «side» conditions asked the less the money price available, with private property, the open-market provides each person the broadest opportunities to find exchanges on the best terms possible. The person who wants pleasant employers who will also provide a more relaxed atmosphere can accept a lower money salary. That is why more pleasant working conditions are associated with lower money wages, and riskier, less pleasant work with higher wages. Conversely a less desired type of employee can obtain a job by asking for a lower money wage.

The old principle of «equalising differences» applies to all exchange — not merely to labor and wage markets. The lower is the monetary payment asked by the seller, the more will he be able to get in non-monetary forms of equalising differentials. This is simply an implication of the negative sloping iso-utility line in a convex utility preference function.

A private property system seems to be dominated by formal marketable means of payment — money; but, as we have seen, pleasant working conditions, congenial colleagues often serve as payments in attracting employees (who are a form of good purchased by the employer). It is not the case that private property results in the maximum possible monetary price as the principal rationing criteria. If it did, we would not see people of the same skills working for less pay in accord with working conditions. An open-market seems to maximize the permissible range of feasible mixtures — the variety of behavior from which one can choose — perhaps to one's regret. My tentative conclusion is that if you
would increase the range of variety of mixtures of goods and exchange conditions — and remember that a society is essentially a means of facilitating exchange of specialised services — then a private property system scores high (est?). I am further tempted to mean by freedom that range of options (not the size of the particular basket selected). This does not imply that freedom is the only goal in my utility function. It is trade some of it for more porridge i.e., for a larger sized basket out of a narrower option. I trade options for more of a given good ...else why would I be employed at a state owned and operated university?

Costs of Policing Exchange.

But in speaking of private property I have talked as if there were no costs of obtaining information about exchange options, or of negotiating contracts and of policing their enforcement. Lumpiring momentarily the costs of discerning exchange opportunities and of communicating with potential exchangers, and of contracting and enforcement, it can be seen that these costs will, in some instance for some goods, be so large as to preclude market exchange. For example, the cost of policing the occupants of a parking lot and of negotiating payment may be greater than the cost of providing such parking space. At a zero price the parking lot may always be full, with rationing accomplished on a first-come, first-served basis. If one desires to accommodate those who feel the cost of making themselves the first come is excessive relative to the value of the parking space, more space could be provided, or the parking lot could be policed and the spaces sold via market (i.e., money) exchange. If policing costs exceed the costs of providing enough more spaces to accommodate the desired second-comers, and if having space for the second comers is worth the extra cost of more spaces, then more spaces will be created and provided free until the marginal cost of the land equals the marginal gain — which may or may not be in sufficient quantity to avoid rationing at even a zero price. Free (i.e., non priced) parking spaces near large department stores in suburban areas where land is cheaper but not economically free, are more common than in cities where land is more expensive — they are not priced — i.e., free because the cost of transactions via the market is higher relative to the land value in the suburban areas. So, if one thinks private property should be or is associated with market clearing prices, he must first reckon with the costs of private property systems.

Other resources than land, say water in rivers or underground basins, rights to emanate radio energy, or rights to moving-cocoon of airspace all may be allocated by a non-market pricing system because the costs of policing the market contract exceed the value of using a superior rationing system. If radio rights are worth $1, but if the costs of recording and negotiating a market sale exceed $1.00 it is cheaper to assign in some other way. The exchange price (value to the highest claimant) must exceed the cost of negotiation and contract enforcement by at least the cost of production of the exchanged good (1).

Employee Policing Costs.

Transactions or contracting or enforcement costs are present also in an employee-employer relationship. An employee acts for the person vested with private property rights to the goods being allocated. In such case the employee-agent is a supposed to act as if he were the owner himself. If the proceeds accrue to the employer as his private property, the employer will take some care that the employee charges the market clearing money price, despite the employee’s preference for a lower money price so the employee could ration the goods on some non-monetary price criteria in such a fashion that more of the payment accrues to the employee. For example, at a lower price the employee can be more relaxed in making sales and less solicitous to potential customers; he can induce customers to be more patient and even to perform some of the functions of the employee. The customers (in order to enhance their competitive basis — which is no longer completely manifested in money prices) will offer other kinds of appeals pleasing to the employee. We all learn this, at least, from our experience with price controls and government employees. However, the lower the are the costs of carefully watching and policing the activity of the employee, the closer will the market price be to the market clearing price.

I believe the costs of policing the activity of employee-agents increases the larger the number of employees and the larger the number of people among whom ownership is divided as in a corporation. Thus I would expect to find more deviations from market clearing money prices in a large firm than a small one, and more deviation in a widely held corporate firm than in a proprietorship or closely held firm. Rules and regulations imposed on employees serve to prevent their straying from the path of maximizing employer wealth. We all know that in some special or unusual circumstances it would be better for the employer if the employee did violate some inflexible rules. At such times, we, as customers or subordinate employees, are annoyed by the red tape that prevents managers from acting in a sensible way. We complain that if only we could talk to the owner he would make an exception to his rule — a rule used because of the conflict of interest between employer and employee. However, if authority to deviate is granted, deviations will occur to further the employees also, to the detriment of the employee. Do not misunderstand; there is also a common area of interest. Nor am I arguing that employees of private employers behave just like employees of governments or nonprivate employers. They do not, as we shall see later.

(1) I wonder what fraction of our total product is devoted to policing property and contracts? Is 10 percent too large an estimate?
This implied kind of deviant behavior by the employee in large enterprises is frequently characterised by the assertion that large corporations are less likely to adjust prices to clear the market than the small firm; that the small firm will adapt itself to customer desires more readily than the large firm. The same kind of consequence is evident in the behavior of foremen and supervisors intermediary between owners and employees. Supervisors, foremen and managers will, the greater are the costs of surveillance and enforcement of activities directed at maximizing the owners wealth, engage more in favoritism or "arbitrary" employee promotion or firing practices. The subordinate employee feels the supervisor or manager is taking advantage of his situation in a larger corporation. But the analysis is incomplete. Competition among present or potential employees and among supervisors has the effect of reducing behavior that departs from employer interests. New employees will offer to take the place of old employees who are inefficient in attending to the interests of the employer. With perfect competition among employees we would eliminate this effect — if by perfect we include information as a free good.

But information is not free. All potential new employees do not know what can be achieved. Circumstances are always changing; opportunities change. Insiders may know more than some outsiders. Which employee is acting inefficiently? Which employee's interests could in fact be better attended to by you? It does not suffice to say that inefficiency exists. To eliminate it the person who can do better must know where the inefficiency is. This is costly to ascertain and to the extent it is costly, employees can act inefficiently, and competition among employees will not immediately eliminate it. However, inefficiency will be more viable where the employer himself is not the owner of the enterprise nor a manager agent for some private owner.

Kinds of Property Rights and Rewards of Exchange.

Not all non-money market-clearing prices occur because of high information, policing and transactions costs relative to the marketable value of the rights. The exchange value of the rights may be biased downward by the kind of property rights in them. If no one owns a peach tree, the value of the ripe peaches is not reflected in any marketable way that anyone can capture. People will pick the peaches before they are ripe for fear that someone will beat them to the peach. If no one possesses the right to the peach, the marketable value will not be as effective. In controlling that resource, private property rights have the characteristic that it is easier (cheaper) to exchange the rights for other forms of marketable (money) than for rights that are less private. In fact one dimension of the concept of private property is this relatively greater ease of converting or exchanging private rights for marketable value. In publicly owned property it is not legally possible for one person to sell his rights to public goods to some other people. The rights are not marketable individually as is corporate stock ownership. It is this feature which I think is the crucial distinction between private and public property.

I do not intend to suggest only a bipolar distinction between public and private property: rather I use the terms as the two ends to the spectrum of things in the marketable transferability of the rights. In passing it is wise to remember that marketability implies capitalisation effects, or effects on present values. Thus, long range effects are thrust back on to the current owner of the marketable value of the goods. He will heed the long-run effects of current decisions more carefully than if the rights were not transferable. It is this feature which some people forget when they say that all a stockholder can do in a corporation is sell his stock if he doesn't like the way things are going — as if to say that this has no effect on the way things will be going. There exists a strong temptation to identify incorrectly the power of a person with his relative share of voting strength — thus equating the political power and acts of a single person in a society of ten thousand voters with that of an owner of 1 share of stock out of 10,000.

Diffused private property still retains one powerful difference. Rights may be exchanged and may be consolidated into blocs, so that some people do have large interests. This ability to sell an attribute has two features: first is the capitalisation of future effects on to present value — something that is not feasible with public property. A larger span of value effects is imposed on each current rights holder and is more effective on current decisions. Secondly, the ability to sell the rights enables some to specialise and exercise greater control in particular goods. For example the specialisation gives incentives to people to buy shares of malfunctioning corporations, improve them and capture the capitalised gains. There is a similar incentive on politicians to assemble voting blocs, but these do not possess the same elements of capitalisation and concentration of power. One should avoid the mistake of thinking of a large, dispersed private property business as identical to an equally large (number of owners) publicly owned enterprise.

An implied observable difference is that private firms will be closer to market clearing prices than will the publicly owned agency. Example — water, telephone, power and transportation services. Shortages will be more chronic in publicly owned than in privately owned enterprises, with the consequent change in the weights of competitive factors and behavior in the rationing of the available services.

Suppose that as citizens of the state, we prefer to see public goods used where their value is highest. The costs to each of us of enforcing efficient behavior is higher and the gains lower than in a private, equally large enterprise. The absence of both (a) transferable marketable rights that can have exchange values revealed, and (b) the possibility of concentrating one's rights in particular directions so as to capture more capital value gains of improved marketable value of the resources imply
a lower force toward market-clearing money prices for services rendered by publicly owned agencies.

Before illustrating this deviation from market clearing money prices, it is useful to note there is a spectrum of rights from private to public. For example, in between there can be placed non-profit enterprises, public utilities with limited profits, profit sharing cooperatives and labor unions. The protected public utility with a limited profit is an instructive case. Increments of wealth beyond the limit would accrue not to the stockholders but to the customer; if profits exceed the legal limit, prices to customers would be cut to pass the gain to the customer. Stockholders will not be willing to incur as much costs to insure wealth maximizing behavior in the public utility. Employees will have greater scope for personal non-market sources of utility increments, e.g., easy working conditions, prettier secretaries, more discrimination according to color, sex and age, and easier retirement and weaker discharge policy. Unions will find public utility managers more agreeable to wage rises.

It is safe to say, I believe, although I have not tested this systematically, that the kinds of behavior characterized by Berle and Means in the famous book on corporate behavior applied more to the limited profit, public utility corporation than to the privately owned, unrestricted corporation and even less to the closely held corporation.

In this range we can fit also the not-for-profit corporation, and the publicly operated agency that is supposed to dispose of its product via the market, (leaving for the extreme, in the rationing of immigration visas, radio and television broadcast rights and a polyglot host of other goods controlled by other groups controlled by the government). In non-profit institutions, there are no private owners. Trustees or stockholders exist, but they can not sell the stock or declare dividends for stockholders. Costs are inflated to match receipts, by paying larger salaries, by not firing incompetent people, by hiring more expensive luxuriously furnished buildings, furnishings and people. Prices of services will be set too low, relative to clearing the market so that the operators can reap more benefits either directly from customers or by an easier management task. As a prime example, I cite the mutually owned cooperatives. They are active in the savings and loan business in the U.S. Yet their record relative to privately owned stock corporations is exactly in accord with the implication mentioned. It is the stock-owned companies that are first to adjust interest rates to clear the market — to cite but one (and for present purposes, the relevant) example of evidence.

Between the diffused ownership of a corporation and the citizen-owned rights to public property there is the labor union or self-licensed profession in which licenses are awarded by the profession itself. In a union in which entry is limited, as in the case in several unions, entry permission constitutes a rationing and allocation of a monopoly rent. The entry controllers do not have private property rights in entry permits (and the monopoly rents). They therefore have less reason to sell them in the market, since marketable payments would redound to the benefit of the union treasury. Union entry will be underpriced (in money terms), but the non-money payment price of entry will be higher. Furthermore, applicants queuing for admission will agree to not advertise, will perform special services to help incumbents (do charity work for doctors or do the lesser paying jobs), will be relatives of incumbents, and will agree not be critical of their colleagues. Negroes and other minority groups will find exclusion more common.

Where should we rank government agencies like the Port Authority of the New York, or the Tennessee Valley Authority, or the Federal Reserve System — agencies that have their own sources of revenue but which are publicly or governmentally owned? State or public universities, with which we are better acquainted, serve as better understood examples of the ability to avoid market clearing prices. We note in passing that there is an alternative hypothesis — that state universities are employed in order to avoid market rationing of services, i.e., to avoid full cost tuition as the rationing criterion.

Before exploring that example more fully, let me review the discussion. The setting of price is the setting of standards and criterion for the allocation of rights to scarce resources. But this is the allocation of property rights. And this affects the kinds of competitive behavior people manifest in their attempts to improve their utility. The setting of prices is itself dependent upon the rights possessed by those who can transfer the rights. In sum the structure of property rights affects the way prices are set — the way rights are distributed or transferred. Some classification of rights structures has been attempted and I have tried to show these affect the pricing system used. By implication these would then affect the behavior of the people, as they compete for access to rights or to transfer of rights. That is why it seems that to ask how prices should be set is to ask what kinds of behavior we want or what kinds of property rights should be instituted in order to get that kind of behavior if any of us think that knowledge of such questions would in fact affect policy.

Applications to Pricing of University Services.

To make the analysis vivid, I shall discuss the allocation of educational services — something we know about. I shall interpret events as implications of the preceding theory of property rights and behavior. A public university in privately financed from taxes — not from sales to customers. Even private schools have similarities; a large portion of their proceeds come from endowment or sources independent of market sales. What is the rationing system? More generally, what behavior by students and faculty and administrators is fostered by institutional arrangement?

I recognize that an alternative interpretation is that university education should not be rationed at a market clearing price and should
not be controlled by market sales. If I accept that I then ask what institutional system will permit that desired rationing system. If I do not accept that premise — as I do not — then I merely shift emphasis from intent to effect. And since intentions are not sufficient to make behavior viable, we can agree that the issue is one of viable, not of intended or unintended, behavior.

Universities are marked by zero or low tuition fees. (I shall be extreme and put things in black and white terms and you can interpret to put it in comparative terms). We use grades as conditions of entry and of continuance in school. We impose required courses with examinations. We have faculty control; academic freedom; tenure; and acquiescent students. Students are severely restricted in their ability to transfer from course to course, to drop courses in mid-term, to repeat courses until they obtain passing grades; they are policed in the kinds of behavior that will result in dismissal or inability to enter. Compare that with a department store. Do the employees or managers so control or select customers? Of course not, and the reason is not that education is different. Education is different, but it is the ownership arrangement that is the explanatory difference and only that. Such is the bed I am making for myself; now notice how comfortably I can lie in that bed.

I (a member of the faculty) can survive with a market clearing price. But students will insist on better treatment else they will transfer their custom to a competitor, and competitors will exist at market clearing prices. Intentionally or not, with foresight or not, we keep the fees low in order to accommodate less wealthy, more needy but deserving students. Low fees enable us (faculty) to select students according to non-money criterion. My utility will be enhanced as I select the better learners and smarter people who obviously deserve a higher education. How easy to swallow that self-serving contention!

The same reasoning can be applied elsewhere. Concerts should be free and financed by the state so that musicians can select the audience, admitting those who have the keenest ear and are best at making music themselves. Less discerning people can do other things. After all there is no sense in wasting music on those least able to appreciate it. If food were rationed at a zero price, chefs and dieters who prepare the food could see that only the most deserving got the good food, while those who were less appreciative of food would get standard food without luxurious and expensive deserts. Or if we are couturers and dress makers, we will let only the most beautiful women have the best clothes. The average woman can wear her shapeless, less expensive dress. How wasteful to spend hundreds of dollars on a woman of hopeless figure, while there are women who, if beautifully dressed, would provide external benefits to the rest of society. Clearly, on the external benefit count alone, clothing should be distributed as is education. That the beautiful and shapeless alike should both have to pay would never cross our minds. After all how could a poor beautiful girl pay. Certainly she could not borrow and pay out of later proceeds, for how could she earn more?

Education could readily be financed by borrowing, but not beautiful clothes. After all education is productive of income — but beauty, no. We must provide zero-priced beautiful clothes to the prettiest women, while education can be sold at market clearing prices, with repayments out of later enhanced income. Couturers have long advocated that the state finance dress-making with zero prices for clothing so that they too can select their clients with the gracious social beneficial care that we teachers employ. But not until the designers get tax supported endowment support or non-profit dress design and manufacturing institutions will they be able to serve society as well as we teachers do.

We tax supported professors ration our entrants according to criteria that increase our utility, and bring in less revenue to the institution, but see it in order to increase the welfare of society. Once a student has arrived with a good scholastic and behavior record, we give him grades, not simply to tell him how he is doing, but to see that he continues to act in ways to support our utility. Of course, if a student offered to pay $100 for the privilege of staying in my class a second time after failing it, I would accept, except for my contract with the university which, for not mysterious reasons, prohibits such behavior. Yet my golf teacher, my Berlitz foreign language teacher, my teachers of music, typing, shorthand, driving, dancing, electronic computer programming, all are willing to continue to teach me so long as I pay the admission price. They do not seem to care if I take only part-time schooling, or get drunk periodically. But we teachers at zero tuition schools are less tolerant. Tolerance would be a waste of resources — to us. Once the student has been admitted he is subjected to a battery of tests to satisfy some psychological research worker, he must stand in line for hours to register and pay his bills (can you imagine a department store making you stand in line to buy and to pay your bills!); he must continue to behave in an exemplary manner; he must not belong to fraternities that discriminate among races. Can you imagine a private for-profit store engaging in such customer exclusionary tactics and suffering the loss of monetary wealth?

And the student who seeks advice about courses is ignored. Professors do not advertise their courses in the student newspaper as do the bookellers. Since students are not rationed on a money income basis, we mistreat students with greater success the lower is the tuition. The cost of our doing is so lower, the lower is the tuition relative to costs of education or the value of it to the student.

The land and facilities of the university are internally assigned on a non-price basis. Faculty offices, parking lots, uses of classrooms are not rented. They are distributed so that those in charge of the allocation get a greater utility than if the market-clearing sales proceeds were collected and turned over to the university administration or added to the state or university budget. As Dean of a department I could get parking space under a zero-price market scheme with excess demand. As a faculty I could get space before any student could. But under a
market rationing system I would have to pay more for space I get now «free». The sales proceeds would give less benefit to any administrator than if he were a manager for a privately owned enterprise. Hence parking spaces are more frequently allocated not by pricing but by hierarchical status. My point is that allocation of rights to use of university space is based on a hierarchical system reflecting the avoidance of trouble and obtaining an easier life for the administration — more so than if it were privately owned or market oriented. So we practice the principle of rationing with the squeaking wheel getting the oil.

What means do use students to exert pressures on the administration? Leave? Small effect that would have with queues of new students already «too long». Taking their business elsewhere is not as effective as it would be in a market place. Protest? Yes, by staging and being obnoxious. Protest in the guise of constitutional rights and basic civil freedoms such as free-speech. If students protest by sit-ins and physically taking over the premises in the name of free speech — the faculty, conditioned to respond to the phrase «free speech» like Pavlov's dog to the bell, will lick their chops and rush to the students' aid rather than expelling them. So long as students have power to «talk» we of the faculty mistakenly think they have a constitutional right to the space. So long as students identify their demands with free-speech, our faculty colleagues will associate free speech with free resources. Free speech has nothing to do with free resources. We think the students should have the right to take whatever resources they wish — as if were free — in order to engage in «free speech». How easy it is to confuse «free» (in the sense of governmentally unrestricted rights to say what you want to a willing listener) with «economically free» resources with which to talk. Free speech (in the sense of unrestricted voluntary conversation) does not require «free goods». One can hire a hall.

— Free speech does not involve use of public resources. Until this distinction is understood I fear we shall go on thinking we have given students free speech, when in truth we give them paternalism and economic goods — i.e., qualified rights to use university facilities for certain purposes, (e.g., conversation). For example, they may use the space only so long as they do not express immoral ideas. But in a privately hired hall, filthy obscene words are consistent with free speech... even though many people would regard that as abuse of free speech — thereby exposing the fallacy that free speech is something provided by access to non-private property. The public space is allocated and rationed at a zero price so long as it is used as the rationer thinks is appropriate. With private property, the rationer's own standards can be bought away and resources more reliable made available for whatever speech is voluntarily agreeable to the two discussants.

So we find that rationing space that is controlled by an agent not responsible to private owners implies less use of market clearing prices and an increase in non-marketable types of goods; to wit, an increase in the ability of the allocator to condition the behavior of applicants, as with students. Furthermore we increase the resort to public demonstration on public property as a means of acquiring control over more of the non-market price rationed goods. Such protests impose costs on the allocators (rather than monetary rewards), and as a condition of being relieved of such costs the claimants are given what they seek. This is known as the inalienable right to protest, though I confess I fail to see the difference between that and the man who sits in my house and prevents my using it until I let him have a room. There appears to be a difference because my house is typically sold or rented at a market clearing monetary price, whereas public property is not. Hence in the latter case, rationing devices that are typically used include first-come, first-served and political pressures upon the agent. Pressures run a wide gamut of devices including simple blockage of any use of the resources... now popularly known as sit-ins or public demonstrations blocking use of the streets for travel.

It is not surprising that a «first-come, first-served» method of protest is applied to public streets. Since street use is normally rationed at a zero money price with first come first served, we are accustomed to that system for streets. We often ask why people drive so rudely, when they behave so nicely in other places. The simple fact is that we ration space on the road in accord with the first-come, first-served principle; so we see that kind of «rule» behavior on streets.

That is how prices should be set if you wish to encourage that kind of behavior. And to get prices set that way it is more viable to have the streets (or resources) public owned. One can look at the range of public services and find this principle of rationing widely used: public parks, golf courses, public housing, water, telephones, court room services — to name a few. In some instances I find it preferable — especially if I happen to have the characteristics that increase by being «first comes» or if I happen to be the allocator as with university resources. So do not condemn my remarks.

Private property reduces the scope of control authority by politicians, it reduces the scope of wealth available to those rich in the survival traits of political competition for access to political power. Viable behavioral traits depend upon the political system. In some countries it is skill at military tactics. In others it is personality appeal and oratoric ability. We can not imagine Lincoln acquiring political power in a military junta. We can not imagine some dictators acquiring power in a democratic election. Certainly some people are more skilled at political endeavors than the market oriented survival skills. In students of political science and in business administration and in engineering you will see signs of developing differential skills. Small wonder then that politicians will be rewarded by public ownership. Their own power is enhanced, politicians will look more sympathetically upon public ownership and respond their desire for it to help the public. The man who enters political life to restrain the growth of public ownership, publicly operated agencies and services will enter an office, if elected, in
which he must dismantle his major sources of power and wealth once he is in office. His survival traits in political office will diminish compared to one taking the opposite position.

I have tried to show (1) the kind of pricing or rationing criteria used has a significant effect on behavior socially, culturally as well as economically, and (2) the pricing or rationing system employed depends upon the system of property rights held by the allocators of the goods. A valid theory of the relationship between kinds of property rights and rationing criteria and techniques and generated personal behavior is not completely absent. Economics is social science. Applying it so narrowly to the private property market and to business administration, we have concealed its enormous applicability to sociology, political science and jurisprudence.

ARMEN ALCHIAN

HOW SHOULD PRICES BE DETERMINED?

by Karl Brandt (*)

Introduction.

Phrased as a question the subject deserves first of all a clarification of the meaning of the verb to determine. In order not to limit the discussion of economic policy, price determination must be conceived as including the functions of all and any factors, circumstances or processes as well as deliberate action that lead to the formation of a price or to its change. It must not be confined to the contemplation of authoritative regulation or setting of limits to the movement of prices.

The determination of prices covers an enormous range of problems of economic policy. In order to avoid skimming over the surface in incontestable general statements and retiring into the sphere of purely theoretical analysis, I prefer to confine my observations to prices of primary commodities produced in agriculture in the broadest sense. This basic industry is engaged in the utilization and development of all land, water, and climatic resources of the earth for the production of food, feed, as fuel for animal-propelled transportation, fibers, and other organic industrial raw materials for the market, while it also provides food, shelter and other needs for the people engaged in this industry.

While the scope of a few hundred commodities produced in agriculture compared with an almost unlimited number of manufactured goods consumed is narrowly limited, the range of price problems posed by agricultural products is broad enough to explore the major existing alternatives for policies. Indeed, the formation of prices for these primary commodities and any policies affecting the process are closely related to the problems of other primary products such as the minerals—on one side—and all processed and manufactured goods. Hence concentration on primary commodities will inevitably lead to the major issues in the worldwide controversy over the underlying principles of economic development, foreign trade, aid and finance.

However, the choice of this group of commodities has also the advantage that in the 20th century governmental interference with price mechanism—or the abolition of price formation as response to supply and demand in free and open markets—began in all countries with farm products. Moreover, proceeding from price controls in national markets toward international manipulation of prices, public policies have also concentrated on agricultural commodities.

To those of my esteemed colleagues who have never descended to the level of supposedly primitive problems involved in the very concrete and realistic world of commodities, I like to mention that there is hardly one commodity which is not tightly bound to the entire set

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of macro / or micro / economic problems or, beyond that, to problems of the philosophy of law and the social and political order. Treating commodities as more or less primitive technical engineering matters has been the cause of immeasurable suffering for great numbers of people and the cause of abrogation of freedom and the rule of law in many parts of the world.

A. The Alternatives for Price Determination.

Being by definition the ratio at with commodities, i.e., goods in consumer use, are exchanged between sellers and buyers—either against other useful goods or money as medium of exchange—prices can be formed in two alternative ways:

(a) A price can be formed for each individually offered quantity of a commodity by acceptance of a buyer's bid by the seller. This freely moving price presupposes a market with ordinary security of life, liberty, and property for buyers and sellers and a prevailing rule of free competition among sellers as well as buyers. The price is formed between willing sellers and willing buyers—free from coercion by either side or by third parties. The price moves in such fashion that it clears the market. It is the equilibrium price at which the day's effective supply and effective demand are in perfect balance.

Such markets do not necessarily depend on money as a medium of exchange, and function under primitive conditions even today by barter of commodities. In this case the ratio of exchange is usually expressed in terms of a unit, say one kilogram, of a commodity in general demand, say goat's meat.

(b) Instead of being formed as freely moving prices in free competitive bidding between willing buyers and free competitive acceptance of bids by sellers, prices can be controlled or authoritatively determined when competition is weak, absent, or deliberately excluded. This can be done

(1) by individual or corporate producers who have a monopoly of supply;

(2) by cartels of sellers or cartels of buyers, or by agreement between such cartels, i.e., temporary associations of firms which cooperate without losing their identity. Such cartels can be formed by private initiative or by government initiative. In the latter case they become compulsory and are subjected to a penal code.

(3) by the government, at federal, state, or local levels directly through administrative agencies, or through special public or semi-public corporations.

The methods and devices used in controlling prices via price-cartels or government action are too numerous to be all listed, but they include among others: allotment of marketing areas, quotas on domestic sales or exports or imports, licenses, levies, discriminatory pricing for specific uses or users, restrictions on production, harvesting, processing or conversion, rigid price fixing tying or prices to various indexes.

B. The Role of Prices in the Open Society and its Dynamic Economy.

Before the impact of freely moving or fixed prices can be evaluated, there must be clearly seen the role which prices play as activating forces in the dynamic processes of any economy at any stage of economic development, but particularly in a still predominantly agrarian economy.

In view of the generally accepted but exaggerated and somewhat arrogant assumption that widespread illiteracy among agricultural producers prevents any progress in productivity, it deserves special emphasis that prices are a universal language that conveys most pertinent messages to all concerned even in the remotest locations and with the more powerful amplifying effect the less people rely on one form of communication, namely the printed word. Prices traverse even endless jungles by the grapevine and are communicated by primitive tribes via drums.

(a) In a market economy without restraints, freely moving prices function as the signals by which the ultimate consumers express the priority of their needs and wants and their preference concerning the type, quality, time of availability and quantity per sale of the supply of specific commodities. This holds despite the presence of all sorts of imperfections of the competitive situation in the market, due to oligopolistic or even monopolistic influences and despite all efforts to influence the consumer by advertising. From this continual plebiscite, the consumers' decision expressed in dollars and cents is conveyed through all links in the trade chain to the producers. They cannot but accept and fulfill the orders of the sovereign consumer so long as the difference between the consumer retail price and the aggregate of all marketing costs called the «dealer's margin» leaves a loco-farm price that covers costs of production.

Thus it is ultimately the body politic of anonymous consumers that allocates resources to the production, contraction, processing, transporting, storing, retailing of specific commodities. This totally decentralized process of decision-making via freely moving prices guarantees optimal satisfaction of the needs and wants of the people in a nation not according to anybody's blueprint or any fixed pattern, design, or plan, but as these needs and wants evolve in the course of change in the humane society. Indeed, in case the national economy has no restraints against the free entry of goods from other countries the market is bound to carry the national consumers' decisions to foreign suppliers as well, and to respond to decisions by foreign consumers.

(b) However, the freely moving prices of commodities in a market economy have simultaneously the role of signaling the command of adjusting to necessity in the opposite direction, from production and sources of supply back through all links in the trade chain to the consumers. This system of signals conveys the facts and even the prospect of facts in the near future concerning the supply and costs of production, producing and trade to everybody concerned as buyers. These signals lead the consumer in his effort to maximize the aggregate satisfaction of all his needs and wants to compromise on the quantity for his purchases of specific commodities in accordance with relative prices, to substitu-
tion and even temporary abstinence from buying. Thus, beyond an extraordinary responsiveness of supply to demand, flexible prices give an economy a remarkable elasticity of aggregate consumption of such commodities as those that fill a nation's food basket.

c) The most decisive causational impact of prices toward automatic adjustment throughout an entire economy derives from the fact that what dictates the decisions on the supply side as well as on the demand side is never the price of a commodity but rather the relationship between such price of one commodity and the prices of all other commodities pertinent to consumption, retailing, processing, wholesaling and stockholding, and beyond that the prices of all services the consumer buys. In a developing economy it is this continually shifting relationship that reflects the multitude of changes in all factors affecting shifts in the supply and demand schedule, i.e. the changing structure of costs per unit at varying volumes of output and the changing structure of the demand at varying volumes of commodities sold. Price ratios favorable to specific products act as the powerful incentive of higher income to producers, who respond with greater output, and to all those who convey the products to the ultimate consumer.

C. Commodity Characteristics vs. Pricing Alternatives.

To appraise what is involved in the varying alternatives for the formation of prices of agricultural commodities it is necessary to consider some characteristics of these commodities. They comprise, according to their utilization, major groups such as: food, industrial raw materials, and agricultural producers' goods, i.e. seed, feed, draft animals, breeding stock and production animals. As to their transportation, storage, and handling they are:

1. Staples, with long storability, yet mostly needing protection from deterioration, such as grains and pulses, wool and vegetable fibers;
2. Semi-perishable products, such as potatoes or cabbages;
3. perishables, such as vegetables, fruits, milk, eggs, meat, fish and all other seafood.

Their supply is derived from the widest range of forms of land—and water utilization—from the most extensive collecting and pastoral economy type to more and more intensive types of production of plant and animal products, including orchard and horticultural enterprises.

The biological production cycle ranges from 3 months for some vegetables, meat chickens or spring wheat to 1 or 2 years for other vegetables or cereals, from 3 to 12 years for some livestock, sugar cane or orchard crops, and from 15 to 30 years for many tree crops, and from 8 to 80 or 100 years for cellulose, word pulp and timber.

Some perishable commodities like milk constitute an urgent flow-production which cannot be stopped without large losses to producers and processors. The sale of the product frequently takes the form of delivery contracts for six months or a year between farmers and processors, dealers, or retailers.

For due consideration of the complexity of economic dynamics touched by price policies it deserves mention also that one commodity that appears at first sight as a model of simplicity, i.e., wheat, happens to function as four decidedly different commodities (with durum wheat as a fifth) with specific locations of production and specific separate utilization and demand. The same holds for rice, with greater complexity.

These many commodity characteristics are mentioned chiefly in order not to belittle the problems involved in price formation even when we consider such supposedly basic, simple, and relatively primitive items in the world's business of agriculture as staples like wheat or rice, with recognized, standards and grades for measuring quality.

There are today very few countries where the formation of prices of farm products proceeds in response to the forces of supply and demand entirely free from government interference. This generalization includes particularly the leading industrial countries outside the Soviet orbit. Many of these countries, like the United States and several members of the EEC and EFTA, cling to a predominantly private enterprise economy. But such a rapidly developing primary products export country as Australia has its wheat industry under iron-clad government price control.

However, in spite of this situation it deserves recognition that e.g. in the United States in 1965, of the farmers' cash receipt for all products sold less than 10 per cent stood under government price support.

D. The Reasoning behind Price Control.

Attempts at controlling prices are not inventions of the 20th century but reach far back into antiquity. The economic doctrine of Confucius and his school around 1100 B.C. led to price-fixing by government and control of demand and supply by this means. In the 4th century B.C. the Athenian government tried to control the speculative grain trade and imposed the death penalty for violations of regulations. In 391 A.D. the Roman emperor Diocletian by edict fixed maximum prices at which grain, beef, eggs, clothing and other items—over 800 in all—could be sold while salaries and wages were also fixed. For violators the edict prescribed the death penalty. The net result was total economic failure and repeal of the law. There is an abundance of examples of other coercive efforts in the history of many countries. They are mentioned merely to emphasize the persistence of the economic, social, and political problems posed by imperfections of the market system.

The main reasons advanced in the 20th century for interfering with the free movement of prices of agricultural commodities or controlling their formation are the following:

a) In the socialistic planned economies.

In these countries agriculture is designated as the «sector» of the economy which must yield to the state a major part of the capital to be invested in the growth of heavy industries and the economy's productive capacity outside of agriculture. This maxim prevails in the socialistic
centrally directed economies even when agriculture is not entirely operated as collective communes or as state farms.

The squeezing out or tapping off of capital is achieved by the device propagated by Leon Trotsky as the "open price scissors"—or high prices of all industrially produced means of agricultural production and manufactured consumer goods—and a low price level for agricultural commodities. In view of the price disincentive by which this policy frustrates the farm population it is inevitably combined with compulsory delivery quotas for staple commodities assessed every year on all agricultural production units. That any excess beyond the delivery quota may be sold in a scantily supplied grey market at high prices makes it worse because all producers who did not fulfill their compulsory delivery quotas are the buyers and they deliver it at fixed low price to escape hard labor in prisons.

b) In countries with a private or "mixed" economy.

In countries with private property in land and in means of production which adhere for the majority of industrial goods and services to competitive markets, the prices of major staple farm products are nevertheless determined in many instances by public authorities for either one or several of the following reasons:

(1) Prices of such staple commodities are to be kept above a certain minimum in order to lift the earnings of low income groups among farmers above a distress level. This motivation falls in the category of social relief for marginal producers or the mitigation of hardships caused by necessary adjustments in the structure of agricultural production which are actually trying to put the brakes on, if not prevent the movement of farm land into the hands of the managerially fittest operators.

(2) In many advanced industrial countries prices of specific staple commodities are supported by public policies in order to protect the agricultural producers as well as their industrial and commercial suppliers against violent fluctuations of gross returns irrespective of the causes. A sharp decline in prices of specific commodities may be due to a bumper crop, a release of stocks, an over-expansion of production, a radical shift in demand in the domestic or foreign market, or a decisive change in the costs of production. The end to be achieved is proclaimed as price stability over periods of several years. Once adopted this goal is usually extended to price stability within a year, meaning interseasonal stability.

(3) Similar but more mixed motives prevail in many developing countries. With a large proportion of their labor force still employed in agriculture and rural handicrafts these countries have inherited from the former colonial administration or have newly adopted government stabilization of prices of major agricultural commodities for the same avowed purpose of protecting the producers against drastic decline in the prices of their main cash crop and resulting shrinkage of cash returns by unexpected gluts in the market. Enforced by compulsory delivery of the commodity to a Marketing Board or Commodity Authority, this price stabilization tends to yield a substantial profit and to make capital available to the government for ambitious plans of investment in heavy industries, irrespective of the comparative disadvantage of such "white elephants".

(4) In many instances government operated or government sponsored projects of colonization and settlement on uncultivated or waste land, like swamps or semi-deserts, are also providing the motivation to fix the price of the main product at a remunerative safe level as an incentive to settlers. This has often the support of international agencies such as the Food and Agriculture Organization (FAO) of the United Nations.

Of the many reasons behind commodity price controls in countries with a market economy the most influential is that listed under (1). In advanced industrial countries on both sides of the Atlantic the social relief type of justification is used in subsidizing expansion of agricultural production at extraordinary costs to the taxpayer and at the expense of serious interference with the foreign trade between developed and less developed countries. In view of the powerful impact this agricultural price fixing has on the expansion of the public sector versus the private sector, the amazing evolution of the "parity concept" deserve a brief survey.

Ever since the early 1930's agrarian socialists, technocrats, and many other advocates of economic dirigism in Canada and the United States have asserted the necessity of fixing the prices of agricultural commodities by government at a "fair, adequate and equitable" level because—so they claim—in the modern market economy of countries like the United States competition does not exist but is sheer myth. The modern capitalistic economy is—so the yarn runs—functioning almost exclusively under the dominating power of trusts, cartels, i.e. by monopoly or oligopoly—leaving the farmers as the only surviving producers who buy and sell in a "atomistic competition" with each other to their mutual injury. The protagonists of this agrarian socialism in their atrocious abstractions detach themselves so far from reality as to assert that not only all industrial and commercial business firms are tailoring their income by control of output and price, but that enormously powerful labor unions are also tailoring the income of the workers. Therefore, they claim it to be the only logical correction of injustice that by fixing prices of farm products at a remunerative level the government fulfills its duty and guarantees to all farmers an equitable income—something industry and labor grant to themselves.

To expose the absurdity of this caricature of the American economy one needs merely point to the fact that out of a labor force of 78 million people some 17 million are members of labor unions and none of these demands higher prices but have some control of wage rates and benefits for their members. Or one may consider the fact that any five or more farmers can form a cooperative enterprise with subsidized attorney's services and access to credit, and that more than 900 farmers cooperatives with
over 7 million members did over 12 billion dollars worth of business in 1960-61.

Among professional economists who contributed the economic analysis congelial to the yearning for state control of farm prices and the appetite for converting agriculture into a nationally and later internationally controlled cartel, Professor Fritz Runde and his socialist school took the lead in pre-Hitler Germany beginning in 1927-28. In the United States Professor Gardiner C. Means and the brain Trust of Secretary of Agriculture Henry Wallace under the first Roosevelt administration supplied similar initiative. In 1934 Means' publication *The Reality of Administered Prices* began to dominate the interpretation of the market structure of agriculture and continued to do so for many years.

When during the early 1930's policies of farm relief were first improvised but then shaped as reforms of the market economy, the theory of parity prices in 1934 was built into the farm legislation of the United States for decades to come. Parity prices were supposed to give the producers of the commodity the same purchasing power as in a certain historical base period of years when agriculture was supposed to have been reasonably prosperous, such as 1909-15. The legal definition of what constitutes parity, the base period and the statistical measures had to be revised time and again, while the Congress shifted from parity prices to income parity. For many years it has been a recognized fact that the parity concept is economically untenable and serves merely as a political excuse to set price supports at some level above what would be the equilibrium level in a free market.

The concept of parity prices and parity income is derived from the vague but charitable notion that farmers should earn an annual income which, when broken down into a wage per hour worked by the self-employed man and the working members of his family, should be equivalent to the average hourly wage earned by hired workers in industry or commerce. It has always been mysterious how one can compare earnings under totally different packages of working and living conditions—security of gainful employment, a large variety of amenities and the cumulative gain in equity in farm real estate for all owner-operators on one side and a wage income when employed and fringe benefits on the other. It is equally baffling why legislators of the democratically governed people of most advanced industrial countries have accepted the claim to parity income only for agriculture but not for the handicraft industries and the family-operated retail stores.

However, in countries with representative government by law the question of price policies is decided ultimately by the electorate. In the majority of industrially advanced countries the urban population has an overwhelming majority of the votes. It is, however, the rule for all western democracies that the tendency to grant governmental assistance to the farmers increases as their share of the votes declines. Underlying the friendly attitude of the urban voters is a sort of guilt complex toward those whom they consider as having been left behind in the march of progress, who are working harder than all city dwellers all year round, exposed to the hazards of weather, isolated and imbibe.

As I pointed out in an agricultural policy seminar of the American Farm Economic Association in 1962 at Storrs, Connecticut. This *Paradise Lost Complex* and the inverse ratio between the share of representation of the rural electorate and its political influence prevailed throughout the continental European democracies and are even more evident in the United States and Canada. This general attitude helps to explain why such an untenable economic concept as parity price or parity income is still being adhered to in the United States after more than one generation of costly distortions of the agricultural economy and embarrassing consequences in foreign economic policies, as well as in the obscured accountability of the aggregate fiscal burden of farm subsidies in their aggregate.

If, in spite of the high cost and the inadvertent drift into growth of the public sector, the idea of price control of a commodity like wheat still has a worldwide appeal, there must be an explanation. The reason lies to some extent in the successful operation of the wheat economy of the Australian Commonwealth under four prize utilization plans of five years each since 1948/49. With only 52,000 wheat farms which are for the most part operated efficiently and located in typical wheat climates the Australian Wheat Marketing System functions as a government controlled trust, in spite of nominal control by growers. It includes guaranteed prices, franchised handlers, a Stabilization Fund and the Australian Wheat Board as its sole sales agency and the largest charterer of cargo ships in Australia. The export monopoly has more and more increased sales to Red China as well as to Soviet Russia. If this unique case proves anything it is merely that the exceedingly small number of Australian wheat farmers have fared moderately well during the last 17 years with their national wheat export monopoly.

Another pragmatic reason for the continued appeal of granting parity payments to producers of basic foodstuffs is the fact that since World War I the United Kingdom has used the relatively least objectionable method of subsidizing the income from wheat. It abstains from direct intervention in the market but pays the grower the difference between a guaranteed minimum price and the price actually obtained in the market. These *deficiency payments* are limited in advance to a fixed national aggregate number of bushels and thus put the brake on expansion of production.

Yet — while this direct payment method is least damaging as indirect intervention, it has nevertheless in principle the same serious drawbacks as the more damaging ones of all other means of subsidization. The general tendency is a social limitation of payments and thereby discrimination against efficient low cost producers.

c) At the international level.

Attempts to influence if not control prices of major primary commodities moving in world trade have been made since the end of World War I by cartels of producers.
Rubber (Stevenson Plan), sugar (Chalmers Plan), cotton (Egyptian Cotton Restriction), coffee (Brazilian Valorization Scheme), tea (India and Ceylon Tea Association Supply Restriction) wheat (Canadian Wheat Pool) and tin (Tin Producers' Association) came under schemes that were designed to stabilize prices at levels which would guarantee the profitability of production and the value of the investments for the members of the cartel. Price manipulation was accomplished by control of the supply fed into the market and by restricting holding of stocks and productive capacity.

During the years of the two World Wars attempts were made to establish for some major commodities, instead of producer cartels or national price stabilization schemes, inter-governmental commodity control arrangements, which were later called international commodity agreements, or ICA's. These efforts were continued during and after World War II and at present five ICA's exist, one each for wheat, sugar, coffee, olive oil and tin. However the one on sugar is inoperative since June 1966.

The Delegation on Economic Depression of the League of Nations in its report «The Transition from War to Peace Economy» of April 1943 stated that «If the objectives of the United Nations are to be fulfilled, means must be devised for maintaining in time of peace—so far as possible—the high levels of production and employment achieved in wartime». The International Labor Office in its volume on Inter-governmental Commodity Control Agreements published in the same year explained the purposes of such arrangements in the following cautious language:

To stabilize prices at such level as to:

1. promote the constant availability of adequate supplies at prices which give a reasonable return to the efficient producer, and
2. be held sufficiently stable to afford him protection against erratic fluctuations of major dimensions, but
3. do not involve the exaction from the consumer of monopoly profits or the payment of prices held at unduly high levels to maintain the profitability of high cost capacity.

This tortuous definition of the purpose of price administration uses such stretchable concepts as «adequate supplies», «reasonable return» and «profitability of high cost capacity». It implies that price administering bodies can measure what is adequate for whom and reasonable to whom, or determine who among thousands of producers is the efficient one or where high cost capacity begins or ends.

A considerable amount of economic research on short term, long term and random business cycle theory attributed the major generating causes of the second and third types of business cycle to agriculture, namely either via disastrous weather or via overexpansion of productive capacity and output. Hence it was a logical sequence that prior to and after World War II extraordinary new, non-doctrinaire research efforts were made by many independent scholars and prominent business experts to explore new, unorthodox methods of controlling extreme fluctuations in commodity prices. Benjamin Graham's book World Commodity and World Currency of 1944 started a major project financed by the Committee for Economic Stability, conducted by Merrill K. Bennett and the Food Research Institute of Stanford University. A report was circulated in December 1947 among leading scholars of the United States and the United Kingdom — including Professor F. A. von Hayek — and published in 1949 as a book with a concluding commentary by Graham.

This thorough, reliable and sound review is, in my opinion, still up-to-date. It arrived at everything but an encouraging evaluation of the feasibility of stabilizing prices internationally by the management of buffer stocks and issuance of convertible commodity securities.

This study notwithstanding, the attempt at stabilizing commodity prices has been pursued via International Commodity Agreements since World War II.

Instead of including only exporting producer countries as in the earlier private multi-national cartels, these ICA's comprise importing countries as well. There are extreme differences between the exporting member countries of an ICA relative to a commodity like coffee—differences in the importance of that item in their economy and in their foreign trade. Such dissimilarities inevitably weaken the unity of interest and even more the prospect of agreement with the corrosive suspicion of violation of obligations by certain member nations and the impracticability of enforcement and administration of penalties by the central office of an ICA.

ICA's are meant to correct functional disorders in the international distribution of commodities:

1. short-period fluctuations of prices;
2. disorders concomitant with general cyclical business contraction or expansion; and
3. disorders which are the outcome of structural modifications in relations between existing productive capacity and the need of society for certain commodities and groups of commodities.

In order not to belittle unduly the aggravating seriousness of the problems tackled by ICA's it must be realized that a broadly accepted explanation of the causation of such severe world-wide business depression as the one beginning in the late nineteen twenties was the exorbitant overexpansion of the production of primary commodities which happened to be raw materials in a World War during the postwar period in response to price inflation toward the War's end and the impossibility of promptly contracting the output.

None of the ICA's has succeeded in stabilizing the prices or the business of the producers or in protecting the interests of the consumers. Sugar provides probably the worst example of failure. Prices in 1965 and 1966 hit the lowest level in many decades. The ICA has merely provided the accompanying cartel music of declarations of good stabilizing intentions as background for what would have happened in the international market without it. If the prices of wheat have been relatively free
from violent gyrations it was due to the fact that the governments of the United States and Canada have shoulderled the exorbitant costs of holding vast stocks themselves. These costs, of course, are borne by the taxpaying public.

Aside from what is being done under ICA’s there is the powerful supranational regional arrangement of the Six-Countries of the European Economic Community which under the Rome Treaty in July 1962 adopted decisions leading toward a common agricultural policy. This policy establishes common price levels within the Community and according to the Treaty of Rome shall: (1) increase agricultural productivity, (2) ensure a fair standard of living for farmers, (3) stabilize markets, (4) guarantee regular supplies, and (5) ensure reasonable prices to consumers. While by 1969 the Agricultural Customs Union will be completed, the methods used in the EEC to attain the ends set forth in the Rome Treaty are everything but those of a freely competitive market for farm products. Since mid-1962 EEC market organizations have been in existence for wheat and feed grains, pork, eggs and poultry, fruit and vegetables, and wine. Since autumn 1964 rice, beef and veal, and dairy products have come under market organizations, and to execute EEC policy fixed or flexible import levies are applied to guarantee a fair price level while more and more subsidies are paid to farmers for improvements in productivity.

E. The Economic Impact of Price Control.

In the present attempt to survey and appraise the impact which price control tends to have on the course of human events of nations, a few types of the most significant and characteristic economic results of such policies will be identified and weighed.

In general, in countries where it is effective, price control actually amounts to price fixing. If the movement of the price of one or more commodities is controlled by a guaranteed minimum, or a price support or floor, this level is set higher than what it would be without support—or higher than equilibrium. This stimulates the expansion of production and supply to a higher volume than what the private demand absorbs. Thus a surplus is created which must be removed from the market by government purchase and transfer into government stocks. While such stocks are temporarily locked up they still remain visible supply. Hence the price is fixed at the floor or guaranteed minimum. Minimum price fixing by its intrinsic nature creates the surplus and therefore eventually leads to attempts by the government to put brakes on supply and production in order to limit the bleeding of the Treasury.

Price control via a price ceiling or maximum that must not be surpassed usually also fixes the price at that level because it throttles the flow of supply to less than what effective demand would absorb and thereby fixes the price at the ceiling. However, this situation creates promptly by definition de facto, de lege and de jure a black market.

Price controls are at the least, even in the most highly sophisticated and elaborate forms in most advanced countries, incredibly crude, massive interventions in the enormously complex self-adjusting dynamic performance of an economy. The rigidities created cause multitudes of unforeseeable, costly side effects. These distortions are not all traceable and even less quantifiable as to extent or social costs.

While agriculture, as a biological industry with many impediments in the division of labor, is supposed to represent far less complicated patterns of economic activity than the non-agricultural spheres of an economy, the primitive modes of performance of the price control mechanism is revealed by the fact that—outside of war emergencies—only a few of the staple commodities have actually ever been kept under effective price control.

As was mentioned earlier, these basic commodities are primarily some cereals, sugar, and coffee beans. They are supposed to lend themselves best to price manipulation because they have—presumably—a relatively price inelastic demand, use controllable land resources, and in general present fewer economic problems in factors affecting price. In fact, cereal and sugar markets are fairly well explored, so far as commodity economic research goes. Coffee markets are also relatively well known.

But as soon as the next major group of food commodities is considered, we find that the complexity of the price mechanism has so far defied any exact quantifying analysis. This group consists of the major vegetable and animal fats and oils, with some 26 competitive and substitutable commodities in world trade, and very large numbers of less important varieties.

When we approach the most precious protein-bearing commodities of vegetable and animal origin we face such a tremendously involved range of price problems that nowhere in the world has research yielded more than a little useful knowledge of cyclical response of supply to the price ratio between feed and meat. Yet the price of one pound of protein in different products has, e.g. in the United States, a range from 3 cents to $12.00 as compared with a far narrower range of energy-bearing starches, sugars, or fats—somewhere between 3 cents and $3.00.

Outside of a good rationing system during prolonged wartime emergencies, price control is usually unsuccessful whenever it tries to cope with one or more items of the perishable groups of food commodities which make the difference between a crude diet of survival and a healthy diet for civilized people. These perishables comprise an endless variety of fruits and vegetables as well as an equally endless variety of animal protein foods. Among the latter are such commodities as red meat in the form of venison (e.g. meat of caribou, moose, elk, deer, wild pigs, antelopes, mountain goats, mountain sheep, bear, bisons, etc.) or in the form of meat from slaughtered farm animals (e.g. buffalo, cattle, camels, horses, sheep, goats, pigs). Also in the same group belong all white meat, again in the form of any number of hunted wild birds, hare and rabbits, or from the slaughter of farm birds (such as pigeons, chickens,
turkeys, geese, ducks, pheasants, Guinea hens, and farm raised rabbits). Finally this group comprises farm-raised eggs and several hundred items of seafood (from fish eggs or roe to water mussels, crustaceans, fish and sea-mammals) as well as ‘agricultural’ raised fresh as well as salt-water fish. The failure of price control in its application to these perishable products — irrespective of whether it is applied to one or many commodities — derives primarily from the consumer's ability to shift his day to day demand among specific products, and his habit of doing so, under the incentive of maximizing his income. The multitude of price relations brought about by price fixing intensify the consumer's substitution of other products for those with fixed prices. However, price fixing causes also a multitude of shifts in production and processing, and even more in whatever short term holding of supplies may prevail. Finally the tricky speculative aspects of storing surpluses which price fixing may create or the technical impracticability of such storing render market intervention for perishables a totally different affair from that of fixing the prices of staple commodities.

When the price of such staple commodities as rice or wheat or millet is fixed by the government at a level which piles up surpluses, these can be locked up for years at cumulative costs. (The U.S. Commodity Credit Corporation in 1966 still lists stocks of 1962 crop corn, 1963 crop wheat, corn and grain sorghum, and 1964 crop wheat, corn, barley, oats, and grain sorghum, which is collateral for a loan and can be reseized and the subsidized credit extended for another year).

However, the crudity of the interference with the self-adjusting processes of resource use in the totally decentralized realm of the agricultural and food economy causes painful distortions and misallocation of resources even when only one or a few so called basic commodities are subject to price fixing. To expose this crudity, it is necessary to consider one case in some detail.

Suppose the price of wheat comes under control. This requires first that the government determines which wholesale market and which type and quality of wheat shall represent the standard price, which will then be kept at the desired level. What prices will actually be paid at all stages back to the farmer will depend on the performance of the trade. Thus if the standard price would be e.g. Minneapolis $2.00 per bushel of wheat it might be $1.35 loco farm at Portland Oregon.

Price control next requires fixing the production capacity. Farmers who have grown wheat in recent years receive an acreage allotment, i.e. they are now on members of the cartel of wheat producers. This establishes a numerus clausus. Freedom of entry into this business is blocked, although there may be just as many farmers who in recent years grew other cereals on their wheat acreage. Since to have an allotment yields the right to a subsidized return from the production of the cartelized commodity, the freedom of entry, i.e. not to grow wheat, is also impeded.

The total national acreage allotment, ascertained by registration of all claimants to membership in the cartel, comprises of course, enormous differences in wheat yields from area to area but also from farm to farm. In order to establish some sort of justice the individual acreage allotment is translated into an equivalent of tons of wheat by multiplying the acres by the local area's historical average yield. While this creates a static geographical yield pattern, it is only the beginning of rigid bureaucratic engineering that interferes with the operation of every farm that grows wheat.

The government fixes for the next crop year the national allotment of ‘x’ tons of wheat after estimating the anticipated aggregate demand, based on domestic human, animal and industrial consumption, plus the desired carryover, and net balance of foreign trade. Following this hazardous projection of ‘x’ tons of aggregate demand, the projected quantity is broken down into state and county shares of the supply needed to satisfy it. This leads to a decision of the percentage of the acreage allotment the wheat farmer will be permitted legally to sow to wheat in the coming year with the expectancy of receiving the supported price. However, the price the farmer is to receive must be fixed at regional levels in accordance with average transportation and handling costs to central markets. This computation divides the country into a multitude of artificial price regions, with price steps at each boundary.

Since the fixed price represents a subsidy for the owner of the acreage allotment it sets as an incentive to increase the yield per acre. Therefore, the government cannot do anything except reduce the permissible percentage of the basic acreage allotment. This creates considerable injustice. Suppose the acreage is cut by 20 per cent. One farmer receives 80 per cent of his gross returns from wheat, another only 10 per cent. The cut may bankrupt the former while not affecting the latter.

Since prices fixed above equilibrium level mobilize all forces to increase yields per acre but acreage allotments are ineffective in controlling supply, the logical next step in supply control is the imposition of marketing quotas. This additional price control device, however, causes far more evils than it cures. It promptly creates a black market by designating different lots of the same commodity and the same quality either as legally exchangeable at a guaranteed preferential price or as a sort of contraband. The enforcement of such law, if it should be attempted at all, will rather undermine general obedience to law than effectively implement the control of supply.

One additional feature that is usually neither planned nor foreseen when the control of prices is adopted as a policy is a perfectly legal and logical adjustment by those who so far held, by contract or by physical possession, title to the commodity: they now abstain as much as possible from stock holding because the risk of sudden arbitrary decision by the price controlling authority is too great for them. In due time this leads to the sociatalization of stock holding in controlled commodities, namely the holding at the risk of the government, i.e., the national treasury.

Due to the use of allotments price fixing freezes the otherwise continually mobile geographical location of production as well as the
scale of production per enterprise with the result that the desirable lowering of unit costs of production is impeded. This in turn provides the incentive to producers outside the jurisdiction of the price-fixing authorities to expand production or start it in new areas, but it also provides the even more powerful incentive to the production of substitutes which diminish the demand for the price-supported original product. This unintended subsidization of competitors has occurred in many countries for a number of commodities. Price fixing of cotton in the United States has priced U.S. cotton progressively out of foreign markets, piled up a surplus that is now one year's total world export, and boosted cotton production in Mexico and South America countries. In fact, one of the prominent initiators of price-fixing policies, U.S. Secretary of Agriculture Henry Wallace, propagated deliberate withdrawal from the world market as the costly but worthy alternative to living with the hazardous fluctuation of commodity prices in the world market. Aside from freezing cotton production for over 30 years in the notoriously high cost Appalachian areas, subsidizing high cost producers, and rigidly fettering more efficient producers in more favorable locations, price fixing has led to the subsidization of all exports of cotton—which is being dumped on the world market at prices one-third below the mandatory support price to U.S. farmers—and to the subsidization or protection of textile manufacturers who use American cotton and have to compete with the imported goods made with U.S. cotton dumped abroad. While the price fixing policy reduces the acreage in 1966 by one-third, the use of the substitution man-made fibers has exceeded 42 per cent of the aggregate use of cotton and this group of substitutes combined.

The two other classic cases which demonstrate clearly how price fixing can jeopardize the entire economic foundation of primary products industries are those of rubber and coffee. The attempt to fix the price of natural rubber from Indonesia and Malaya initiated plantations in tropical Africa and South America, the cultivation of several latex yielding field crops and the development of synthetic plastomers from coal, fats and petroleum. If natural rubber production is still a promising industry in Malaya it is due to the successful lowering of costs by a multitude of biological, genetic, harvesting, and other technological and economic innovations which have jointly increased production per acre, per tree, per unit of capital invested, and per man-hour. It is further more the result of the astute and economically most sensible decision to let the price of natural rubber of Malayan origin move deliberately and freely downward. This satisfies an increased demand and impedes expansion of synthetic rubber capacity.

In the case of coffee, the valorization scheme and the later ICA's have strengthened the rise of coffee production in Africa and Asia, the breeding of extremely fast and high yielding low elevation (Robusta) varieties, and the mass production of instant coffee. This method of coffee processing yields roughly one-third more coffee in the cup from the same amount of beans as well as facilitating the blending of low cost varieties with a seasoning of high cost (Arabica) ones which require high elevation.

Another, and in the long run even more serious consequence of the price fixing of agricultural commodities is the capitalization of the allotments of licenses in the value of the farm real estate. The benefit implied in the subsidized price of the commodity boosts the price of the farm with an allotment, and as soon as the farm is sold the higher land value becomes an element in the cost structure of the commodity. Abolition of this price fixing policy would probably eliminate this differential land value between such farms and cause their value to decline.

Commodity price stabilization is being attempted in the United States by compulsory cartels on the basis of state or state-and-federal legislation in the case of certain selected perishable commodities, such as fruits and vegetables — or of milk and dairy products. In 1935 there were in force 25 such State Marketing Orders for certain varieties of peaches, pears, plums, prunes, strawberries and walnuts, and 7 for a few specific vegetables. The only one of these marketing orders which may have had some beneficial impact concerned canned cling peaches in California — and even this is most dubious. This evaluation emerged from an intensive research project in depth which Dr. John A. Jamison and I took before retirement as Director of the Food Research Institute of Stanford University. With reference to the regulation of retail milk prices, 26 states had introduced such price fixing at producer, wholesale, and retail level beginning in the depth of the depression in 1933. Beginning in 1935 states began to abolish such regulation and by 1963 no less than 18 states had done so. Only 14 states had them still in operation in 1965. Thorough study by the most competent scholar, Professor Roland W. Bartlett of the University of Illinois has established beyond doubt that by keeping distribution margins and retail milk prices unnecessarily high and by discouraging the introduction of new lowest methods, state regulation of consumer milk prices has curbed milk consumption, ...and has definitely been undesirable and against the public interest.

Under-estimation of the resiliency and unpredictability of the evolution of an economy with freely moving prices by those who would cure the imperfections of the market by price control does the greatest damage in countries which depend heavily on earnings in foreign trade. This applies to highly industrialized countries as much as to exporters of primary products. Food, after all, is the basic raw material of the most advanced industrial countries, and its price enters into the cost of living and the cost structure of all manufactured goods and of all services and thus into the purchasing power of the national currency and its badly needed basic stability.

F. The Political Impact of Price Controls.

So far it has been shown that the economic impact of price control, even if applied to only a few agricultural commodities, involves varying degrees of costs which may go so far as to cause serious jeopardy to the
economic growth and stability of a nation. It remains, however, to cast an eye on the political costs of this sort of state intervention.

No matter how cautiously the abrogation of the free movement of prices is undertaken, it gives the executive branch of the government extraordinary power of administrative decision on strictly economic affairs and power of punitive action in enforcing control. Instead of merely guarding the observation of the rules of free competition and assuring protection from coercive or fraudulent practices by any parties in the market, the government is now no longer performing the duty of an umpire but playing the role of a monopolistic business agent through its politically determined administrative action. Government outranks as the competing monopolist all private firms.

Since any decisions made by the respective members of the civil service have a far reaching effect on the value of stocks of the price-regulated commodity and on the capital value of facilities for transportation, storage, processing, and contracts, such decisions bring windfalls of unexpected gain to some parties and losses to others. Foreknowledge of decisions offers opportunity for exorbitant gains or avoidance of losses. This creates in any country the opportunity for corruption of administrative officers or members of their staff. Either they or their relatives or friends cash themselves in or they yield to bribery by those who seek the leakage of such information. If a country's civil service is already beset by corruption its engagement in any price fixing policies tends to make it more corrupt. One of the U.S. Under-secretaries of Agriculture, Dr. John Schnittker, has stated accurately and with great candor in a formal address on July 11, 1906 at the Centennial Observance of U.S. Crop Livestock Reporting, that security measures must be observed with the greatest severity when the July crop Report is becoming know to the officials. He said there would always be the danger of leaks that would benefit the speculative interests at the expense of the producer and consumer.

The developing scandals, real or insinuated by militant politicians, tend to undermine the faith in or the electorate in the honesty of the government and play into the hands of plotters and anarchists.

Even if the administration of price control is free from illegal or corrupt practices, the distribution of material benefits by administered prices establishes a vested interest among all groups which benefit from such policy. To defend their benefits, pressure groups have come into existence because of the windfalls. Their activity makes any change in such policy or the termination of it extremely difficult—as shown by more than 30 years of an economically untenable policy of price fixing of farm commodities in the United States and many European countries. Beneficiaries of windfall earnings from the purchase, storage and disposal of, say, exorbitant surplus grain stocks by the government that fixes grain prices range from farmers to operators of truck and railroad freight carriers, grain elevators, inland and ocean cargo boats, and all labor unions involved.

The large number of civil servants employed in connection with price control operations and the concurrent law enforcement and supervision become an influential lobby of their own that uses its power to maintain, if not expand, price control. This applies to national as well as international price control policies.

It is almost redundant to mention that such political vested interests are not confined in their action to domestic political affairs of one or another country but that such group interests invariably try to arrive at close cooperation with similarly oriented groups in other countries. The European Economic Community (EEC) stated in the May 1959 issue of its bulletin (No. 92), published in five languages: The Six Community countries already apply a common policy amounting to $5 per cent of their total output. EEC market organizations which have been in force since 1962 cover wheat and feed grains, pork, eggs and poultry, fruit and vegetables, and wine. Since autumn 1964, rice, beef and veal, and dairy products have been under a Community policy and other market organizations will be established according to the Council timetable.

G. Free Society Policies Concerning Prices.

The inevitably apathetic survey of major defects of price controls and their high economic and political costs to society leads to the pertinent question whether the exclusion of any manipulation or control of prices leaves the Free Society only the alternative of a do-nothing or laissez faire policy and reliance on competition as the sole corrective force. As remains to be shown, such a dogmatic laissez faire course is not only remote from the realities of the worldwide combat against the enemies of the Free Society, but it evades the crucial need for fortification of the real foundations of the non-coercive economy and thereby contributes its share to the self-destruction of political democracy.

The market economy, with its freedom and enterprise and allocation of resources by the consumer, depends first and last of all on harmony between the core of values to which the society adheres and the set of laws that establishes the system of order for all economic activities. The more wisdom and prudence pervades this framework, the more it is obeyed by the people and gradually ascended, the less urgently and frequently will there be need for corrective governmental interference in the economic process and for coercive action.

The rules for the market economy must anticipate and provide leeway for continual structural changes in the economy as the aggregate result of the allocation of all resources by the people through the price system. The rules must also provide for changes in the functional performance of all individuals, families, and groups active in the economy and dependent on it.

These rules, laid down in the law and enforced by jurisdiction under due process, must provide for the exclusion from the economy of free exchange such practices by individuals or group as acquisition of goods or services by force of any sort, including particularly the power of monopoly, duopoly or oligopoly, or by deception or fraud.
In other words, in order to function properly the free market economy requires the protection of all responsible, self-disciplined and law-abiding citizens by a market police, just as the free use of highways requires law enforcement by a highway police.

The government should do everything possible under the law to keep the entire market, including particularly the market for agricultural commodities, free from interference with or restriction of competition and should assist all private enterprises in improving the flexibility and effectiveness of the price system.

Among policies to strengthen the market system are the following:

(1) Keep the national currency stable in its purchasing power and freely convertible.

(2) Protect the freedom of contract and enforce the fulfillment of all valid contracts under due process of law. Advance the clarification of specifications of what is actually contracted between the parties concerned.

(3) Provide facilities for trading of contracts on future delivery of commodities, as well as commodities at wholesale or retail level and protect all parties against fraud, intimidation, or coercion of any kind.

(4) Establish standards and grades of quality for all agricultural commodities in order to make prices meaningful, and thereby reduce the opportunity for breach of contract and defrauding of farmers or consumers by enforcement of such standards and grades.

(5) Make all markets as transparent as possible by truthful information to the public on all prices, including the declaration of the content in standard measures of weight or liquid content on any containers, and declaration of ingredients mixed into food or feed products (cf. the tenor of the U.S. Pure Food and Drug Act.). However avoid bureaucracy regulation beyond this proper supervision.

(6) Outlaw any attempts at preventing, restricting or impeding competition through the passage and enforcement of anti-trust legislation, which must apply to all individuals, groups, corporations, and include, particularly, all cooperative associations, employers’ associations and labor unions.

(7) Abandon any attempts of ‘allotments’ of permissible use of land or any other resources, as well as any attempts at planned control of supply, particularly including marketing quotas, irrespective of whether applied equally to all producers or with discrimination against efficient large scale producers.

(8) As a transitional method permit the irrevocable sale of allotments under open bidding and their transfer by the buyer to any land he chooses. This will restore the now frozen mobility of the location of enterprise.

(9) Open the market to competition from abroad as the most effective discipline to strengthen the progress of productivity in the domestic economy.

(10) Remove any import quotas or other quantitative restrictions, such as compulsory ratios of domestic or foreign commodities in trading, processing, or use.

(11) Abstain from all other forms of protection against foreign competition in lieu of tariffs, particularly by excise taxes, ‑‑ buy national product requirements in public works, arbitrary price definition for imports, ‑‑ peril point ‑‑ criteria, escape clauses, packaging requirements, extreme protective requirements on the basis of human, animal, or plant health, and a multitude of others.

(12) Insofar as protective tariffs exist abstain from flexible rates which give the state bureaucracy the freedom of arbitrary power decisions on closing a market completely to foreign competition.

(13) Abstain from any International Commodity Agreements or other forms of valorization of commodity prices, such as buffer stock schemes, but support compensatory financing by the International Monetary Fund.

(14) Instead of supporting low income groups in agriculture via price supports of commodities, offer for a period of 5 years diminishing tax benefits to any enterprises that employ farmers or members of their families on or off the farm for more than a certain minimum number of days per year.

(15) Mitigate further the social hardships caused in the transfer of manpower from agriculture to other activities by educational as well as financial assistance to support this essential adjustment for economic development which must rely on the young generation, not the aged people in their understandable lack of professional, geographical, social, and cultural mobility.

(16) Encourage contract farming in the production of commodities by one season contracts between competitive processing or trade enterprises and farmers, irrespective of the size of their farm or whether they are proprietor or tenants.

(17) Instead of ruining the most efficiently operating price-oriented agricultural enterprises, the large scale plantations, by discriminatory tax, wage, social security, foreign exchange and commodity price control regulations, stop this ideological craze and adopt a positive policy of using these enterprises for the benefit of all small producers. Provide by appropriate legislation the proper frame for a development triangle—a plantation, a processing plant, and a cooperative association of small and medium sized farms. Induce the plantation and the processing plant to function by this arrangement actually as the Agricultural Extension Service which makes the last word of technology available to small producers.

(18) Instead of accepting the propaganda verdict of the socialist planners of all shades that asserts that private enterprises cannot individually or collectively develop the ‑‑ infrastructure ‑‑ of industrially retarded economies, encourage enlightened governments to invite leading foreign enterprises to develop indigenous natural and human resources
on the basis of staked-out bona fide concessions of 15 to 20 year's duration with the obligation to create the needed infrastructure and the freedom to transfer earnings and to sell shares to citizens of the host country.

Conclusion.

What has been stated in response to the question «How Should Prices Be Determined?» can be summarized as follows. All improvements in economic research and statistical analysis of past and present fluctuations of prices and the responsible cause and effect relations have not provided governments with any methods of price control that avoid the by-product of serious rigidities, misallocation of resources and unforeseeable structural and functional distortion of an economic system at its basis. A competitive market economy with freely moving prices and the freest communication with the world market — particularly when aided by unfettered speculative trade in contracts on future delivery of commodities — offers a far greater assurance of avoiding disastrous descent or skyrocketing of prices than any kind of price control. Price controls applied to agricultural commodities have in any country and at any time the powerful innate tendency to spread governmental controls into more and more spheres of enterprise. This derives from the fact that competition is an exit with 500 lives and tends to undermine price control systems, particularly when they are enclaves in a more or less free market.

In the interests of the healthy growth and stability of an economy, farm commodity prices must remain free and flexible because in an efficiently functioning agricultural system the agricultural producers derive their orientation for the utilization of land by their management, labor, and capital not from the price of one or two products but from the continually changing relations between the prices of all products, particularly the relations between animal products and crops, and between low and high yielding crops.

The need for the rule of leaving prices of farm commodities free from control and market intervention is nowhere as compelling as it is in agrarian countries with a major part of the labor force engaged in agriculture. No government has found a method of forcing farm people via control of prices or supplies to contribute an optimal share to the nation's gross national product at declining unit costs.

Fixing farm prices at a lower than equilibrium level as a subsidy to urban consumers or as a source of capital for public investment in new industries is blocking the road to industrial development by preventing the consumer from adjusting his diet to the changing nutritional requirements of urban work. This in turn impedes the productivity of industrial workers. Industrialization at the expense of agricultural development congests the prospect of serious food shortage, sudden import deficits in the balance of payments and jeopardy of the stability of the currency.

Whatever policies the government of an industrially advanced country may pursue either to mitigate social hardship involved in the necessary transition of manpower from agriculture to other work or to relieve disaster due to natural or economic causes, such policies should strictly avoid interference with the price mechanism and the competitive market. Any aid given should assist people in finding the places in the developing economy where they can make their optimal contribution rather than keeping them at public expense in untenable positions.

KARL BRANDT

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(The most comprehensive and penetrating theoretical and dynamic analysis of basic commodities and Resource Development.)

Riassunto — L'autore in questo articolo esamina gli enormi costi economici, sociali e politici necessari per correggere le imperfezioni dei prezzi dei liberi internazionali e internazionali sul mercato per cercare di stabilizzare o controllare i prezzi. Egli considera gli sforzi che i paesi aderenti ad una economia di libero mercato hanno sostenuto da più di mezzo secolo per realizzare politiche di prezzi riguardo ai principali prodotti agricoli, e valuta i risultati in termini di efficienza e di distribuzione delle risorse. Conclude che i controlli del mercato e la stabilità del prezzo allenano sostanzialmente i produttori di grano e il settore agricolo. Per contro, non si assiste a una diversa situazione nel settore del cibo e del riso, dove i controlli sono meno efficaci. L'autore conclude che, in generale, il sistema di controlli dei prezzi è inefficace e che è necessario un approccio differente per stabilizzare il mercato agricolo internazionale.
PRICING POLICY FOR STATE-OWNED ENTERPRISES

by G. Warren Nutter (*)

To the theorist, the problem of how a firm should set its prices poses no great difficulty: let it simply equate marginal cost and marginal revenue when both are properly defined. This rule, he will tell you, applies no matter who owns the firm, who manages it, or what circumstances surround it. What more, he will ask, does one need know? Nothing at all, except how to put the rule into effect. One can hardly quarrel with logic, and the rule of equating cost and revenue at the margin is impeccable logic since it is another way of saying that a firm should do the best it can under the circumstances. But how the firm does that is a question of management and entrepreneurship, not logic.

The formal problems of efficient management are the same for all firms, regardless of the nature of property rights. Costs are to be minimized, price and output "optimized". With these ends in view, activities must be organized and controlled, basically through a chain of command but also, in varying degrees, through mutual interaction. Organizing activities in an efficient way is the key problem of a firm, and success in resolving it depends on motivation of agents, elements, and units throughout the firm's structure, from top to bottom. Motivation, in turn, depends on the nature of property rights.

It has been refreshing to see economists revive their interest in the question of how property rights influence the behavior of firms. With the important work of Professor Armen Alchian and his associates, we are beginning to build a framework for systematic analysis of this question. The only other one has been Marxist doctrine, which has scarcely established a record for accurate prediction. In my brief discussion here, I will try to follow Alchian in focusing on how property rights affect the pricing policy of firms, in order to prepare the way for useful analysis of the state-owned enterprise. Emphasis throughout will be on how firms do behave, not on how they should. For there is little point in trying to prescribe behavior that is unlikely or even impossible.

I. Consider the classical firm cast in the role of an enterprise within a market economy and a regime of private property. The entrepreneur — the owner of the enterprise itself but not necessarily of the capital invested in it — is interested in earning as much as he can. This simple motive combined with the entrepreneur's skill determines the size of the firm, or how many activities are organized within.

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It and how many through the market place. It also determines the methods of organization used and the costing and pricing policies followed. Whatever increases the entrepreneur's earnings for a given effort will be done; whatever decreases them will not be. Private property and freedom of enterprise fix simultaneously the firm's role in the economy, costs incurred, prices charged, and output produced.

There is nothing automatic about this process, of course. The firm must be managed in accord with the owner's interests, and this task grows geometrically with the size of the firm. Proper orders must be both given and obeyed, and hired managers and workers as such normally have no direct interest in either giving or obeying orders that benefit the entrepreneur alone. The entrepreneur must therefore link the manager's interests to his own through surveillance or partnership, in varying degrees and mixtures. Managers must do the same with respect to workers.

Badly supervised management must be expected to press forward its own advantages to the detriment of the entrepreneur. If salaries are fixed, other means will be found to raise incomes at company expense. Secretaries will be hired for beauty as well as and instead of efficiency; offices will be comfortably furnished with plush carpets and original paintings; richly appointed executive dining facilities will be arranged on the premises; a park of limousines and aircraft will be set up and staffed with courteous and personable chauffeurs and pilots; ample allowances for business entertainment will be provided; and so on. Ways will also be found to reduce the workload: banker's hours, lengthy business lunches, conferences on the golf links, and so on. Lesser workers and employees will have more limited opportunities for on-the-job leisure and perquisites, but they will not lack ingenuity in exploiting them.

Mismanagement may go undetected as long as it merely keeps the entrepreneur's earnings lower than they might otherwise be, but it is immediately brought to light when it results in actual losses. Private property sets a limit to divergence of interest between manager and owner. Lack of success in one or the other—management or entrepreneurship—will eventually be eliminated by the ultimate disciplinarian: bankruptcy.

II. Private property rights are, of course, never absolute, being always restricted by the political order of any society. Property rights in far measure the degree of the holder's liberty; the amount of property together with the rights, the degree of his power. It is clear that the pricing behavior of a firm will depend directly on the nature of property rights held by its effective owner.

For example, let the owner's earnings be taxed at a flat percentage rate. It is now in his interest to consume some of his income in perquisites enjoyed through his business. Like the badly supervised manager, he will try to set up a well-appointed office staffed with attractive personnel, and to add other well-known side benefits. Business affairs will be discussed at expensive restaurants and night clubs, or in conferences scheduled at pleasing localities. In hiring managerial personnel, it will become worth while to pay less attention to managerial talents and more to conversational skill, golfing or bridge-playing abilities, and the charm of wives. Tax authorities will naturally frown on such practices, but they can control them only to a limited extent short of taking over actual management of the firm. And then similar practices would arise to the benefit of the tax office.

In other words, costs of doing business will rise as the entrepreneur takes advantage of his firm as a place for consuming services at a bargain rate in terms of net earnings forgone. The changed cost conditions will probably also lead to higher prices and lower output as well as smaller take-home earnings.

Let us take one further step and fix a progressive schedule of tax rates beginning with the flat rate already supposed. Presumably even more income will be consumed through the firm, raising costs and prices and lowering output and earnings further. If the tax rate becomes confiscatory at some point, the entrepreneur loses all personal incentive to realize higher earnings. He will try to gear his business so as never to generate more than that maximum net revenue before taxes, eating up any excess in perquisites if necessary, unless motivated by patriotism or concern for the public good as attended to by government out of tax revenues. Such motives may be high, but they are not always strong or abundant.

III. How do these situations differ from behavior of a state-owned enterprise? The first thing to do is to identify the effective owner. If an abstract entity such as the state is to be called the owner, then government must be the concrete agency charged with trusteeship. Government will be of some definite form, ultimately responsible to some group of persons for whom it is acting as agent, and it will presumably be responsive at least indirectly to their interests. Ultimately, then, the persons controlling government are the effective owners of state-owned enterprises, while government or some part of it serves as manager.

The interests of owner and manager will diverge here just as surely as within a regime of private property, and the means of bringing accord are the same: surveillance and partnership. But the political order raises new problems. In the first place, it is seldom easy or sensible to change a government because a single enterprise has been mismanaged. In the second place, mismanagement is not readily recognized by interested parties and communicated among them.

Government is, after all, a unified institution, capable of only a limited degree of compartmentalization. In the market for private property, on the other hand, ownership can be subdivided almost indefinitely, and each owner can divest himself of his property at any time. Hence management of a single enterprise can be turned over at any moment without materially affecting the rest of the economy, and
awareness that something is wrong in an enterprise is quickly transmitted from owner to owner through transactions in capital markets.

An even graver drawback for state-owned enterprises is virtual absence of the ultimate discipline of bankruptcy. In principle, there may be no reason why each enterprise cannot be endowed with its own limited capital and be forced to make its own way on its own resources, being put into bankruptcy when it becomes insolvent. But in practice every government is reluctant to follow this course: an enterprise serves political as well as economic ends; bankruptcy reflects on the credit of the government itself; receivership for collective property can hardly be transferred from the political arena; and so on. It is generally more expedient to subsidize a floundering state-owned firm than to put it into receivership or out of business.

In the face of all these difficulties, how can those to whom government is responsible keep a close eye on the efficiency of governmental enterprise, in the first place, and remedy divergence of interest, in the second? Few examples of institutions successful in promoting these objectives come to mind.

IV. The sheer technical problems of costing and pricing in state enterprises are minimized when they operate within a general environment of private enterprise, since the market place resolves most difficulties. As ocean of private enterprise will determine the value of a bay of governmental enterprise. It is only when the roles are reversed that the problem becomes serious. Are prices and activities to be set by some central political organ or by some kind of market or quasi-market? This is the subject of debate now in the Soviet Union and its European satellites.

One hardly needs to catalogue the shortcomings of a centralized command economy. They are well known and acknowledged, perhaps most forcibly at the moment by commentators in the Soviet world itself. The virtues of decentralized decisions and mutual interaction are recognized throughout most of the civilized world today, and all Soviet economies except Communist China and its allies are seeking ways to decentralize economically while preserving an authoritarian political order.

These efforts are bound to be disappointed. Mutual interaction in an economy dominated by governmental enterprise can be accomplished only by subdivision of political authority, since collective ownership must be divisible into units subject to mutual competition if effective markets are to arise. The larger the economy, the more intensive the divisibility needed. Some form of federated government would seem to be essential for effective economic decentralization within a regime of collectivized property. This is not to say that the extreme form Stalinist economy cannot be improved upon without sacrificing an authoritarian political system. Yugoslavian is a case in point. Quasi-markets were created by establishing semi-autonomous collectivized enterprises with the right, although limited and controlled, of competing with each other. Obvious improvements in efficiency have been experienced without an immediate threat to the political system, but serious problems have also accumulated that may have no easy solution without political changes as well.

V. We come finally to the question of how state-owned enterprises should set prices, and we cannot answer this question without prescribing a political order as well. Otherwise we are engaging in idle chatter, just as we do when we complain about the weather. There are, of course, better and worse ways of managing governmental enterprises within any political system, but the room for manoeuvre is small and the issues boil down essentially to narrow technical questions of how to improve surveillance or harmony of interests. The more interesting issues all quickly acquire political overtones.

If we confine our attention to a decentralized democratic system, the basic advice would be to create institutions forcing each state enterprise to make its own way and unifying the interest of management and public. Whether it should be encouraged to maximize earnings will depend on its monopolistic position, but in every case it should be designed so that costs are minimized. Compensation of managers should clearly be tied to success of the enterprise, and the enterprise should be subordinated to the lowest possible political unit. But such advice makes sense only on a constitutional level. Unless the electorate is willing to agree to self-denying ordinances determining the proprietary status of governmental enterprises, the latter will quickly become something else affect on political seas. There will be no point in complaining about their management since it will be determined by political tides of the moment.

In short, the basic problem is to create for the political order an institution comparable to private property. That is all there is to it, but that is enough.

G. WARREN NUTTER

Riassunto — La teoria economica classica non dice come la produzione dovrebbe essere organizzata nelle imprese statali. La regola fissa che il costo marginale dovrebbe uguagliare il prezzo non ha contenuto operativo e non significa niente più che minimizzare un comportamento razionalmente.
Il meccanismo direttivo in regime di capitalistico deriva originariamente dalla istituzione della proprietà privata, che fornisce un incentivo ed una disciplina per una efficiente organizzazione e direzione della produzione. Una tale efficienza può essere in regime di controllo statale solo se si trovano alcuni mezzi per suddividere l'ordinamento politico in maniera tale che la proprietà collettiva diventi divisibile in unità soggette a concorrenza reciproca e responsabili del loro operato. Il problema di base è quello di creare per l'ordinamento politico una istituzione paragonabile alla proprietà privata.

IV.

ECONOMIC POLICIES IN DEVELOPING COUNTRIES
DEVELOPMENT PLANNING, FOREIGN AID
AND ECONOMIC PROGRESS

by P.T. Bauer (*)

I

I intend to examine critically two related, dominant themes of the contemporary discussion of policy for the economic development of underdeveloped or developing countries (these terms are, in fact, euphemisms for poor, or more exactly technically backward). The first is that economic advance requires comprehensive, central development planning, in the sense of a large measure of government control of economic activity outside subsistence agriculture. The second is that a tolerable rate of material progress of poor countries necessitates large scale foreign aid in the sense of inter-governmental grants or heavily subsidised loans. Although the first refers primarily to domestic policy, and the second generally to international policy, the two themes are inter-related in several ways.

There is a great need for a critical examination of these ideas. The two themes are treated largely axiomatically in much current discussion. It is very generally assumed that comprehensive development planning and foreign aid promote material advance; indeed, they are often seen as a necessary or even as a sufficient condition for such advance. Once a policy is axiomatically accepted as desirable, either progress or stagnation can be instanced with superficial plausibility for its continuation or extension: progress is evidence of its success, and retrogression or stagnation as evidence of the need for its reinforcement. Thus both the economic and the wider social and political repercussions of the policy are accepted without examination. Even its constituent elements escape effective criticism, because they can always be justified spuriously as elements of a policy which is desirable overall.

II

The contemporary development literature widely assumes that comprehensive development planning is a condition of economic progress. I shall illustrate this with some passages from the writings of Professor Gunnar Myrdal who is one of the most influential social scientists today. He writes: "It is now commonly agreed that an underdeveloped country should have a national economic development policy. Indeed, it should have an overall, integrated national plan, as is also urged by everybody. All underdeveloped countries are now, under the encouraging and congratulating applause of the advanced countries, attempting to furnish themselves with such a plan... What we witness is how this much

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more than half of mankind living in poverty and distress is not only accepting for itself the persuasion on a grand scale of a policy line which we are accustomed to call 'socialistic,' but that positive and urgent advice to do so is given to them by all scholars and statesmen in the advanced countries and by their governments when participating in solemn resolutions of all the inter-governmental organizations. Apparently nobody in the advanced countries sees any other way out of the difficulties, which are mounting in the underdeveloped countries, than the socialistic one, however differently one's attitudes may be towards the economic problems at home>(1).

He writes elsewhere: «The special advisers to underdeveloped countries who have taken the time and trouble to acquaint themselves with the problem, no matter who they are, all recommend central planning as the first condition of progress» (2).

It is, of course, not true that all economists think that comprehensive planning is necessary for material progress. There are many prominent economists who deny this, for instance Professors Haberler of Harvard, Friedman of Chicago, Frankel of Oxford and Yamey of London. It is true that practically all advisers to governments of underdeveloped countries favour comprehensive planning. This is because only those who accept the current orthodoxy are appointed as advisers which reflects the method of selection and not the consensus of economists (3).

Professor Myrdal is also right that most economists in this field share his views. Discussion of the reasons for this would tempt us into the treacherous fields of the sociology of knowledge. This would be inappropriate here because we are concerned with the validity of arguments and not with the reasons for their popularity, which have nothing to do with each other.

Nor are these views academic advocacy only. Comprehensive development planning is the essence of economic policy in many parts of the underdeveloped world, notably so in India. And because such a policy is now widely regarded as a condition of economic advance, governments pursuing it are treated preferentially in the allocation of foreign aid, as they are regarded as helping themselves, and thus deserving of support.

In both the official and academic literature development planning is envisaged as comprehensive and detailed control over the economy. Once again, Professor Myrdal supplies a convenient formulation: «The plan must determine this overall amount and must, in addition, determine the proportions of the capital which should be allocated in different directions: to increase the overall facilities in transport and power production; to construct new plants and acquire the machinery for heavy industries and for light industries of various types; to raise the productivity level in agriculture by long-term investments in irrigation schemes and short-term investments in tools, machinery and fertilizers; to improve the levels of health, education and training of the working people, and so on. To be practical and effective, the plan must be worked out not only as a general frame, but must have this frame filled and concretized by careful segmental planning. And it must contain definite direction on all points and, in addition, spell out instructions for the specific inducements and controls by which the realization of those directives becomes effected» (4). Comprehensive development planning thus means that what is produced is determined largely by the government rather than by the individuals comprising the society.

These passages which could be easily multiplied, simply assert that an economy will progress more rapidly if the government rather than individual consumers and producers determine what is to be produced. They assume this result axiomatically, without argument. But such policies do not augment resources, they only centralize power. As will be noted, Professor Myrdal in the passages quoted does not say how and from where the resources for his projects are to be provided. It is certainly not clear why and how the overriding of the decisions of individuals should increase the flow of income, especially that of desired goods and services which constitute the standard of living. Yet, if development is meaningful as a desirable process it is appropriately discussed in terms of general living standards, and not simply in terms of collections of physical goods and services unrelated to consumer demand and standards of living.

Comprehensive development planning is more likely to retard than to promote material advance. This conclusion derives primarily from a simple fundamental and yet widely-ignored consideration, namely that an economy consists basically of people. The performance of an economy is always substantially influenced, and usually even largely determined, by the qualities, attitudes and motivations of the people. And its performance is appropriately judged by the standard of living which it yields to the population at large.

The peoples of underdeveloped countries cannot hope to secure the material living standards of the West without the corresponding human

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(1) Development and Underdevelopment, Cairo, 1966, p. 43.
(3) Moreover, followers of the orthodoxy regard economists who do not share their views as disqualified. This is explicit in a recent book by Professor John P. Lewis, head of the Indian operation of the U.S. Agency for International Development. «This is what he says: "It has been decided in India that it is the duty of government — and it cannot be delegated — to create and maintain that "growth perspective" which, Albert Hirschman has rightly insisted, is the sine qua non of economic development. Outside supporters of the Indian development process who refuse to accept this proposition will find disqualification themselves from the outset.» Quiet Crisis in India, Washington, 1962, p. 23.
(4) Development and Underdevelopment, pp. 63-64.
qualities, attitudes and motivations which have made these material living standards possible. It is the differences in these qualities and motivations which largely explain differences in economic performance and in living standards. There are great differences in economic performance between different peoples, in much the same way as there are between individuals. These differences in performance, in turn, reflect differences in such qualities as industry, thrift, enterprise, ability to take a long view and readiness to perceive and exploit economic opportunity. We do not know the factors behind these differences in economic qualities, notably the relative importance in this context of various historical, biological, climatic or institutional factors. I want to make quite clear that I am talking here solely about qualities making for material success. These are not those which necessarily give dignity to life or happiness to those who possess them. For instance, they do not necessarily include sensitivity, a sense of harmony, a capacity to love or a reflective turn of mind. Moreover, material success does not guarantee happiness, understanding, sympathy or contemplation. The differences seem to go back a long way, though they are probably not fixed for all time.

The social and institutional background is almost certainly an important factor behind these differences in economic qualities and performance. For centuries, and perhaps even millennia, this background has been generally more favourable in the West than in Asia and Africa to attitudes, motivations and qualities encouraging material progress, chiefly because it has been less authoritarian in the West than in Asia and Africa. The subjection of the individual to authority, including both political authority and the authority of traditional values and attitudes, discourages the qualities behind material progress, notably the spirit of experimentation, a questioning turn of mind, and an interest in material advance. Revision of the attitudes encouraged by authoritarianism is required for material progress in the sense of a general rise in living standards. It requires a modernisation of the mind.

Extension of state control continues and reinforces the subjection of the individual to authority. It goes counter to that liberation of the individual from subjection to authority which is required to encourage the qualities, attitudes and motivations behind material advance. This is the prime reason why comprehensive development planning, so far from being a necessary condition for material progress, is more likely to obstruct than to promote it.

Large-scale development planning also means that whatever is produced is largely unrelated to the demands of the individuals comprising the society, and thus to living standards. Thus, even if there were an increase in total production compared to what would have occurred without these policies, this is likely to be unrelated to living standards.

There are various factors reinforcing the strong general presumption that comprehensive planning is more likely to retard than to promote a rise in total output, and even more in general living standards. Close economic controls restrict occupational and geographical mobility within the economy, which obstructs the establishment of new contacts and the spirit of experimentation, including the opportunities of setting up new enterprises. Mobility and experimentation promote material progress in a number of familiar ways. They often serve also to undermine, without coercion, traditional attitudes and customs which, especially in poorer countries, are major obstacles to material progress.

These controls necessarily extend to external economic contacts, including trade, capital movements and migration. And these flows normally serve as vehicles not only of physical commodities and financial transactions, but also of new attitudes and ideas, crops, methods of production and wants. They have often served to engender a new outlook toward material progress, and to undermine values and customs adverse to it. These results have been brought about by voluntary ad justments to new opportunities, without the costs and hardships of coercion.

Development planning implies close government control over the livelihood of the population. In such conditions the achievement and exercise of political power becomes a matter of widespread anxiety and acute concern, particularly among the active elements of the population. When state power is extensive, it becomes very important by whom and how the power is wielded. This situation increases the stakes in the fight for political power which diverts the energies of ambitious and enterprising men away from economic activity into political life. It intensifies the struggle for political power which enhances political tension. This is particularly notable in multi-racial societies.

Within economic activity, the conduct of people comes to reflect the dependence of material success on political decisions and administrative favours rather than on economic efficiency and enterprise. These various factors obviously impede material progress.

These results or corollaries of state control of economic life depend largely on the closeness and the types of state control of economic life, matters which cannot be inferred simply from statistics say of the size of the public sector. For instance, government expenditure may be comparatively small, and yet government control over the economy close if there is extensive licensing of economic activity. Conversely, even if government expenditure, as proportion of the national income, is substantial, this need not imply close control over the economy, if the expenditure is on the familiar traditional functions of government. Thus in assessing the political implications of government intervention in economic life the character or form of the intervention is of major relevance and this character cannot be inferred from easily available statistics.

When there is close state control of economic activity, the conduct of people comes to reflect the dependence of material success on political decisions and administrative favours rather than on economic efficiency and enterprise. These various factors obviously impede material progress.
These criticisms of comprehensive planning do not in the least deny that there is a very extensive range of essential government tasks in poor countries. Although the list should be familiar, it still bears spelling out. It includes the management of external affairs to the best interests of the country; the maintenance of law and order; the effective management of the monetary and fiscal system; the promotion of a suitable institutional framework for the activities of individuals; the provision of basic health and education services and of basic communications; and also agricultural extension work. In fact, preoccupation with development planning and especially with the establishment of closely controlled economies has brought about widespread neglect of these essential tasks. The governments seem anxious to plan, but unable to govern. One reason perhaps why the traditional and well-recognised functions of government are so widely neglected is that although they are generally necessary for economic progress, they do not involve close and intensive government control over the lives of individuals.

III

As noted earlier, much of the contemporary discussion the case for comprehensive planning is regarded as axiomatic. At times, however, it is supported by arguments which seem at least to be based on technical reasoning and to have specific content. On closer examination they turn out to be spurious.

Comprehensive planning is sometimes regarded as required to increase investment expenditure. This argument is irrelevant, because saving and investment can be encouraged by a budget surplus, or by various fiscal, financial and institutional measures designed to promote private saving and investment. Moreover, a piece of expenditure does not become productive simply by labelling it investment. The case for an investment programme cannot, therefore, be taken for granted. Its merits can be assessed meaningfully only after estimating prospective returns, set against the costs in terms of alternative uses of resources. It is necessary to take into account also the repercussions both of the collection and of the expenditure of the resources. Moreover, to be meaningful in the context of economic development as a desirable process, the return should refer to an increase in the flow of income, especially of those goods and services which constitute the standard of living.

The contemporary ideas that development depends essentially on investment is responsible for enormous waste throughout the underdeveloped world. By justifying spuriously all expenditure termed investment, it has encouraged spending, regardless both of cost in terms of alternative uses of resources, and of the repercussions of their transfer. Indeed, in current parlance all expenditure of money other than on current consumption or current government service has come to be termed investment and regarded as productive of income, and hence desirable. This itself encourages wasteful expenditure. Moreover, it also provides spurious justification for a wide range of specific controls on the argument that their imposition is necessary to permit a particular level of investment expenditure; and these measures are likely to inhibit both the economic allocation of resources and also their growth.

The emphasis on investment expenditure has led to a neglect of other factors (that is other than investment expenditure) affecting development, such as the emergence of appropriate economic qualities and attitudes, the expansion of the exchange economy, the establishment of suitable institutional arrangements, the advance of technical knowledge, and the extension of inter-regional contacts. In the promotion of many of these influences government action is often indispensable; they tend to be obscured by the insistence on investment expenditure. For instance, this insistence leads to over-emphasis on physical plant, and a neglect of the development of human resources, both by formal education and by the modification of traditional attitudes which restrict the activities and energies of people.

Much of the current official and academic literature treats the growth of income as dependent largely on investment expenditure, often in terms of crude though apparently sophisticated ideas about capital output ratios. The relation between investment expenditure and income is much more complex than is assumed by this approach. The accumulation of capital can be a potent instrument of material advance. It is generally, though not invariably, a condition of the growth of income. But it is not a sufficient condition for the growth of income which is never a simple function of investment expenditure.

The importance of this issue may justify some elaboration of the argument. Neither private nor public investment expenditure necessarily promotes the growth of income as compared with alternative deployment of the resources. This is so for various reasons.

First, investment decisions, whether public or private, may be mistaken in the sense that they do not add to the flow of income, or add less to it than alternative uses of the resources. This hazard is inherent in the nature of investment and the hazard is less likely to be assessed carefully when the process of investment is regarded as productive and desirable per se.

Second, investment is less likely to be productive when those who determine its volume and direction have themselves no direct interest in its productive deployment, because they do not bear the cost themselves, nor do they enjoy the return. The interest of the supplier of capital is usually a major influence in its productivity.

Third, the expenditure of publicly directed funds cannot usually be geared so closely to consumer demand, or to the supply of co-operative resources (that is, to market conditions in the widest sense) as can private investment. We must also remember in this context the point already noted earlier that even if investment expenditure does increase output compared to some alternative use of resources, this does not necessarily imply an increase in present or future living standards if the output is not related to consumer demands.
Fourth, the collection of resources for public investment expenditure may, and indeed probably will, have disincentive effects on saving, effort and enterprise (5). The contribution of investment to development is a net factor after allowing for the repercussions of both the collection and the expenditure of the funds; and the repercussions include not only a diminution of resources in activities or sectors from which have been transferred, but also the effects of their collection on the incentive to save, invest, undertake risk and incur effort. Yet many discussions of planning consider government development outlay as an equivalent addition to resources, regardless of the provenance of the funds and of the repercussions of their collection. For instance, the effects of public finance (both of taxation and of expenditure) on the ability and willingness of people to produce for sale, and also direct investment in agriculture, are often ignored in this context.

Fifth, the desire to achieve a given level of investment expenditure may involve the imposition of a variety of controls, the repercussions of which are likely to impede the growth of income.

Sixth, a significant part of investment expenditure takes the form of additions to the stock of consumer durables such as houses, hospitals and motor vehicles; these are more appropriately considered as consumer assets acquired out of income than as instruments for increasing the flow of income in the future (6).

To forestall possible objections, I wish to make it clear that these remarks about the current investment fetish are an aspect of, or a corollary to, the criticisms of comprehensive planning, that is of large scale government control of economic activity. They are not criticisms of investment expenditure required by the traditionally well-recognized necessary governmental functions.

Another popular argument for comprehensive planning is that it is required for the accelerated industrialization regarded as indispensable for economic development. This argument is again spurious. First, there has been massive development of manufacturing in both rich and poor countries without development planning. Second, accelerated industrialization is not a condition of economic advance. It is true that on the whole richer countries are more highly industrialized than poor countries although the correlation is not so strong as is often implied. But, of course, this correlation does not reflect a cause and effect relationship. Both the higher level of industrialization and the greater prosperity reflect the possession of valuable resources, notably including skills and experience. The crude suggestion that this correlation reflects a cause and effect relationship is analogous to saying that because it is on the whole rich people who smoke cigars, the smoking of cigars will make you rich. Moreover, as the relative preponderance of service industries in rich countries compared to poor countries is even more pronounced than that of manufacturing, the advocates of accelerated industrialization ought to propose the accelerated development of service industries. Again, the advanced industrialized countries were already more prosperous while still predominantly agricultural with far higher incomes than those envisaged for poor countries for decades ahead. Industrialization is much too vague and general a concept for an assessment of the merits of a policy without examining the agencies, methods and costs of the process.

A variant of the argument for accelerated industrialisation advocates the establishment of capital goods industries in poor countries. This is instanced as necessary for progress and development planning is regarded as necessary for their establishment. In fact, of course, economic development does not depend on the prior development locally of a capital goods industry. The arguments in its support hardly ever refer to costs in terms of the alternative uses of resources, nor the demand for the output, nor to the effects of the programme on living standards. There are all sorts of activities which would not emerge without comprehensive planning, but it does not in the least follow that their emergence would represent either an efficient use of resources, or that it would promote economic progress. The need to subsidize a particular economic activity yielding a saleable output (7) suggests that the resources would be more productive elsewhere in the economy.

Now much of the discussion in this general area is confused by a tendency to focus attention only on particular activities or sectors. The output of these activities or sectors is treated as somehow a net addition to total output, and both the cost in terms of alternative uses of resources and the economic demand for the output are simply ignored.

Yet another argument for comprehensive planning suggests that it is required to secure the benefits of so called external economies. But this argument again simply begs the question. The activity promoted by development planning implies a transfer of resources, and a corresponding diminution of activity and of external economies elsewhere. They promote economy of resources and growth only if the subsidized activities or the state enterprises yield goods or services and external economies exceeding in value those lost through the contraction of the taxed activities, allowing also for various other repercussions of the transfer. It is improbable that there should be any significant net economies after allowing for these costs, let alone economies large enough to outweigh the wider costs and repercussions of development planning. Thus it is not surprising that the adoption of comprehensive development planning has nowhere served to raise general living standards. So far from being indispensable to economic advance, comprehensive development planning was not used in the development of any one of the

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(5) Private investment does not have this effect because it does not involve taxation.
(6) This point is related to difficult conceptual problems which involve the basis of the distinction between consumption and investment which cannot be pursued here.
(7) The reference is to saleable output to distinguish it from activities yielding indiscriminate benefits, activities the performance of which falls within the well recognized traditional functions of government.
now highly-developed countries. It is only in the Soviet-type economies that it is a central instrument of economic policy, where it has not benefited mass living standards after decades of its operation. On the other hand, the nature and texture of these societies reflect the pervasive character of this policy.

IV

The failure of comprehensive planning to raise general living standards has not affected its popular appeal. There are various reasons for this, some of which are well known. For instance, such a policy promises positions of power both to politicians and to intellectuals which they could not hope for in a less centralized society. Again, as is well known, economic controls often benefit influential sectional interests. Those who benefit from government controls are generally aware of the benefits whilst those who are harmed are much less likely to realize this. If an industry is established or expanded as a result of planning or controls, this is applauded, but the costs of the process are all too often ignored. There are also certain other less obvious and more deep seated factors in the appeal of development planning. One is that it usually promises benefits in the indefinite future, and often calls for great sacrifices for the attainment of undefined benefits in the distant future. In a sense, it promises salvation here, but not now. The distant and ill-defined nature of the benefits paradoxically enhances the appeal of comprehensive planning. This is so for several reasons. First, the promise can never be checked against the performance. Second, the system escapes the all too familiar disillusionment which often accompanies the attainment of material success and prosperity. The appeal to sacrifice, even for undefined ends, often also has its political attractions. Lastly, for many people belief in comprehensive development planning has taken on the attributes of an all-embracing and secular materialistic faith. This can, and often does, offer a haven to the many people who have lost their moorings and bearings as a result of the rapid collapse of traditional beliefs and values. These are among the reasons for expecting the continued appeal of comprehensive development planning even if it fails to raise living standards.

V

The second major theme of the development literature assumes that without massive foreign aid the underdeveloped countries are doomed to stagnation, generally because their poverty is said to prevent the capital formation necessary for higher incomes. This is regarded as an instance of the vicious circle of poverty, a thesis which suggests that poverty in itself sets up practically insurmountable obstacles to its own conquest. This thesis is obviously untenable, as is shown by the rise from poverty to riches of innumerable individuals and groups throughout the world in both rich and poor countries. It is refuted further by the very existence of developed countries, all of which began as underdeveloped, which would have been impossible on the thesis of the vicious circle of poverty. Moreover, as the world is a closed system and clearly began by being underdeveloped, this notion is inconsistent with the phenomenon of development. Yet again, many underdeveloped countries have advanced very rapidly in the last half century or so, which is particularly relevant in this context. This advance is sometimes overlooked because in much of the discussion a low level of income is identified with a zero rate of change, which is a simple error in logic. In many countries, the level of income is still low, and yet there has been a rapid material advance which has, however, begun only comparatively recently and from a very low level. There are, of course, many areas where the standard of living is not only very low, but where material progress has been relatively slow and where such progress as has occurred has been largely absorbed in the form of an increased population. But this has nothing to do with a generally operative vicious circle of poverty. It reflects the presence of human qualities and attitudes and of social and political institutions unfavourable to material advance.

It should be obvious that foreign aid is not a generally necessary condition of economic advance. This is clear from the history of the developed countries, all of which began poor and have invariably progressed without government-to-government aid. It is evident also from the history of many underdeveloped countries—notably in Latin America, East and West Africa, South-East Asia and the Far East—which have advanced in recent decades without foreign aid.

Nor is foreign aid a sufficient condition of economic advance, or even a generally effective force in its promotion. Indeed its failure to advance living standards in poor countries after more than a decade of its operation is recognized in current discussions. These emphasize the continued low living standard in the recipient countries, and insist on the need for indefinite continuation of aid at current or higher levels.

The comparative ineffectiveness of foreign aid to poor countries is evident from the experience of the last ten to fifteen years. The experience of India is perhaps the most familiar example. Fourteen years after the beginning of Western aid and the inception of the five-year plans, the country experienced in 1965-66 the most acute of its recurrent, almost annual, food and foreign exchange crises. For years now India has been dependent on large scale foreign aid and gifts of food, without which there would have been mass starvation in 1965-66. External dependence has now come to be taken for granted. Algeria, Burma, Ceylon, Ghana, Indonesia and the United Arab Republic are among other countries with acute domestic economic difficulties after prolonged foreign aid.

Thus, foreign aid is neither a necessary nor a sufficient condition of economic development of poor countries. This is obvious. I believe further that, at any rate in its present form, it is more likely to retard
than to promote such advance. This conclusion is paradoxical because foreign aid increases the resources of the recipient countries, or at any rate of their governments. But this does not mean that the flow of aid increases the rate of development in these countries. The result depends on the effects of aid on the determinants of economic progress, notably on the repercussions of aid on the policies, institutions and on the allocation of resources in the recipient countries. These repercussions are often harmful and outweigh any favourable result of the inflow of resources. This is the reason why foreign aid, although it may sometimes improve economic conditions in the recipient countries, has not served generally to promote their development. It has not fulfilled and is most unlikely to fulfill the expectations which it arouses.

A digression may be useful here to forestall an objection particularly likely to be raised by readers in Western Europe. This is a reference to the success of Marshall Aid to Western Europe which is so often instanced in support of the potential value of foreign aid to poor countries. In fact, this experience suggests the exact reverse. The countries of Western Europe had to be restored, while those of present recipients have to be developed. Europe after 1945 was demonstrably short of capital resources, especially stocks of food and raw materials, but not in the necessary human resources and market opportunities. Its peoples had the attitudes, motivations and institutions favourable to development, as was clear from the performance of Western Europe for centuries before the Second World War. This distinction explains the rapid return of prosperity to Western Europe (in spite of the inflow of millions of refugees into West Germany and the continued dismantling of plants for reparations superimposed on war-time destruction), and the termination of the Marshall Aid programme in four years. Almost all the aid represented the cost of food and raw materials and was essentially an emergency programme. The contrast with the economic plight of India and of many other recipients of aid after a much longer period, is clear. The difference in effectiveness between Marshall Aid to Western Europe and foreign aid to poor countries is also recognised by the widely-held assumption that aid to poor countries must be continued for many years to come.

I have already suggested that I think people's economic qualities and attitudes, their values, objectives and motivations, and their social and political institutions are the major factors in development. Natural resources and external market opportunities, especially the latter, often also play a significant part, though the former have usually been of only minor importance both in the development of most of the advanced countries, and also in the recent progress of many poor countries. Moreover, the exploitation both of market opportunities and of natural resources always depends on human resources. The ineffectiveness of foreign aid as an instrument for development derives from its inability to affect the human factors substantially, at least in a favourable direction. This ineffectiveness is reinforced by the manner of its operation, notably the criteria of allocation.

The obvious failure of foreign aid materialy to improve the economic conditions in the recipient countries is, of course, regarded by its advocates as a ground for advocating still larger scale extension both in volume and time. This interpretation is a corollary of the axiomatic belief that foreign aid is a necessary instrument of economic advance. As I have already noted, it is a corollary of such an axiomatic belief that either success or failure of a policy can be used as an argument for its continuation or extension.

I think that foreign aid has in most instances retarded the development of the recipient countries by encouraging qualities and attitudes unfavourable to material progress, and also by promoting policies harmful to it.

The flow of sustained, indefinite and large scale aid encourages the pauperisation of the recipients. A pauper is a person who relies for his livelihood on un-earned public assistance. Accordingly the term pauperisation denotes the promotion and acceptance of the idea that unearned doles are a main ingredient in the livelihood of nations, as of individuals. This undermines the status and prestige of the self-reliance required for material progress. Both the discussions on aid and its flow, divert attention from the fact that the populations of the developed countries themselves have had to develop the qualities, attitudes and institutions which favour material progress. The suggestion that material progress depends on external grants encourages the belief that the prime determinants of development can be had for nothing. This belief is unfounded. Of course, it is the governments and not the individuals who receive the aid. But the whole process implies and promotes the idea that material advance depends largely on external grants rather than on the emergence of appropriate human qualities, attitudes, values, and also on the removal of institutional constraints. Various factors reinforce the likelihood of the pauperisation of the population of the recipient countries, such as the prevalence in many of these countries of certain attitudes and customs, notably the recognised status of beggary, and the absence of social stigma in the acceptance of indiscriminate charity.

There are further reasons why it is more likely to retard than to accelerate material progress. The flow of aid increases the weight of the government in the economy by increasing its resources relatively to those of the private sector. This increases the concentration of power in these countries. These effects are enhanced by the influential support, or even pressure, in the donor countries for comprehensive development planning in the recipient countries. Comprehensive planning has come to be regarded in the donor countries as a condition of economic development in poor countries, and its adoption by the recipient governments is accordingly considered as an earnest of their intention to promote it. As I have argued before, this belief is unfounded, and is indeed more nearly the opposite of the truth, because comprehensive development planning is much more likely to retard than to promote economic progress.
In recent years the amount of aid has often come to be geared to the short fall of resources required for the development plan, particularly as reflected in the balance of payments difficulties of the country. This deficiency of resources has even come to be known as development deficiency. The adoption of this criterion then encourages or even compels the recipient governments both to engage in comprehensive development planning and also to make their plans as large as possible. They are encouraged to pursue an inflationary policy which then results in balance of payments difficulties or crises. These crises serve as an effective basis for an appeal for aid. They also present apurposes arguments for the imposition of extensive economic controls, which both the recipient governments and the advocates of aid often welcome for a variety of motives.

There are also important indirect effects in this context. The recipient governments are discouraged from building up reserves as their presence would be used as an argument against the need for aid. Indeed, balance of payments difficulties or crises are now widely regarded as corollaries of governmental development efforts. The link between foreign aid and payments difficulties is an important specific influence in the direction of the pauperisation of the recipients of aid which I have already noted as a general danger of foreign aid. It is hard to think of a more effective way of discouraging self-reliance.

As a matter of fact, the policies encouraged by linking aid to development planning and balance of payments difficulties tend to encourage the flight of private capital from the recipient countries. The imposition of controls, the inflationary policies and the balance of payments crises engender a widespread feeling of insecurity, which in turn discourages the local population from saving and investing, and encourages the export of capital. Thus, the inflow of foreign aid is matched by an outflow of both domestic and foreign private capital, which is likely to be more productive than foreign aid funds as its deployment is more closely geared to local conditions.

There are yet further adverse effects of the operation of aid. For instance, it has reinforced the prevailing investment fetish, that is the belief that economic development depends largely on the money expenditure on investment, this being defined as all expenditure other than on current consumption. I have already noted some major adverse results of this fetish. Moreover, it is worth noting here that foreign aid does not necessarily increase investment expenditure in the recipient countries. Some of the repercussions of aid, which I have already noted may serve to reduce private investment and even encourage the flight of capital. These are likely results of the imposition of extensive controls, of a high level of taxation and of balance of payments crises. Again, foreign aid is likely to discourage the recipient governments from seeking capital on market terms. From the point of view of the recipient governments it may be both unprofitable and politically unwise to pay market terms if foreign aid is available, that is if funds can be secured gratis or on heavily subsidised terms.

The investment fetish, reinforced by the advocacy of foreign aid, has served as spurious justification for all sorts of expenditures regardless of cost, return, or other repercussions of the collection of resources. It has served also to favour conspicuous, large scale show projects at the expense of the improvement of the existing facilities, or the creation of more modest facilities which are often more effective in advancing development than the conspicuous or ambitious schemes (8).

The flow of aid, the uncontrolled ineffectiveness of investment expenditure (which in turn has been reinforced by the advocacy and flow of aid) and the insistance on development planning, have diverted attention from the basic determinants in development which I have already listed, and from the possibilities and problems of influencing these.

The emphasis on investment expenditure and foreign aid, though misleading, is often comforting. It absolves people, especially those responsible for policy, from considering the possibilities and costs of operating on the basic determinants of material advance. It encourages the facile belief that such advance is possible without the qualities, attitudes and efforts which it has required elsewhere — in other words, that economic development is possible without cultural change.

One of the more difficult and complex governmental tasks that have been neglected is that of the promotion of a suitable institutional framework for the activities of individuals which would lead to economic development, particularly by encouraging the emergence of attitudes and qualities favourable to material progress. It is unwise to be dogmatic about the possibilities of government action in this sphere. I think that in many underdeveloped countries there is considerable scope for government action designed to modify the institutional framework in a direction which would encourage, without coercion, the emergence of attitudes more favourable to development. Possible policies and measures could include the extension of peaceful external contacts, the encouragement of the emergence of individual tenure of land, the encouragement of limited liability, and possibly the revision of the system of inheritance. The adequate performance of the other essential governmental tasks which I have already listed would also have favourable repercussions in this field. In fact, however, in the sphere of institutional change the activities of the recipients of foreign aid have so far been largely confined to the expropriation of politically weak and unpopular classes, in the name of land reform, social justice or the removal of exploitation. These policies and measures have generally retarded economic development and the rise in living standards.

Thus the attitudes, policies and outlays promoted by foreign aid have served to retard rather than to promote material advance. They

(8) Of course, in many instances the expenditure made possible by foreign aid is quite unrelated to any type of capital formation. It may and often does serve such diverse aims as the equipping of an expeditionary force to invade another country, or the enlargement of the political police, or expenditure on training « freedom » fighters.
have generally outweighed any favourable effect of inflow of resources. This applies both to foreign aid funds and to domestic resources, whose deployment is often diverted from uses more likely to lead to economic advance.

VI

How far are these defects inherent in intergovernmental foreign aid? I think that its operation could be much improved, particularly by radical changes in the criteria of its allocation. It could be allocated much more selectively than at present. In particular aid could be so distributed as to favour governments which, within their human, administrative and economic resources, try to perform the essential tasks of government (including attempts for suitable modification of the institutional structure), while at the same time refrain from close control of the economy. Adequate performance of the appropriate governmental tasks would fully stretch, if not exceed, the resources of every government of a poor country which I know. Such criteria in the allocation of aid would promote relatively liberal economic systems in the recipient countries which would both minimise coercion and advance economic development and living standards generally. The allocation of aid could also be divorced from pressures by commercial interests in the donor countries, for whom foreign aid often presents subsidised markets. But even if foreign aid were reformed along these lines, which is improbable, it is still unlikely to serve as an effective instrument for the economic development in the poor countries. It is certainly quite wrong to regard it as a necessary condition for this purpose (9).

P. T. BAUER

(9) I have not discussed the role of foreign aid as an instrument of Western political strategy because this is not germane to the two principal themes of this article. I may note that it has been quite ineffective for this purpose, which is not surprising. It is widely regarded by the recipients as a partial expiation of a guilt complex, or a partial restitution for past wrongs, or an instrument for dumping unsellable goods on the recipients, or a device to promote the political power of the donors. Moreover, by promoting closely controlled economies, foreign aid assists governments which quite understandably lean towards the Eastern bloc with which they have more in common.

sono strettamente correlati, pur riferendosi il primo principalmente alla politica interna ed il secondo a quella estera. L'a. svolge un esame critico di queste idee, mettendo in evidenza che, quando le politiche del tipo di quelle prime illustrate vengono accettate come auspicabili, si è poi costretti a considerarle le conseguenze come perfettamente plausibili. Il progresso viene allora giudicato un indice di successo, ma anche una recessione o stagnazione viene giudicata come un indice della necessità di insistere in quella politica. Partenenti se ne accettano le ripercussioni sociali e politiche. L'a. confronta le argomentazioni dei fatti della pianificazione dello sviluppo in quanto condizione indispensabile al progresso economico, sostenendo la tesi che la pianificazione non conduce al progresso economico ma anzi lo ritarda.
CURRENCY OVER-VALUATION
IN SOME UNDER-DEVELOPED COUNTRIES

by B. R. Shenoy (*)

1. The currencies of many under-developed countries would seem to be heavily overvalued at their official exchange rates. We shall limit our analysis to the currencies of Burma, Ceylon, India and Pakistan.

2. Evidence of the over-valuation of these currencies is found in, firstly, their persistent balance of payments difficulties — not merely balance of payments deficits — and the prevalence in these countries of exchange control and import restrictions. Given an equilibrium exchange rate, i.e., a rate at which the balance of payments are in equilibrium, export earnings may match the import requirements of an economy and balance of payments difficulties — apart from seasonal and other temporary stresses and strains — may not become persistent. With the balance of payments in equilibrium, there would be no need for exchange control and other such physical import restrictions. The continued maintenance of exchange control and import restrictions suggests, therefore, that the official exchange rate is unrealistic.

3. Secondly, currency over-valuation is evidenced by the premiums above parity at which the U. S. dollar or other convertible currencies are quoted, in terms of the currencies of the under-developed countries, in the free markets for foreign exchange or in the black markets within the countries concerned. If the exchange rate is in equilibrium, the aggregate demand for foreign exchange would be balanced by the available aggregate supply of foreign exchange. That is to say, the demand for foreign exchange would be met in full at the official exchange rate. If so, there is then no room for the phenomenon of a spill-over demand for foreign exchange giving rise, in turn, to free markets abroad, and black markets at home, for foreign exchange, in which quotations diverge from the official exchange rate. Two markets and two prices for foreign exchange bespeak of currency over-valuation.

4. The third piece of evidence for currency over-valuation is found in the prices which import licences fetch in the black markets. Given an equilibrium exchange rate, the demand for import goods at the official exchange rate would be met in full; imports would be free and unrestricted; or, if subject to licence, perhaps for historical reasons, imports would be freely permissible under Open General Licence. If import needs are thus fully met, import licences cannot command any market value.

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If, on the other hand, import licences happen to be highly prized documents, this would indicate that the demand for imports at the official exchange rate far exceeds the permitted quantum of imports; and that the exchange rate is not at equilibrium.

5. In some countries — as in India — import licences are not legally transferable as a rule; in such cases, data of the prices of import licences may not be easily or fully available. But de facto transferability, nevertheless, obtains in all countries. In India import licences are transferred through the legal fiction of the forward purchases of the import goods concerned, or by the market buyer of the licence acting as the licensee's legal 'agent' for Customs clearance — though, in reality, the buyer acts only for himself. As these transactions are illegal, the market for the licences is not a free and open one. But a section of the press in Bombay, India's principal international trade centre, occasionally publishes quotations for import licences.

6. In 1963-64, the weighted average of the market quotations for import licences for 22 items of imports was 105 per cent of the face value of these licences. This average went up in 1964-65 to 115 per cent. In 1965-66, under the influence of accelerated inflation and particularly following the drastic import cuts in May 1965, the gap between the landed costs and market prices of import goods became wider than ever; and the prices of import licences in general rose to record levels.

7. The devaluation of the rupee by 57.5 per cent pushed up the landed costs of import goods and the windfall gains from imports fell correspondingly. This led to an equal decline in the prices of import licences, which fell precipitously upon the announcement of import liberalisation on 21 June 1966; in the case of Art Silk Yarn from the predevaluation figure of 750 per cent to 550 per cent; in the case of Drugs from 140 per cent to 75 per cent; and in the case of Surgical Goods from 275 per cent to 125 per cent. It may be noted that these prices indicate that the rupee prices of art silk yarn are still 6½ times, of drugs 1½ times, and of surgical goods 2½ times, their respective external prices (1). Vast disparities between internal and external prices continue in respect to import goods in general, though devaluation has considerably reduced these disparities.

8. From the free market quotations in Table 1 below, we find that striking divergencies exist between the official and free market exchange rates of the Rupee, the Ceylon rupee, the Pakistan rupee and the Indian rupee, as evidenced by the heavy premiums on the Swiss franc in terms of these currencies. These premiums varied from 43 per cent, in the case of the Indian rupee, to 263 per cent, in the case of the Kyat. The premium

<table>
<thead>
<tr>
<th>Currency</th>
<th>Units</th>
<th>Average rate in the Official Market Bid</th>
<th>Offer</th>
<th>Discount % of 4 109% (4 x %. 100)</th>
<th>Free-market Premium at the official rate (3 x %. 100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Kyat (Burmese)</td>
<td>1</td>
<td>0.90 3/8</td>
<td>—</td>
<td>0.25</td>
<td>72.34</td>
</tr>
<tr>
<td>2. Rupee (Ceylon)</td>
<td>1</td>
<td>0.90 3/8</td>
<td>0.28</td>
<td>0.35</td>
<td>69.03</td>
</tr>
<tr>
<td>3. Rupee (India)</td>
<td>1</td>
<td>0.47 2/8</td>
<td>0.40</td>
<td>0.49</td>
<td>20.92</td>
</tr>
<tr>
<td>4. Rupee (Pakistan)</td>
<td>1</td>
<td>0.90 7/8</td>
<td>0.50</td>
<td>0.62 1/2</td>
<td>44.67</td>
</tr>
<tr>
<td>5. DM (West Germany)</td>
<td>100</td>
<td>108.22</td>
<td>108.19</td>
<td>108.23</td>
<td>0.03</td>
</tr>
<tr>
<td>6. Dollar (U.S.A.)</td>
<td>1</td>
<td>4.3190</td>
<td>4.31 6/8</td>
<td>4.32</td>
<td>0.06</td>
</tr>
</tbody>
</table>

Source: Swiss Bank Corporation, Zurich: fortnightly quotations.

in terms of the Indian rupee was 113 per cent on 31 May 1966, a week before devaluation (2). Through devaluation by 57.5 per cent on 6 June has produced a sharp drop in the premiums, it is still considerable, being of the same order as had obtained in 1963-64. It is not practical, in these countries, to try to avoid devaluation by deflation, in order to raise the free market exchange rates to the official level. There is no escape from devaluation for these currencies. In the case of the Indian rupee, that is to say, there is need for a further devaluation, though the extent of this may now be less than that required for other currencies.

9. Though the continued maintenance of exchange control and import restrictions indicate the pressure of currency over-valuation, they do not provide a guide to the extent of the over-valuation. This limitation applies, too, to the second criteria of currency over-valuation, namely, the prices offered for import licences. These prices vary with the commodities to which the licences relate. They reflect the gaps between landed costs and market prices of the commodities concerned. The landed costs — the overseas prices multiplied by the official rate of exchange plus insurance and freight (3) — of import goods remain artificially low because exchange rates are held rigid in an inflationary context. The market prices of import goods, on the other hand, may move upward,

(1) If the prices of import licences are x per cent of the landed costs of the import goods concerned, the rupee prices of the import goods would be (100 + x) per cent of their landed costs.

(2) The price of Re. 1 on 31 May 1966 was Swiss francs 0.43 1/2 and the average exchange rate in the official market 0.90 3/8 Swiss francs.

(3) Import duties are paid by the buyers of import licences. They are not debited to the prices paid for the import licences.
being influenced, firstly, the extent of the inflation and, secondly, the extent of import curtailment; both of these may vary, inflation being governed by the pressures for deficit spending and import curtailment by the pressures of foreign exchange « scarcity ». The gaps between landed costs and market prices, and the premiums commanded by import licences, are thus determined by arbitrary factors, being the combined effects of currency over-valuation, inflation and severity of imports controls. The prices of import licences, or their weighted index, may not, therefore, be a dependable guide to the extent of currency over-valuation.

10. On the other hand, the premiums on convertible currencies in the free markets overseas may reflect the equilibrium value of these currencies, as transactions in these markets are unfettered. The supply of Indian rupees (and other currencies with exchange control) on these markets comes from smugglers, — who smuggle into India gold and other commodities commanding high rupee prices, and who smuggle out the rupees thus obtained — and from those who wish to make concealed transfer of funds abroad, including travellers who sometimes carry small amounts. The supply of exchange on these markets comes partly from those who smuggle goods out of India, but mainly from the under-invoicing of exports and the over-invoicing of imports. The exchange thus obtained is sold in the free markets at a much higher rupee price than the official one, and the rupees thus obtained are now smuggled back into India. The supply as well as the demand for rupees being adjustable according to changing market conditions, the free market quotations should reflect the equilibrium value of the rupee, minus the additional costs, necessitated by exchange control, of smuggling in and smuggling out rupees.

11. It is possible that the costs of the two smugglings of rupee notes may be embodied in the difference between the buying and the selling prices of exchange — after the analogy of the gold standard, under which the costs of transporting gold determine the distance between the gold points.

12. Like the par of exchange under the gold standard, we may conceive of a par of exchange for the free market quotations of a currency. If we may assume this latter par to be midway between the <Bid> and <Offer> prices in Table 1 above for the currencies cited in the table, it was on 29 July 1966, in the case of Ceylon, Ceylon Rupee 1= Swiss franc 0.23; and in the case of Pakistan, Pakistan Rupee = Swiss franc 0.51-½. The <Bid> prices for the Kyat and the Indian rupee not being available, we have no knowledge of the free market exchange par for these two currencies.

13. The costs of smuggling the currencies each way would then be equal to the difference between this exchange par and the <Bid> price, or between this par and the <Offer> price. If so, in the case of the Ceylon rupee these costs may be 15 per cent of the free market par values of the notes to be carried. The explanation for this high cost may be that, being an island, exchange control enforcement is comparatively efficient in Ceylon, smuggling currency in and out of the country being a highly risky venture, involving considerable care and cost.

14. On the same reasoning, the costs of smuggling rupees in and out of Pakistan may be 2.4 per cent for a single trip. Black-market transactions in foreign exchange in India are common enough for the quotations to be published in the press occasionally; and the difference between the buying and selling rates in this market is roughly Re. 0.50 for transactions in pounds sterling, which are valued at about Rs. 30 per £ 1. On this basis, the costs of smuggling rupees in and out of India may be even lower than in the case of Pakistan, being less than 2 per cent for the round trip. This suggests the comparative stream-lining of the smuggling traffic, in India more than in Pakistan.

15. The Articles of Agreement of the International Monetary Fund permit the buying and selling rates of foreign exchange of member countries to deviate from the statutory par by 1 per cent. Seeing that free market quotations for the India rupee are within this standard deviation from the free market par of exchange, we may perhaps infer that in the case of India the free market quotations of the rupee may not differ unduly from the equilibrium exchange rate. The latter may diverge from the free market rates in the case of the Pakistan and Ceylon currencies.

16. Continued currency over-valuation has produced a moral consequence. It has brought into being two markets in foreign exchange, the official market at the over-valued official exchange rate, and the free markets, in the overseas money centres, at fluctuating rates, the latter being more or less close to the equilibrium exchange rate, depending on the risks and costs of smuggling currencies in and out of the countries concerned. When transactions are effected at the free rates within the national frontiers, they are described as black market transactions; such transactions, being unauthorized, are illegal.

17. When there are two markets for the same currency at the same time, with prices in the two markets diverging from one another by more than the cost of transporting the currency, there will be a growing tendency to purchase the currency in the official market for sale in the free market; or the currency will be otherwise diverted from the former into the latter. Foreign exchange is diverted from the official market to the free market through under-invoicing exports, the concealed export receipts being sold in the free market; through smuggling out exports, the proceeds being sold in the free market; or, by routing family remittances, donations and other transfer payments, as also tourist funds, into India via the free market instead of via the official market. When more foreign exchange is purchased than is required,
through over-invoicing imports and exaggerating officially permitted payments under «invisibles», and the excess foreign exchange thus acquired is disposed of in the free markets, foreign exchange is, in effect, purchased in the official market for sale in the free market.

18. This temptation to maximise purchases in the official market, at the lower exchange rate, and to maximise sales in the free market, where higher rates obtain, has impaired the balance of payment positions in the official market, the free markets having no balance of payments problems whatsoever. The heavy and intractable balance of payments deficits of under-developed countries (with over-value official exchange rates), relate to the deficits in the official market. It will be noted that these deficits must persist so long as the system of two markets and two prices for the same currency prevailed.

19. Under-developed countries which finance some of their investments from imported savings (government-to-government aid or private capital inflows), may have balance of payments deficits on current account. When their exchange rates are in equilibrium, these deficits may be wholly covered by the imported savings; and there may be no need for emergency support of their balance of payments position. When, however, their currencies are overvalued and two markets exist for foreign exchange, to the amount of the development deficit will be added the amount of the foreign exchange transferred or diverted from the official to the free and black markets. The currency reserves of these countries being close to the legal rock bottom, virtually the whole of their balance of payments deficits are made good from imported savings. Foreign exchange funds for covering these deficits cannot come from elsewhere.

20. It follows that when foreign aid covers the official foreign exchange deficit, aid provides foreign exchange not only to cover the deficit representing developmental expenditures but also to finance the deficit resulting from currency over-valuation. Aid, that is to say, will provide foreign exchange to pay for smuggled imports including gold, concealed capital exports and other unauthorised transactions effected through the free and black markets. Though the balance of payments deficit emerges in the «official» transactions, as we have been, both categories of deficits are merged into these. The two are indistinguishable, one from the other.

21. It is a case analogous to the black-bird (the Koel) laying its eggs in the nest of the Crow. The latter, being unable either to count or to distinguish its own eggs from that of the Koel, hatches both with the same care and affection. The Central Banks of the under-developed countries and their Ministries of Economic Affairs, «sell» the «official» deficit to the aid-giving countries as being all developmental deficit, or, as may sometimes be the case, as partly the result of crop failure due to unfavourable weather conditions — whether or not they sincerely believe this to be so. And, under a complex of pressures, principally humanitarian and political, the Aid-India and the Aid-Pakistan Comsortiums agree with this, though, unlike the Crow, some of them may be conscious that all the eggs that they collaborate in hatching may not be developmental eggs.

22. There is no solution to this problem of misdirection of aid other than to eliminate the two-price system for foreign exchange. This may be achieved through currency devaluation to the equilibrium level; by floating the currencies, i.e. by adopting the system of flexible exchange rates; or by adopting a gold currency standard with full-bodied gold coins in circulation.

23. Under the prevailing climate of caper economic opinion, which regards monetary management by a Central Bank as a sine qua non of modern economic life, the state of economic enlightenment of the public, the politicians and the policy-makers in the under-developed countries, the adopting of a gold currency standard is not practical, even apart from the pros and cons of the controversy on this subject. This reform must first be adopted in countries with high economic and political sophistication before under-developed countries may be willing to consider it.

24. The politicians, the administrators and their advisers in these latter countries have a strong bias for over-spending and over-investment by the State. This rules out the monetary and fiscal discipline necessary for the maintenance of a fixed exchange rate in reasonable equilibrium. In such a context, there is a strong case for floating currencies. This may provide a more effective check against bad monetary and fiscal policies than pressures from aid-giving countries, as such policies would immediately show up in exchange rate depreciation. Considering the popular hostility to devaluation, this may be viewed with disfavour by the public and politicians may be disposed to steer clear of the policies leading to currency depreciation. As no other system has a chance of survival and, therefore, could not guard against the misdirection of foreign aid resulting from currency over-valuation, this aspect of the matter merits the serious attention of the IMF, the World Bank and the aid-giving countries.

25. Currency over-valuation has other damaging effects on the economies of under-developed countries. Exchange control and import restrictions have been adopted by them as a corrective to the acute «scarcity» of foreign exchange. Export earnings are pounced upon and rationed out among importers, imports being divided into three broad categories, essential, less essential and luxury goods. Imports of luxury goods are drastically curtailed in order to increase the availability of foreign exchange for the imports of raw materials, accessories,
spare parts and equipment. The low proportion of consumer goods in general and of luxury goods in particular in their imports, and the correspondingly high proportion of capital goods, are frequently advanced as evidence of the austerity which they are willing to suffer voluntarily, in order to support programmes of accelerated economic development. And, from experience, they find that this makes a good impression on the administrator and also the technicians of the aid giving countries, and helps the case for generous aid.

26. It is not generally appreciated that it is the magnitude of national savings and the most effective investment of these savings that make for accelerated economic growth; and that the dissection and restriction of imports do not add to national savings, nor help in their most effective investment, even as the dissection and overall curtailment of the purchases and sales of a trader, operating in a competitive market, cannot add to his income and savings, nor help in the expansion of his business. It is appreciated even less that a restriction of imports necessarily restricts exports and retards the expansion of international trade; and that the growth of international trade, like the growth of domestic trade, accelerates the pace of specialised production and, therefore, speeds up the expansion of the national product and the national income, as also the accumulation of savings and the pace of development. A dissection and restriction of imports may be good «singe» or «blockade» economics in times of war. It is difficult to see how it can form part of peace-time developmental economics, though most under-developed economies and their advisers, including visiting experts, seem to be convinced that drastic import scrutiny and import restrictions, with the axe falling heavily on luxury goods in particular, and consumer goods in general, constitute among the first essential tools for accelerated economic and social progress.

27. These policies of exchange control and import restrictions have had disastrous effects on the structure of production in under-developed economies. First, as imports in these countries have been drastically curtailed, the goods available for export have declined as a direct consequence of such drastic import cuts. The logic of these events is somewhat as follows. Import curtailment does not reduce the flow of money incomes seeking to purchase goods, this flow of incomes being a counter part of, and, therefore, determined by the national product. The part of these money incomes hitherto directed to the purchase of the import goods now no longer to be seen in the market, is diverted to feed on exportable goods, if the latter are capable of domestic use, as no other components of the national product would be available for the purpose (4); alternatively, resources are diverted from export production

(4) The assumption here is that the domestic national product (Y) plus imports (M) are all used up in consumption (C), investment (I) and exports (E). The money demands, which are denoted import goods, cannot feed on I or C,

and used to fabricate goods to meet the unsatisfied domestic demand ensuing from import curtailment. The net outcome in either case is that every time imports were axed, exports shrunk. Trade statistics of country after country, which has been adopting import controls, illustrate the working of this principle. Though Indian national income rose by 44 per cent (at constant prices) from 1935 to 1951, Indian exports (also at constant prices) declined from Rs. 7.8 billion in 1935 to Rs. 6.12 billion in 1954.

28. This process of diversion of resources from export industries, mostly agriculture, mining and the semi-processing of primary products, into more sophisticated manufactures to replace imports, receive added stimulus from deliberate policy pressures for import substitution, which many under-developed countries have been pursuing vigorously as part of their policies of «planning». Import substitution is believed to make for increased «self-reliance», contributing a «saving» on foreign exchange. This has, however, resulted in the comparative neglect of primary producing industries and in the encouragement of poor-quality, high cost manufacturing output. In the case of India, this has also involved restraint of the expansion of the cotton textile industry, to make room for heavy industries, the so called basic industries.

29. Currency over-valuation, by penalising exports, and continuing inflation, by driving up domestic prices, have hastened import substitution and the shift of resources from export industries into the manufacturing sector. In India, from September 1949 to 5 June 1966, £ 100 worth of exports bought no more than Rs. 1,335 to the exporter, though, in the meantime, general prices had risen by over 50 per cent. Thus profits from exports were continually reduced or turned into losses, while the attractiveness of the domestic market improved. Here, if costs rose, prices rose even faster. Thus the home market had a much greater appeal than overseas markets.

30. These policies of pressurised industrialisation also had an adverse effect on the aggregate national product and on employment. Import substitution being pursued indiscriminately, it soon became unduly expensive. In India, domestic substitutes are, on an average, of an order of 75 per cent to 100 per cent more costly than the import goods they replace. Every expansion of production of import substitutes thus added significantly less to the national product than what might have been obtained if the same resources had been utilised to produce export goods, with which to acquire import goods. The magnitude of the continuing damage to the national product and, therefore, to overall economy as the flows of moneys in both these sectors continue as before, being unaffected by the cut in imports. The unsatisfied money demand, therefore, eats into E, the output normally exported or, what is the same thing, resources are now diverted for home production at the expense of export production.
ployment has been disastrous, as incredibly large proportions of total resources — perhaps of an order of two-thirds of domestic saving and foreign aid — have been devoted to the development of such industries.

31. Currency over-valuation, through creating an artificial gap between landed costs and market prices of import goods, has caused untold social damage. This phenomenon has received less attention than it merits, especially on the part of the overseas critics of the Indian economic situation. The benefit of these cost-price gaps accrues to industrialists and businessmen, who frequently find it necessary to share it with the corrupt among the politicians and administrators, who issue these licences, and with the now well organized body of trade and other intermediaries. The values of the cost-price gaps in respect to private sector imports was, judging from the prices which import licences fetched, of an annual order of Rs. 5,000 million, prior to devaluation. It is not wholly correct to assume that the benefit of the cost-price gaps in respect to public sector imports all accrue to the state and, therefore, may be viewed as a species of taxation; there is room for leakages from them into private hands.

32. These gains represent the largest part of the annual increases in Indian national income. It follows that these increases are largely appropriated by the beneficiaries of the system of import restrictions, who belong to the upper income groups. Nor is it as if the tax collector drains away these incomes from the pockets of the rich for the benefit of the community. Trafficking in import licences is generally illegal; incomes accruing from traffic have to be concealed and are, therefore, tax free.

33. The cost-price gaps induce corruption and extravagance. Though the cost of production of import licences is zero, they are documents of enormous value, these values depending upon, as we have seen, the cost-price gaps. To obtain these licences industrialists and businessmen are induced to offer corrupt payments and a machinery has sprang up for the illegal trade in the licences. The subsidies which these licences bring keep alive uneconomic undertaking, which, under competitive conditions may get eliminated. The more efficient undertakings inflate their costs, through managerial extravagance, needless advertisements, luxury expenditures and so on, to absorb the subsidies, as, otherwise, they would be drained away in income tax payments.

34. Evidence of the massive resource shifts from primary producing industries to manufacturers is writ large in the statistics of national income and of exports of the under-developed countries pursuing these policies. If export industries and industries catering to the needs of the home market expanded at about the same pace, i.e., if there had been no pronounced shift of resources from the former to the latter, the ratio of exports to the national product should have been roughly cons-

35. In under-developed countries with over-valued currencies, the reverse prevails. During the past over a decade, the ratio of exports to national income declined in India from 6.4 per cent in 1953 to 4.9 per cent in 1964; in Burma from 22.0 per cent to 18.5 per cent; in Ceylon from 28 per cent to 28 per cent; and in Pakistan from 8 per cent to 5 per cent. This indicates that the investment attention paid to export industries has not kept pace with the investment attention paid to the rest of economic activity. Seeing that, at constant prices, exports in these countries have declined over this period, the presumption is that, export industries, viewed as a whole, may not have received in 1964 much more attention than in 1953. The lion's share of the freshly accruing investment resources has been, apparently, devoted to the rest of the economy.

36. We have statistical evidence of the increased consumption or home use of exportable goods with a home demand. Exports of ten fell sharply from 72 per cent of total production in 1955-56 to 58 per cent in 1964-65; of cotton fabrics from 34 per cent to 11 per cent; of cotton yarn and twist from 6 per cent to 1 per cent; and of rice from 259 per cent to 146 per cent.

37. This shift in production and trade had a destabilising effect. It necessarily implied semi-stagnation of exports in the back-ground of an expanding national product. The rising national product necessitated rising imports to keep the wheels of production moving. Since, however, exports failed to rise simultaneously, the economy was without sufficient means to pay for these rising import needs. In such a context, every expansion of production necessarily widened the gap between the foreign exchange needs of the country and its foreign exchange earnings. Such destabilising shifts in production and trade, and the resulting lag between export performance and import needs constitute the crux of the balance of payments difficulties of under-developed countries with overvalued currencies.

38. This problem periodically assumes crisis dimensions calling for bail-out by aid-giving countries; there is no solution to it other than to shift back production and trade away from reckless import substitution to increased export production. This shiftback cannot come about without restoring the relative attractiveness of the home and
overseas markets to their norm by eliminating the penalties on exporters and the premiums on sales in the home market. For this to come about, exporters must receive the full local currency worth of their export earnings in foreign exchange. Through the device of currency overvaluation, exporters have been deprived of part of the legitimate local currency equivalents of their exports; their losses have been counterbalanced by the fantastic gains of importers who obtain import goods at prices exceedingly lower than these goods’ real value in local currency. This injustice cannot be corrected, and increased export production cannot be achieved, unless such currencies are devalued to their equilibrium level.

39. Indian experience of devaluation last June demonstrates the necessity of this last point. The rupee has not been sufficiently devalued. This is evidenced by the double criteria of the premiums on import licences and the premiums on convertible currencies in the free markets. Though both premiums have fallen, they are far from being eliminated. If the rupee had been devalued to the equilibrium level, these premiums would have fallen to zero. The market value of £1 is currently around Rs. 13.33 = £1. Devaluation of the rupee to Rs. 21 = £1, reduced this premium to about 45 per cent, its level in 1963-64.

40. The result of insufficient devaluation is that the penalty on exports, and the weighted attraction of the home market as against overseas markets, would continue, though in a lesser measure than before. The reorientation of production and trade may not therefore, proceed to the extent necessary for achieving full viability in the external accounts of the country. Exchange control and import restrictions with two markets and two prices for foreign exchange and the need for balance of payments support from foreign aid will continue. If, as is more than likely, inflationary finance should persist, there is a real danger of currency overvaluation assuming intolerable dimensions in due course and calling for yet another devaluation.

41. There is no slide-rule technique of ascertaining the precise equilibrium exchange rate, even ignoring the refinement that the equilibrium exchange rate, in the background of changing relative prices is not a fixed, but a shifting, point. The powerful vested interests benefitting from currency overvaluation and import restrictions may exert pressures against devaluing to the extent necessary to eliminate overvaluation. The surest way of arriving at a viable exchange rate at which to stabilise may be to remove exchange control and import restrictions and to float these currencies initially.

42. The main arguments advanced by government spokesmen, economists and publicists in under-developed countries against devaluation...
are, firstly, that it may add to inflationary pressures; and, secondly, that it may cause prices of their export goods in the overseas markets to fall by anything up to the extent of devaluation, so that the same quantum of exports would bring less foreign exchanges than before, or a larger quantum of exports would be required to earn the same amount of foreign exchanges as before. Indian experience of devaluation helps to resolve both apprehensions.

43. The logic behind the fears of inflation has not been clearly stated. Prices may rise only if either or both of two things happen: the money incomes of the people go up faster than the national product; or, the money incomes remaining the same, the quantum of the national product declines.

44. Neither can happen merely because the rupee has been devalued. The opposite is much more probable. Inflation may ease with devaluation, the quantum of the national product may grow, and we may move into an era of price stability and progress. Inflation may ease because devaluation may convert budget deficits into budget surpluses through stepping up receipts under foreign aid and import duties by much more than the higher rupee costs of external debt services and of defence imports. The national product may grow through the mobilising of idle production capacities, made possible by import liberalisation. The national product may grow, too, if devaluation should lead to a reversal of the policies of indiscriminate import substitution, resources being shifted from costly import substitution industries into the more economical export industries.

45. The Economic Times General Index of prices, after remaining steady for three weeks following devaluation, has been moving up thereafter, the index standing at 165.6 (1959-60 = 100) on 31 August 1965 as against 154.2 on 4 June, a rise of 7 per cent in about 12 weeks. These statistics have been cited as evidence of the inflationary effects of devaluation.

46. A closer look at the overall situation reveals that it is incorrect to infer the price rise on devaluation. First, the Indian economy is presently in the midst of the slack season, which lasts from May to October. During this period, the volume of money with the public shrinks—the monetary reflex of the contracted volume of business activity; and prices tend upward—the result of the depletion of seasonal agricultural output. Secondly, national income statistics show that the quantum of the national product has fallen, the outcome of the neglect of agriculture and of the slowing down of industrial production.

47. Since the slack season began, there has been a nominal decrease in money supply, in place of a sizeable contraction; which is evidence of the continued high rate of inflationary spending by the Government.

This is in line with the record deficit of Rs. 3,709 million in the Budget Estimates of the current year, as against Rs. 2,500 million in 1965-66. The failure of the money supply to contract with the seasonal decline in the flow of output, is inflationary in its effects. If we add to this the effect of the fall in the overall national product and allow for the seasonal uptrend in prices, we have an adequate explanation of the rise in prices without having to blame it on devaluation.

48. It is not as if prices have been rising only since devaluation. Prices have been rising before devaluation as well, and for part of the period faster than since devaluation. If we factor on devaluation the post-devaluation price rise, on what shall we factor the pre-devaluation price rise? The principal cause of the rise in prices before as well as after devaluation has been undue deficit spending by the state.

49. The reasoning behind the apprehension of a fall in the prices of Indian exports is that—to quote from the broadcast talk of the Finance Minister, on 5 June 1965, announcing the devaluation of the rupee—in the case of a few commodities such as tea and jute, Indian exports constitute a substantial part of world trade and that the total world demand for them is also relatively inelastic, and that in their case there was, therefore, the danger of a decline in prices, following devaluation. It is thus feared that, in the case of Jute Hessian, for instance, on the basis of an export price of Rs. 2,475 per metric ton, the new exchange rate might reduce its dollar worth by 30.5 per cent, from $520 to $339. The export duty of Rs. 300 per ton, imposed on this commodity simultaneously with devaluation, would raise its rupee cost to exporters to Rs. 3,375, and its dollar worth to $450.

50. Since a commodity may not sell at below cost, so the argument continues, this export duty may prevent the price of a ton of Jute Hessian from falling below $450 in the world markets; in the absence of the duty, the floor price for the price may be $350. India will be, thus, saved the loss from dollar earnings at least by the amount of the duty. The same reasoning is extended to tea and other traditional exports. But, since they account for lesser proportions of world market supplies than Jute Hessian, the schedule of export duties in their case is lower.

51. The assumption that the prices of tea, jute and other traditional exports may fall as a consequence of devaluation and by the amount of devaluation lacks empirical support and the reasoning behind it has not been subject to sufficiently close scrutiny. The prices abroad of Indian exports are determined by conditions of demand and supply in overseas markets. The flavour of Indian tea remains the same after devaluation; so does the quality of jute as a cheap packing material. Devaluation does not alter the incomes of people abroad who consume Indian tea; nor is the quantum of world trade affected by devaluation.
to cause any reduced demand for packing materials. This logic broadly applies to export goods generally.

52. Devaluation is little more than an accounting change to begin with. Its immediate incidence is on factors internal to the Indian economy. It affects the rupee receipts of exporters; the rupee payments for foreign exchange by residents in India; the relative returns on production for the overseas and home markets; and, as we have argued elsewhere, it would help to correct the perverse effects of currency overvaluation on income distribution, through reducing or eliminating the prices which import licences command.

53. Immediately, devaluation should have little impact on the prices of Indian exports in the overseas markets. Devaluation cannot at once swamp the world markets with a flood of Indian exports, though it involves a diversion, as in the case of tea, of part of the output, now consumed at home, for use of the overseas markets, and also a shift of resources from home industries to export industries. Both phenomena take time to manifest, the second longer than the first. In the case of an item or two, such as jute bags, the domestic consumption of the output being a negligible or minor part of total production, there is no danger of the first of these two phenomena throwing on world markets unduly heavy supplies by withdrawing them from home use. Expansion of export production by transferring resources into export industries from the rest of the economy is a slow process, involving at least one production period. The gradualness of it may make for price steadiness.

54. Market data support this analysis. The price of jute fabrics (LJA, lightings) in London was £ 134 per ton on 3 June 1956, the Friday preceding devaluation. On Monday, 6 June, this price rose to £ 135, instead of collapsing. It remained at this point for some days and, after minor fluctuations, reverted to the pre-devaluation rate on 23 June. The prices of tea, black pepper and linseed oil also reveal that the London markets have wholly ignored rupee depreciation. Since then and as at the middle of August, black pepper and linseed oil have moved up, tea is about steady and jute fabrics have been weak. There is no evidence of a price collapse from devaluation. Past experience of devaluation was similar. Following devaluation by 44 per cent in September 1949, the dollar price of jute (Burlap) had dropped by about 7 per cent; but it had soon recovered and exceeded the pre-devaluation level.

55. Price steadiness may ensue from the working of two other factors. First, during the past over a decade, world trade has nearly doubled. The increase in world incomes, which is behind the increase in world trade, may cause a commensurate increase in the world demand for all Indian exports, though the rate of increase may vary with commodities. If, therefore, the expansion of export production, consequent upon devaluation, should keep pace with the expansion of world incomes and world trade, there need be little apprehension of a price decline in Indian exports.

56. Secondly, industrialists and traders may shift their attention from commodities with low elasticities of demand to the products of, and trade in, commodities with relatively higher elasticities, rather than suffer the penalty of the decline in prices and profits which may attend the undue expansion of the output of commodities with low demand elasticities. This shiftability of capital and effort from trade to trade under the pain of depleting returns or losses may prevent price collapse in respect to even commodities the elasticities of demand for which may be close to zero and of which India may be the major supplier in world markets. Varying demand elasticities may induce the diversification of production and exports, in developing economies. The low elasticities of demand for some export commodities provides no justification for resisting the elimination of currency overvaluation. Low elasticities may merely call for earlier shifts to other trades than in the case of commodities with high elasticities.

57. And ample room seems to exist for such shiftability of capital and attention. The traditional items of exports, with comparatively low elasticities of demand, account for about 56 per cent of Indian exports. If the scope for the expansion of the exports of these commodities should be limited, capital and effort may move to other trades which account for 44 per cent of total exports. Indian exports constitute less than 2 per cent of world exports. Even a substantial increase in export production may not, therefore, make much impression on the world market supply position.

58. The foregoing analysis supports the view that, currency overvaluation, exchange control and import restrictions are among the worst forms of governmental intervention in the economic life of society. Under-developed countries have little chance of economic and social progress unless they abandon exchange control and import restrictions by devolving their currencies to their equilibrium levels, or by floating them. Considering the meagre chances of their willingness and ability to adhere to the monetary and fiscal discipline essential to the maintenance of fixed exchange rates, floating currencies may suit their needs vastly better.

59. Since the termination of Marshall Aid, U.S.A., now joined by the rehabilitated industrial countries, have directed their attention to the task of accelerating economic growth of under-developed countries, aid taking the form mainly of government-to-government grants or loans. The results have been more generally disappointing. There has been little progress and even less stability.

60. To throw the blame on race, social backwardness, population pressures, and the like is to defy empirical evidence to the contrary and
to miss the more basic factors at work. Under altered policy climates in the former British possessions and elsewhere, migrant populations from the under-developed countries have achieved remarkable economic development. Race and social backwardness have not proved an insuperable drag on their progress.

61. The main explanation for the disappointing economic progress would seem to be the systematic violation by these countries of basic economic laws, under misguided policies mislabeled planning. All the under-developed countries that have failed to show progress have defied and discarded the central economic doctrine that scarce resources should be so deployed as to yield the maximum output. They have been dissipating their capital, attention and aid funds on heavy industries and show-window projects, despite their meagre additions to output, neglecting high return industries, generally agriculture, other primary producing and semi-processing industries.

62. Violation of economic laws, as always, has produced scaling effects. Scolding, however, has not led to policy rethinking, as aid-giving countries have rushed in to cover up the damage; and keep on covering it up. Not only is there no effort on the part of these well-wishers of economic growth in the depressed areas of the world, to seek out the deep-seated causes of the malady and to apply basic correctives; but, strange as it may seem, they extend moral support to the law-breaking programmes and, what is even worse, provide a substantial part of the financial munitions for implementing the programmes. It is more than likely that in the absence of this outside intervention, the pressures of the ill-effects of the errors might have steered these countries along the right road to progress. Little wonder that the Indian economy and the other economies in Asia, pursuing similar policies and receiving similar patronage and guidance, are moving from chaos to more chaos. The situation in India is already in such a state of deterioration that it is not possible to say with confidence that Communism is not among the dangers round the corner. And the way of uterence against this danger is not more massive foreign aid — this world further worsen the situation basically — but a well thought out scheme of policy reorientation.

B. R. SHENOY
V.

WELFARE STATE
WELFARE WITHOUT THE WELFARE STATE

by Arthur Kemp (*)

Surely it would be convenient if there were generally accepted, clearly understood meanings of the words and concepts we use. Particularly, this is true of such terms as «welfare» and the «welfare state». Welfare is a «good» word; it conjures up a condition of well-being — a sense of euphoria — and forestalls most, if not all, intellectual opposition that might result from other words or phrases. We speak, too frequently and too eloquently of private welfare, public welfare, social welfare, general welfare, human welfare and so on ad nauseam. Indeed, one sometimes wonders if the concept is not meaningless in its common use.

Economists, however, cannot ignore it because of the vast amount of literature associated with welfare economics (1). Participants in the debates and discussions include many of the most prominent of the present century, among them Pareto, Barone, Edgeworth, Pigou, Marshall, Sidgwick, Lange, Stigler, Samuelson, Mises, Hayek, and Friedman to mention only a few. This does not mean that there is any unified school of «welfare economics» or any well defined field of subject matter. Indeed, it would not be far wide of the mark if one were to equate welfare economics with normative economics as opposed to positive economics, as these terms are used by J. N. Keynes (2) and Milton Friedman (3). Welfare economics is replete with ethical or value judgements expressed explicitly or implicitly and, consciously or unconsciously, there is a tendency to draw positive conclusions on the basis of normative preconceptions.

This applies to most of those who might rightly be called (and who might be willing to accept the label) welfare economists. Carrying Marshall’s rational utilitarianism a step further, both Pigou’s welfare economics and Sidgwick’s ethical utilitarianism seemed to assert that the utility of a dollar to the poor man is greater than to the rich man. Transference of income from the rich to the poor will, therefore, increase the total social income and general economic welfare provided side-effects do not reduce the total national income (or national dividend, to use Pigovian terminology) by more than it is increased by the transfer. Pigou (who was a most able, neo-classical economist) thus pr-
vided a strong utilitarian basis for those who wished to bring about a redistribution of wealth and income through governmental intervention. Extending the reasoning, it was argued that all kinds of social legislation would increase the general welfare provided it was financed by progressive taxation; further, that income taxes are superior to other taxes and that progressive income taxation can be used to increase consumption notions about the causes of business cycles. Utility analyses is now seldom used as the basis for recommending particular policies largely because it has been clearly shown that interpersonal and intertemporal comparisons of utility are impossible and, indeed, are unnecessary for positive economic analysis of policy questions (4).

The literature roughly describable as a welfare economics continues to grow. In general it tends to be critical of the market by emphasizing market imperfections, market failures and market uncertainties or unpredictabilities (5).

But it does not substitute currently one or more over all objective criteria of the kind the utilitarians considered appropriate.

Welfare economics and welfare considerations also appear in so far as on whether rational calculation is possible under Socialism, or if it raises the further question: efficient by what criteria? Here either and it is virtually impossible to keep them out. By the nature of (or all) aspects of society. Socialists and welfare economists alike have tended to emphasize the imperfections of market systems and to infer that the appropriate solution is conscious, governmental efforts to produce the best results.

Historically, the emphasis of socialism was upon the collective (public as opposed to private) ownership of the means of producing, distri- buting, exchanging and financing the output of goods. Most current dic- tators still retain this traditional emphasis on ownership. For example: "Socialism ... the theory of the ownership and operation of the means of production and distribution by society, with all members sharing in the work and the products (7)." The objective was to use this ownership and control in such a way as to achieve a desired ends: co-operative justice or utopia or whatever. There were strong welfare elements in most of these ends, of which a greater equality of wealth and incomes was certainly not the least.

But, as has been pointed out elsewhere (8), the high water mark in western civilization of socialist emphasis on ownership came at the end of World War II. The nationalization undertaken by the British Labour Party when it came to political power in 1945, failed to live up to its advance billing. Nor was nationalization in other countries much more successful. Today, during its second postwar period of tenure, it is doubtful that the British Labour Party will try to pursue the nationalization program much further than required for obsolescence to its past efforts in steel. Few, if any, leaders of recognized socialist parties anywhere in the western world would be willing to advocate complete public ownership (socialization) of all the means of production. In Britain, one of the oldest Labour Party advocates puts it this way: "Certainly much remains to be done; but fiscal policies offer a simpler and quicker way of doing it than wholesale collectivism."

... the ownership of the means of production is no longer the essential determinant of the distribution of incomes; private ownership is compa- rable with a high degree of equality, while state ownership as the Russian experience has demonstrated, may be used to support a high degree of inequality (9).

It is interesting to speculate on why the socialists (except for the Marxist totalitarian) have abandoned the ownership criterion and emphasis. Several suggestions can be made: (1) the example of Russian and Chinese communism (particularly the Stalinist savagery before, during and after World War II) brought recognition that such dangers were inherent in other centrally controlled systems in addition to the German; (2) the experience in Britain with nationalised industries revealed that public employees, as managers, behave much as managers behave in privately owned industries;[3] a recognition that greater equality of wealth and income does not necessarily result from collective ownership; and (4) a growing fear of the power of the state when, being itself the monopolist, its influence and authority cannot act as a counterbalance.


The result, as Hayek, Roepke and others have pointed out, has been a general abandonment of the previously accepted socialist principles and objectives, and the substitution of a heterogeneous, hodge-podge collection of programs and activities, many of which are meritorious in themselves, but some of which are incompatible with individual freedom and all of which, taken together seem likely to establish a system that is as statist and even totalitarian as if this were in fact deliberate intent (10).

This sort of neo-socialism can logically be called, and has been called, the welfare state. It is not, however, a concept with a precise or generally accepted definition. Hayek suggests that the phrase «welfare state» is relatively new to the English language, probably taken from the German term Wohlfahrtsstaat:
«... The German term, from the beginning, was employed to describe a variant of the conception of the police state (Polizeistaat) — apparently first by nineteenth century historians to describe the more favorable aspects of eighteenth century government. The modern conception of the welfare state was first fully developed by the German academic Sozialpolitiker, or 'socialists of the chair', from about 1870 onward and was first put into practice by Bismarck's (11).»

Regardless of its origin, the phrase is widely used. My favorite definition is the tongue-in—check version provided by Ralph Harris (after a perfunctory bow in the direction of the inhabitants of the Scilly Islands', «welfare state: a compulsory system for taking in one another's inadequate incomes. Indeed, part of its general acceptance may well underscore the ideologies of those who use it. Some accept it as a descriptive term applicable to the kind of socio-economic arrangement they desire. To them the welfare state means acceptance by society of a responsibility for certain aspects of «wellbeing» of the individual citizen. What these aspects are, what constitutes «well-being», and who shall decide certainly varies widely. But underlying the concept is a strong belief in the desirability of a government paternalism and a low estimate of the dangers such paternalism and its accompanying welfare bureaucracy poses for individual freedom. Others accept the term, and employ it in a derogatory sense. They regard government paternalism with a high degree of suspicion and they are likely to have a deep concern lest governments, even when their motivation is beyond question, bring about a result that is often contrary to the intent, and frequently prejudicial to individual freedom (12). Almost all modern western nations can be called welfare states. All show a mistrust of the market in some way, although most of them use the market structure probably in a majority of economic decisions. Yet it may be useful to specify the common elements, both negative and positive, underlying all of today's welfare states. This is not to under take to construct an abstract, quantitative definition, but rather to indicate the common aims, methods and results.

First, the welfare state is not a centrally planned economy. No central planning board with the aim of achieving socialism (or communism, or military conquests, or whatever) exists, although there may be local, regional or even national planning boards, or planning teams given such devices as the NICDDs and NICKYs of the United Kingdom, the Planning Council of France, or a National Resources Planning Board in the United States but this is a far cry from central planning boards in modern communist governments. Indeed, the welfare states seem to have multiple planning agencies and central planning boards of one kind or another that are not truly central. The aims and objectives may well be (I'm inclined to say frequently are) mutually incompatible. The relative priorities have not been worked out. This postponement of conflict permits those with different ultimate aims to band together for current and temporary political objectives.

This is not to say that the welfare state may not develop into socialism of a type, or even into some form of communism in the popular use of the word. It may, indeed; but it is not inevitable.

Second, the welfare state does not abolish private property rights in capital although the nature of the welfare state alters property rights in general by a variety of restrictions, both direct and indirect. Private investment, however, is not prohibited as it is in the Soviet Union for all practical purposes, nor even to the extent that it is hedged about with restrictions as in India, and not to the extent it would be inhibited by the socialist programs of the period preceding World War II.

Third, the welfare state implies a social responsibility for government to provide steady and continuous employment for its citizens. One of the most pertinent and potent political slogans of the years during and after World War II was «full employment». Although the concept was vague and the means employed to achieve it or to try to do so vary, it seems an integral part of the welfare state. Doubtless the intensity and duration of unemployment during the nineteen thirties was responsible for its adoption and political popularity.

Fourth, welfare states exhibit a desire to achieve greater equality of wealth and income and a willingness to use the powers of the state through progressive income and inheritance taxation to bring about. It is not necessarily true that welfare states have, in fact, achieved the greater equality in such matters that they sought. The evidence seems

(12) One whose views fall into this category expressed his distaste both in the content and title of a book. See CHAD PALMER, The British Socialist Ill-Fare State (Caldwell, Idaho, 1953). For acceptance, on the other hand, see CROSSLAND, op. cit.
to suggest that, for the most part, they have not; that despite the intent and the stillly progressive some unintended side-effects have tended to preserve the existing distribution of wealth and income by making the social and economic structure less fluid (14).

Fifth, and this may be the most revealing aspect of the modern welfare state, there seems to be a strong and growing tendency to provide a wide variety of goods and services at less than market prices or even at zero prices. The goods and services provided by the welfare state below market price seem not to be randomly selected. It is not washing machines, television sets, automobiles or gasoline that are provided by some method of subsidization, but rather those types of goods considered by those holding political and economic power to be the things people ought to want. A general listing will serve to indicate the nature of these subsidized goods; and, although the names and techniques used vary considerably from country to country, the nature of the goods varies little, if at all.

Old age pensions — the subsidization of annuity programs — is probably the oldest part of the welfare package. It precedes the welfare state, of course, by virtue of poor laws, general public assistance programs and county poorhouses or poor farms. Subsidized housing, education services, transport services, minimum wage laws, certain price support programs and special programs (currently called anti-poverty programs in the United States) designed specifically for underprivileged or disadvantaged groups such as negro youth, mentally deficient, blind, farmers, or whatever. Health, Education and Welfare is a Department of Cabinet rank in the United States. Its title roughly conveys the nature of the goods and services provided by a welfare state at less than market prices — although in the United States provision of such services is by no means confined to that department or to that level of government activity.

Several general elements are apparent in the way in which these goods and services are provided:

First, consumption of these goods and services is promoted relative to other goods and services by virtue of the reduced (or zero) price. It is about as fundamental an economic principle as you can formulate to say that people will consume more at a lower price than a higher one.

Second, there is a tendency to promote monopoly power in the provision of such goods and services. Sometimes this takes the form of nationalization (as in the British National Health Service), or monopoly as in the American Old Age and Survivors Insurance system or intensive regulation of the purveyors as to prices, quality, discrimination, etc. Examples of the latter can be multiplied but the American Unemployment Insurance scheme is one and the so-called Medicare Program another.

Third, the programs involve some elements of redistribution of wealth and/or income. Under the National Health Service's zero price for medical services, for example, a person desiring to have a choice of his surgeon must, in effect, be willing to pay twice for it; once through the taxing mechanism and once through a highly restricted segment of semi-market system. In the United States, the minimal levels for OASDI both death benefits and minimal retirement payments, do not relate the returns proportionately to the taxes paid.

Fourth, the recipient of the subsidized good or service has his range of choice (freedom of choice?) restricted. Indeed, this is the purpose of the welfare state. If you permit people to use their abilities and resources in any way they wish, they may make 'wrong' choices (that is, choices of which those exercising politico-economic power disapprove). The welfare state intends to prevent this; it tries to assure that people will make the 'right' choices (i.e., choices of which those yielding politico-economic power approve). Indeed, this is the crux of much of the basic dispute among ideological systems — between capitalism and socialism, using both terms in their generic sense. Clearly this is the argument expressed by Galbraith's term 'affluent society'. People make 'wrong' choices when they are permitted to do so; they spend in the private sector instead of the public sector; they choose motor cars instead of educational facilities and alcohol instead of health insurance. Galbraith's solution is precisely that of the welfare state: permit the individual to spend a decreasing proportion of his income according to his own choice and, through government, spend an increasing proportion for him on the 'good' things, thus preventing him from erring, or if you like, sinning.

It is small wonder that the proponents of a free society — of liberalism in the classical sense of the word — have been greatly concerned with the growth and proliferation of the welfare state. This is not because they are anarchists, nor because they dislike all forms of paternalism. Clearly it is because they hold value judgments different from those who support the welfare state concept. They are aware that some individuals, if permitted a choice, will make choices that are sometimes unfortunate, ill-advised, regrettable, bad and so on. But they will place a lower value on these bad consequences than on the loss of fortunate, good, desirable and perhaps unknowable consequences that might have resulted from the permission of choice.

Those who favor the welfare state also are inclined to make collective ethical judgements. They believe that moral responsibility can be collective. Riots, robbery, murder, arson committed by individuals

(14) A current study of Sweden states: 'As regards the distribution of income, a public investigation into the taxation system made in 1964 clearly revealed that the net income structure had undergone only minor changes during the postwar period. This does not mean of course that the socialist government has not aimed at far-reaching equalization... The means of production are, in the main, controlled today by a small number of individual capitalists, just as they were 30 years ago. ERIK ANNERG, Socialism versus Progress: The Swedish Case (Zurich, 1960).
say, during the Watts or Harlem riots can really be blamed on society. So, too, can society be blamed for alcoholism, divorce, broken homes, etcetera. The liberal is inclined to deny collective guilt or, at least, to focus on individual responsibility. Of what value is it that a man does e good 2, if he is not permitted to do evil? The classical liberal tradition has very little to say directly about the ethical problem; in brief, it leaves most ethical questions for the individual to work out for himself.

The rise of the welfare state has coincided with continuing increases in the general level of prices. It is not appropriate here to consider some of the very real and difficult problems of measurement of price levels. Our abilities in these matters are improving but are far from being perfect. When comparing price indices in different countries at different times it is difficult to allow for direct price controls, black markets or even dishonest reporting. Moreover, the measurement of changes in retail prices in the short run frequently carries an inherent upward bias for several reasons: first, it is not always possible to allow for increases in the quality of goods and services; and second, the introduction of new goods and services increase the areas of choice; and third, certain restraints and pressures by government can, and do, alter the pricing processes. But, however, one wishes to measure it, the behavior of price levels in virtually all countries in the twentieth century contrasts sharply with the record of the previous two centuries.

Is the welfare state the cause of inflation? Is it the result? Probably both, in the sense that there are common causes and mutual interaction. Clearly inflation (increases in price levels) is not a necessary result of the welfare state, but it is a highly likely one. Inflation plus progressive taxation certainly brings about greater and perhaps different redistribution of incomes and wealth than might otherwise take place. There is no logical limitation of governmental activities in the welfare state. But obtaining the necessary funds to pay for these activities involves difficult decisions. All taxes are unpopular. Politicians would not be politicians if they always refrained from using some form of money creation in order to enhance their available funds and increase their activities.

Perhaps the most important factor of concern to those who favor a free or freer society, is its lack of principle. Hayek calls it unprincipled in the original meaning of the word (16).

There are no logical stopping points. The welfare state has a strong drive toward increasing centralization of decision and responsibility to the detriment of the citizens and the lesser units of government. This may result in greater equality of wealth and income (although this is by no means certain) but it is also likely to result in a greater inequality of political power with the total increased power being concentrated in the hands of the central government. As the process continues, will there be no grumbling as the proportion of a person's income he is permitted to spend for himself becomes smaller and smaller? Will the mass of wage and income earners look with equal favor on a welfare state that spends sixty cents of every dollar they earn as they do when that welfare state spends twenty cents? How about eighty cents of each dollar?

Put somewhat differently, it seems unlikely that the modern welfare state is in a position of stable equilibrium among the political and economic forces of social arrangements. The farther it goes, the greater likelihood that change, when it occurs, will be revolutionary and not evolutionary; political or political and economic, rather than economic alone. In the economic sphere, the welfare state is subject to strong attention toward greater centralization rather than decentralization, or the development of mechanisms and techniques for dismantling itself. In the political sphere, it seems beyond doubt that the modern state will remain centralized, strong and powerful. Whether it will remain 'democratic' in the western sense of free elections, and one-man, one-vote or move toward 'democratic' in the eastern sense of one-party, unfree elections, oneman, no-vote remains to be seen. Nor is it impossible for political and economic movements, particularly in the short run, to take place in opposite directions (17).

Public opinion in the United States, in Britain, Germany, Sweden, France — indeed, in practically all western civilization — seems to have strong undercurrents of humanitarianism and egalitarianism. At the same time, people seem to behave very much as if self-interest alone were the overwhelming incentive. This, of course, is somewhat paradoxical but it is also factual. When it is said that « we should do more > for the poor, the senior citizen, the negro, the farmer, the urban slum dweller, the children and so on, it is not a proposal voluntarily to pool resources for the benefit of the particular group. It is, rather, an expression of a willingness on the part of the advocate to seize the resources of other people and to use those resources for purposes of which he (the advocate) approves. This is a powerful source of centralization within the welfare state. The question is: How can the inherent momentum toward centralization, and the dangers of tyranny this entails, be slowed halted and reversed?

Welfare activities in popular parlance, are activities designed to help someone who, in some way, is considered less fortunate (whatever such phrase may really mean). All societies, at any given time, have some people who either cannot or will not contribute enough to command a sufficient amount of total output to permit them to live in 'comfort and dignity' (18). There is also some danger in helping others, typified (17) See, for example, the article on Uruguay by James N. Wallace. "If You Want to Know How Far Welfare Can Go — " U.S. News and World Report, Sept. 27, 1968, pp. 73-9.

(18) Whatever the phrase means. Probably a logical specification can only be made by those who are able to command a sufficient amount to enable them to so live.
by the Boy Scout who had helped a little old lady to cross the street, and was asked why he seemed so out-of-breath. Gasping, he replied "She didn't want to go."

Nothing in a purely capitalist society, in an ideal free society, prevents welfare activities. An affluent society is better able to engage in such activities, a rich person is more able to engage in such activities than a poor one. Indeed, there has been a proliferation of purely voluntary welfare activities of all kinds over the past two centuries. But, like it or not, it appears that the amount and kind of such voluntary activities were not enough or, if you prefer, such a free society was never achieved — perhaps cannot be achieved. For, in a truly free society no one would be inhibited or prohibited from giving whatever of his abilities and resources he desired, to whatever person or persons he wished to help. Nor would he be inhibited or prohibited from using whatever of his abilities and resources he wished to convince other people that they should voluntarily contribute their resources and abilities to help the person or persons.

The voluntary institutions have not, in fact, substituted for public involuntary government welfare activities. Indeed, they have sometimes promoted the governmental sector at the expense of the private and voluntary. One gentleman who has worked consistently in the direction of expanding the independent sector has accumulated much evidence that the independent, private voluntary welfare associations have promoted and strengthened the welfare state. He does not believe this to be inevitable, however, but rather that the resources and energies were carelessly spent or misguided and their techniques weak and incomplete (19).

Perhaps the immense energies and resources of an independent voluntary sector can be employed in a manner consistent with promoting a free society or, if you like a market society. Some think, for example, that those who manage voluntary welfare institutions are beginning to abandon their dislike of prices: "Independent groups have wasted money passing out middle-class welfare in the name of charity. When they do, they are not relieving misery — only inconvenience. But now they are beginning to free themselves to act on real public problems by charging for services wherever the user can pay for them..."

"The independent sector is not retreating from its missions as it moves in this direction. It is fulfilling its mission. We should rejoice in the affluence that permits people to pay for services others once had to provide for them" (20).

It would be possible to face the problem of poverty directly rather than indirectly. Being poor is simply another way of saying that one lacks purchasing power, and the obvious and simple way to alleviate the condition is to give the poor the desired purchasing power in its

most generalized form: money. Ideally the non-governmental and purely voluntary way to do this is for one person to give money to those whose poverty (lack of purchasing power) induced him to do so. Whether this can be done to an extent sufficient to satisfy our desires to alleviate poverty, particularly in our impersonal urban type of society, may be open to some question.

But we now attempt to alleviate poverty by an almost endless variety of governmental programs that are not only indirect and expensive but also are frequently ineffective or even produce more poverty and suffering rather than less. Currently, there are a variety of proposals that are less damaging to individual freedom and responsibility than the hodgepodge of programs now in existence. Total governmental welfare payments (at all levels of government) in the United States amount to something in the neighborhood of $40 billion per year. Expendng the same amount directly, rather than indirectly, would permit payment of $5,000 annually to the 8 million consumer units at the lowest end of the poverty scale. Not all proposals for direct monetary payments are advocated for the right reasons. Some, indeed, are advocated because of a fear of automation and cybernetics a belief that work will be disassociated in a short time from income (21). But we need not disregard good advice even if it is given for the wrong reasons. I received recently a publication called GAIN (a Guaranteed Annual Income Newsletter) Vol. I, No. 1, published by an Ad Hoc Committee for Guaranteed Income, University of Chicago School of Social Service Administration. The Committee seeks to promote a guaranteed annual income (22). They are assertively aware that current social welfare programs do not and cannot meet present and future needs. Being intimately acquainted with the gross inequities of these current programs, particularly the public welfare system, they cannot ignore either the immediacy of the problem or the moral responsibility to act (22).

Of all the proposals that have been made for some form of money payment to replace the present hodgepodge of welfare measures, the one that I find most appealing is the negative income tax (23). Although it has the obvious shortcomings (from the standpoint of those who believe in a free and voluntary society) of being a dole with no upper limits, and a direct redistribution of income — taxing some for the purpose of

(19) RICHARD C. CORNWELLE, Recapturing the American Dream (New York, 1965).
(20) CORNWELLE, op. cit., p. 133.
(21) See, for example, ROBERT THOMAS, ed., The Guaranteed Income (New York, 1960).
(22) For an impassioned negative, response to the guaranteed annual income, see "Dehumanizers at Work," Wall Street Journal (editorial), June 21, 1960. The idea is described as "a negation of the traditional social and economic framework," "immoral," and "striking at the roots of human responsibility." Despite some sympathy for the value judgments expressed, the question is not really whether such comments are to be applauded or not, but whether such a scheme is any more dangerous than those already existing.
There is little doubt that such a system would benefit private educational facilities and make it much more difficult for educational institutions to be used for purposes of political or religious indoctrination. This, in fact, was the reason John Stuart Mill favored it in his essay On Liberty. It does not alter the question of whether or not education should be compulsory by increasing its or its post-tax incidence, for whatever is desired as the absolute minimum could be required of all. And it is likely that the subsidy payments could be tailored to fit the requirements of those most in need, if that is desired. In many cases in the United States, the present system of ownership and operation subsidizes those least in need of subsidization and fails to subsidize those most in need of education.

The same principle could be expanded to preclude some of the less desirable side effects of such programs as the so-called Medicare in the United States or the National Health Service in Britain. Medical aid to those over age 65 in the United States could have been financed by means of voucher or earmarked checks payments to those over that age (or any requirement in addition to that if desired), specifying only that these could be used for, say, physicians’ services, hospital services, or medical insurance. This would have had the effect of avoiding a national health bureaucracy and with less side effects on the market for health insurance, medical services, and equipment of all kinds. Relative prices within the health field would be determined by market forces thus bringing about a quicker and more efficient allocation of resources within the general health and hospital field. The fact that Medicare was not handled in this way but rather by a variety of zero price, less that market price, coinsurance, deductibles and what not practically guarantees that there will be a period of some shortages, scarcities, grumbling and frustration by consumers and discontent among the medical, paramedical and hospital personnel. Moreover, the costs of administration are almost certain to be higher than they otherwise would be.

Considering the dissatisfaction on the part of both purveyors and consumers under the British National Health Service, it seems somewhat doubtful if the wholly (virtually) public system attempted in 1948, with all services at zero price, would be the method adopted today (26). This is particularly evident if one looks at the various ways in which, since the establishment of N. H. S., that market factors originally disregarded, have been reintroduced in one way or another. To mention a few: [1] limitations of total expenditure on N. H. S.; [2] introduction of partial payments for certain items such as eyeglasses; [3] introduction of a nuisance price on drug prescriptions and [4] medical review boards aimed at reducing overutilization of drugs.

(24) Of course, some might buy LSD or gin or race track tickets instead of bread and housing. But then the problem is not poverty but something else. Recently a high city official in New York opposed legalizing off-track betting sabots (although the voters indicated a strong desire to have them legalized); he reasoned that they should not be permitted because they would injure most the poor families of the city. This raises several interesting questions: Do people make the wrong choice because they are poor? Or are they poor because they make the wrong choice? And who shall decide which choices are wrong? Given freedom to choose for themselves, some people are certain to make choices of which others will disapprove. Indeed, that is freedom in its most fundamental sense.

Clearly then, the efficiency of certain public services would be improved if the various public service schemes carried a safeguard so that individuals would be permitted to 'opt out' or contract out of the system so to speak. In the case of the United States, why not permit the people to choose private insurance or annuity schemes rather than public? Certain minimaxes could be specified, of course; but one effect would be to provide competing arrangements to assure quality, efficiency, and flexibility in the public system. Another advantage is that it would tend to place limits on the temptation to bring about redistribution of wealth and income by hidden methods. Those choosing non-governmental services might well pay part of the bill themselves (as some do, even in Britain).

Such a result would, perhaps, increase the total amount expended (public and privately) on the services (education, health or whatever) and, hopefully, less total public expenditures with consequent lower taxes and side benefits to all taxpayers. Most important of all, for the free society, is that it reduces dependency upon the state and avoids some of the dangerous aspects of the welfare state. The same could be said of health services, public education, and so on.

Indeed, it is by no means clear that, given the knowledge to express preference in these matters, people prefer a continual expansion and increase in state provided service as against private (that is, market) and personal selection. An attempted public opinion type survey in Britain suggested that about half favored allowing people to contract out of publicly provided pensions, health and education and a substantial number expressed interest in the use of vouchers (earmarked checks) as opposed to public ownership and operation of the service function (27).

I am suggesting, in summary, that those of us who believe in the principles of free society — those of us who are liberals in the classical sense of the word — need to seize the initiative without abandoning our basic principles. For those who would move toward greater centralization from the present welfare state, the route is clear and the means and techniques are well-known. The only issue is whether to use it with a mailed list or a velvet glove. To the liberal the task is much more difficult: how to move away from the welfare state without a decrease in welfare. Or to put it in the terms of the title of this session: How can we have welfare without the welfare state?

The techniques suggested here are not new. In brief they are:

[1] to substitute a guaranteed annual income to all in the form of a negative tax for the hodge-podge of welfare schemes and income supplements now in existence;

[2] when such an overall scheme is not practicable and specific type subsidies seem necessary, for whatever reason, to attempt to achieve the desired end by subsidizing the buyer and not the seller, thus reducing substantially the possibility of using the subsidy for paternalistic and political purposes;

[3] to attempt to build into existing welfare state activities schemes that permit individuals to contract out of the services provided for them at less than market prices.

There are other techniques. Sensible fiscal and monetary policies are fairly obvious, because they limit the number and variety of welfare state activities. Beyond this we need to turn our attention to devising other techniques not yet known or tried. Unless we are prepared to do no more than protest, to fall in anguish, the remark made that the liberals were dragged, screaming, into the twentieth century may prove to be more than a snide comment. We must influence, if we can, the direction of change and of developments. This will require new ideas, new techniques, new tactics, new experiments, new applications of old techniques — but not, I trust, new principles.

The techniques suggested here are bold and brash; most are untried except on a limited scale. But they are not conducive to moving the welfare state toward socialism, and they are not conducive to more paternalism but rather less. They are not likely to bring about the millennium, but they can be used to increase somewhat individuals' abilities to use their time, energies and resources in whatever ways they wish. This, I trust, is both a desirable end in itself and the means to pass on the 'fruits of liberty' to posterity.

ARTHUR KEMP

Riassunto — L'autore prende in considerazione, prima di tutto, i molti usi della parola 'beneficenza' e si domanda se il significato compiuto del suo contenuto. Egli traccia in seguito una breve storia delle economie del beneficario: da Pugin e Blackwood all'attuale accento posto sugli invecchi e le imperfezioni del mercato invece del precedente utilitarismo. Si descrive il mutare dell'accento posto precedentsisente nelle proprietà pubbliche e in seguito a beneficario negli scritti sociali. Dopo aver considerato l'origine e lo sviluppo della frase 'Stato assistenziale', l'autore discute cinque caratteristiche essenziali comuni ai moderni Stati assistenziali: 1) mancanza di pianificazione centrale; 2) un doppio amianto alla proprietà pubblica; 3) una responsabilità sociale per uno stabile e continuo impiego; 4) una decisione di raggiungere una maggiore uguaglianza di ricchezza e di reddito; 5) una tendenza crescente a fornire alcuni tipi di beni e servizi ad un prezzo inferiore a quello del mercato. Continuando con un esame di alcune delle implicazioni etiche ed economiche di queste caratteristiche, l'autore suggerisce diverse tecniche che, se adottate, potrebbero ridurre i peccati di centralizzazione inerenti agli Stati del benessere senza venire meno ad alcuni obiettivi umanitari ed anche egualitari. Queste tecniche sono: 1) dare assiduità al compratore invece che al venditore di beni e servizi; 2) una tassa di reddito negativa; 3) permettere agli individui di liberarvisi o di scegliere gli schemi del servizio sociale.
WELFARE WITHOUT THE WELFARE STATE

by A. A. Shenfield

1. In what sense is the liberal concerned with welfare? Clearly he is concerned with liberty. Clearly also he is concerned with the social order which protects, nurtures and extends liberty. Thus he is led into the study of the relations between men with a view to discerning or establishing the system which will serve their liberty best. But welfare is something different from liberty. It is true that it may be a product of liberty, but it is also true that it may exist without liberty or with a closely limited liberty. Is it not therefore arguable that the liberal leaves welfare to look after itself?

2. To say that the liberal leaves welfare to look after itself is not as unambiguous a statement as it may appear. It may mean that he believes welfare to be an important aim, but that it is liberty which produces the optimum welfare (in the extreme case this might even mean that he considers welfare to be more important than liberty, and that he aims at liberty in order to achieve welfare). Or it may mean that, as a matter for and in the context of the social order, the aim of welfare will conflict with the aim of liberty, and that he therefore eschews the aim of welfare. Or, further, it may mean that he has nothing to say on the subject of welfare.

3. Clearly it will not be possible to make progress in this discussion without first offering some definition of welfare. It may refer to the amount or kind of men's psychic satisfaction; or to some concept of general well-being viewed objectively; or, in a specialised conventional sense, to the provision available to men in certain selected fields, usually those of health, education, housing, and income in retirement and unemployment.

4. An examination of the problems of maximising or optimising men's psychic satisfaction would take us into the field of so-called welfare economics. For the purpose of producing a prescription for the social order, this has almost certainly proved to be a blind—alley. If it had not, the liberal would of all people be the most interested in it, and also the best qualified to reach tenable conclusions upon it; for it rests upon a foundation of catalytic or micro-economic analysis which for the liberal is the essence of economic science. However, since welfare economics has turned out to be a largely sterile system of inquiry, we need concern ourselves with it no further for the purpose of this paper.

5. Liberals have always in practice been interested in objective well-being (i.e. seen as the standard of living or command over re-
sources). The driving force of classical economics was possibly as much
the search for ways of increasing men's material well-being as the
desire to discover the truths relating to their economic actions and
relationships. That the two led in the same direction was itself a
powerful support for classical economics, but it implied that liberty
was seen not just as a good in itself but also, and perhaps mainly, as
the cause of welfare in the sense of objective well-being. Hence among
the various tendencies of classical economists it is possible to discern
one which opened the way to the trimming of liberty where and when
it might be shown to run counter to well-being. Certainly not all those
in the classical tradition have fully comprehended the dangers of
applying the test of well-being to the merits of liberty, for it is from
this that democratic socialism (mis-called liberalism in the United
States) has partly sprung. Yet it has always been obvious to the pro-
founder liberals that the principle of the sacrifice of any element of
liberty in exchange for well-being is highly debatable and that at
best the scope for such an exchange is extremely narrow. A fortiori,
one's quite modest degree of well-being has been achieved, a rise in
its level is no test at all of the merits of the liberal social order.
Consider, for example, how frugal the standard of living of the citizens
of the most splendid society known to us, Periclean Athens. It is
persuasively arguable that, amongst other things, it was precisely
because the Athenian was unaccustomed with material comforts beyond
those of a sparsely-furnished home, simple clothing and frugal means,
that he was able to apply an attentive mind to the most fundamental
questions of politics and to the treatment in the most sublime drama
of all time of the most perplexing problems of human existence.
Although the liberal believes that no good, and much evil, must come
from preventing people from seeking material well-being, he knows
also that there are more important things for men to seek.

6. However, although the liberal puts welfare, in the sense of
objective well-being, as the material standard of living, below liberty
in his hierarchy of aims, he has always rejected the claims of his
enemies that they can produce more welfare than he. Since the
debasement of traditional conservatism, which offered neither liberty nor
welfare (though in practice it often conserved a fair medium of both), it
has often been the claim to produce more and more welfare on which
anti-liberals have climbed to power. Or, where group hatreds or
resentments have been their main support in the seizure of power,
they have also relied heavily upon the alleged failure of liberty to
produce welfare.

7. The emptiness of the claims of totalitarian anti-liberals to
produce welfare in this general sense calls for no lengthy demonstration
here. When the relevant statistical and other evidence is properly
weighed, totalitarian regimes show a clear failure to match comparable
liberal regimes either in rates of growth of product per head or in
absolute values. Their failure is easily explicable on the basis of the
impossibility of finding a solution to the problem of calculation in a
truly centrally planned economy; for which reason some among them,
having already discovered the merits of a considerable decentralisation
of initiative, are now discovering those of the measuring rod of profit.

8. The claims of democratic anti-liberals are less easily disposed
of. Of course, in so far as they really mean to achieve a socialist
economy they merge with the totalitarianists, and if they succeed in their
achievement they must themselves become totalitarian. But in so far
as they are mere interventionists, not seeking to destroy the liberal
economy but intervening in order to correct its alleged defects, the
judgement of their claims to produce more welfare in the general sense
than the liberal, though adverse in every case, will vary in severity
from case to case according to the nature and extent of the intervention.
Statistics of national income will be treacherous evidence here, since
democratic anti-liberals are likely to claim the richest countries, e.g.
the post-Hoover United States, Sweden, Australia and others, as exam-
pies of the merits of State intervention in the free economy, while the
liberal will claim their prosperity as a product of their liberty. The
only valid tests here are analytical, and analysis of the many forms
of State economic intervention produces the rough general judgement
that State intervention which operates to thwart, rather than to
smooth, the processes of the market reduces welfare. In many cases
this result comes quickly and obviously; in others it comes when the
full consequences of the intervention have been produced.

9. Having made this brief reference to State interventionism in
general in the free economy, we may pass readily to a consideration
of welfare in the specialised sense of provision for the needs of health,
education, housing, retirement and unemployment. For it is in these
fields that intervention has become most far-reaching and, in some
respects, most widely approved: for which reason it is welfare in this
specialised sense which people most often have in mind when they
refer to the Welfare State.

10. State intervention in these fields is attractive to many people
who are by no means enamoured of intervention in other fields, because
it appears to be concerned with the relief of poverty. And, despite the
wonderful achievements of the free economy in creating and spreading
wealth, the poor have always been with us. Indeed the duty of the
State to come to the rescue of the poor in some measure and in some
circumstances has never been denied by the champions of the free econ-
omy. Though they regard the free economy as itself the greatest
engine for the conquest of poverty ever known, it has never been part
of their case that individuals in a free society cannot suffer from
exceptional misfortune or incapability, or that such individuals must
be left to their fate or to the aid of private charity only.
11. However, the welfare State is concerned not with provision in the fields of health, education and the like for the poor, but with provision for all. Relying on the acceptance of the virtue of State provision for the poor, it slides by way of the view that the provision should be generous in amount to the position that it should be universal in coverage. The process is one of constantly shifting intellectual foundations. Sometimes universal coverage is advocated on the ground that it produces the most economical, effective or generous provision for the poor; sometimes on the ground that, within the limits of what it aims to supply, it produces this result for all (private provision above these limits being regarded as concerned with what is incidental); sometimes on the ground that the means tests, which must be applied to distinguish the needy from others if provision is not universal, cannot be other than degrading, and that hence universal coverage is justified irrespectively of its economy or effectiveness; and sometimes on the ground that the right of all to call for provision by the State is, or ought to be, a badge of citizenship; which, if it means anything, must mean either that health, education and the like are in the same category as justice, police protection, national defence, or, say, consular protection abroad, or that they have some peculiar quality which inspires men to think about them in terms of all for one and one for all.

12. The slide from a preoccupation with provision for the poor to the necessity of universal provision by the State is especially easy when the definition of the poor is so widened as to include a large proportion of the people, so that few may be sure of not falling within that category at any time in their lives. But it might be expected to be more difficult when the needs, as distinct from the numbers, of the poor are exaggerated, for then it might be considered the more necessary to concentrate State provision upon their relief. Yet in practice the exaggeration of the needs of the poor has proved to be a potent cause of the acceptance of the Welfare State, thus illustrating the strength of the grip of emotion upon the public mind in this field.

13. The widening of the definition of the poor has been especially prominent in Britain, where the costs of the National Health Service, which is regarded by its champions as the noblest achievement and proudest badge of the Welfare State, have constantly tended to exceed the estimates. Once this became clear, the defence of the National Health Service shifted to the proposition that what mattered was the proportion that it took of the national income. As long as this did not increase, the argument ran, not only was there nothing to complain about but also there was no true increase at all. This may be called the Theory of Perpetual Poverty: however affluent a society becomes, there must always be enough poverty to call for a constant proportion of the national income to be applied by the State to its relief. From this the next step was easy. It was to discover that poverty was a relative concept, that the level of the poverty line must rise with the level of general affluence, and that hence in the end all those were poor who fell below the average level of income, i.e. one half of the nation. It is a proposition which obviously offends against commonsense, and in a country where millions of people who fall below the average level of affluence can obviously afford many non-essentials, it is unlikely to gain wide acceptance when stated explicitly. But the grain of truth in it, the element of relativity in poverty, is used with much effect in popular propaganda to link the relief of poverty with the advocacy of universal State coverage.

14. The propagandist potency of the exaggeration of the needs, as distinct from the numbers, of the poor is abundantly illustrated in the famous Beveridge Report, which inspired the post-1945 development of the British Welfare State. The evils of poverty were dramatized by conjuring up the picture of the giants of Want, Squalor, Disease, Ignorance and Idleness, and the public mind was thus effectively soften for the push towards universal social provision. In fact the more frightful the giants were, the less could the nation afford to spread its provision over all citizens. But in any case the truth was that, writing in 1914 and having the conditions of 1919 in mind, Beveridge ought to have known that the giants of the 1890s were truly menacing only to the unemployed, the low-paid worker with a large family, and the elderly poor. The economy was productive enough to enable almost all but these groups to make substantially effective provision for themselves, and this despite the fact that its productivity was hobbled by the very factors which produced unemployment. The dramatization of the problem by the picture of the giants had the effect, and perhaps the intention, of weakening critical analysis, and thus of hiding the true nature of what needed to be solved. By contrast the presentation of the case for universal coverage was cursory in character. The demonstration of the benefit which universal coverage would produce for the poor was hardly attempted, for the obvious reason that it could not succeed. The case for universal coverage as a means of benefit to all could be given plausibility only with reference to retirement benefit, where the administrative costs of life insurance supplied to the working class by the market appeared to be high; but even this has lost cogency in the light of the actual development of the State pension system. As for the problem of the means test, the treatment of those who had exhausted their unemployment benefit in the 1930s was given inordinate weight and no serious attempt was made to consider less humiliating ways testing means. The justification on the basis of a badge of citizenship is mainly a later development and is discussed further below (Paragraph 34).

15. Let us now turn to the operations of the Welfare State in the individual fields concerned, as exemplified by the experience of Great Britain. The National Health Service is perhaps the best case for the commencement of a review both because, as we have mentioned...
above, it is the especial pride of the devotees of the Welfare State, and because it illustrates most clearly the failure of the Welfare State to deliver the welfare expected of it. Until recently the pride of the adherents of the National Health Service was so blinded that almost every public discussion of its problems was prefaced by some such claim as that of course we have the best National Health Service in the world, by which was meant not merely what the words appeared to say but also the much larger claim that we had the best health provision in the world. Yet now the National Health Service is in growing measure the butt of criticism from almost all sides, and a source of disillusionment both among doctors and among patients. Among the doctors, the defects of the Service have produced such discontent as from time to time threatens a revolt. Among the patients there is evidence of a growing desire for freedom of choice in the consumption of health services as against limitation to what the national service provides.

16. The debacle of the National Health Service has not been difficult to foresee, for two principal reasons. First, when payment is collective and by way of taxation, and consumption is individual, demand must constantly outstrip supply. At the point of payment there must be resistance to expansion because payment cannot be linked to individual benefit; at the point of consumption there must be pressure for expansion because the effective price is nil (or, where some contribution is required, smaller than the benefit). Hence waste arises and some form of rationing becomes unavoidable. Since it is not possible to ration health services down to a stipulated quantity per head, as in the case of meat or bread, the effect of the rationing is a deterioration in the quality of the service. One may go to a doctor as often as one wishes, but what one receives from him is less time or less care than he would have provided in a free market. One may be entitled to a bed in a hospital for an operation, but one may hate to wait according to some judgement, over which one has no control, of the relative urgency of one's need. At the same time the doctor is dismayed both by the limitation which payment by taxation imposes on his remuneration, and by the waste of his time and talents which results from the excessive demands of his patients. Hence the end result it not only the deterioration of service. It is also the deterioration of professional standards, desire for improvement, and clan.

17. Secondly, in the British case there was at the beginning a fantastic misunderstanding of the nature of medical services. The creators of the National Health Service decided, and it was to their proud boast, that everyone should be entitled to the best medical care available. It was thought to be immoral that the enjoyment of medical care should be determined by the weight of a man's purse. What was overlooked was the impossibility of defining the best medical care, and the capacity of treatment to expand infinitely in cost if every conceivable test, device or medication, tried or untried, were called to the doctor's aid. Hence the tendency of the cost of the service to outrun its finance was aggravated, and so too were the effects of the counter-tendency to hold costs down by reducing quality generally. Thus the right of a man to have the best that money can buy, in the sense of the free benefit of the latest discoveries of science, has caused the community in general to have the worst that is tolerable without revolt.

18. Sooner or later the essential principles of the National Health Service will be abandoned; and it will be made all the sooner by the current tenacious adherence to those principles of the present British Government which, at a time of great financial strain and at preposterous cost, insists on the free supply of drugs to all and sundry. The way out will be found to be the way of the free market. Already, despite the heavy burden of taxes to pay for the national service, large numbers of people have entered private insurance schemes in order to obtain the service they want. This process has gone quite far in the case of specialist services and it has made a successful beginning in the case of treatment by general practitioners. The next step must be to dismantle the State provision, as distinct from financing, of general practitioners' services. These services would then be bought and sold freely, but some people, namely those below a suitable level of means (which would naturally take account of family obligations as well as family incomes), would be subsidised in their purchases. The succeeding step would be to free the specialist and hospital services where, however, the element of State subsidy would be larger and remain longer than with the general practitioners, and where State provision, as distinct from limited State financing would continue in the case of a substantial proportion of mental hospitals. The case of mental hospitals is an exceptional one, where State provision may be justified in some measure on the ground of the protection of the public, apart from the needs of the mentally ill.

19. The effect of these developments would be both a fiscal and a medical revolution. On the one hand the fiscal burden would fall substantially, and would fall further in due time as the general rise of affluence would reduce the proportion of people requiring subsidy. On the other hand the quality of medical services would rise, as would also the psychic satisfaction of the patients, for the satisfaction from services freely bought always tends to be higher than that from services handed out. Welfare in the field of health would rise as the Welfare State bowed out.

20. It is not intended to suggest here that the promotion of welfare in health by revival of the market would be a simple matter. It is indeed simple in conception, but it would raise some by no means simple problems of administration. First, there is the problem of establishing and applying the means test. Then there are the problems of distinguishing between the finances of the general practitioner's personal attention and of his drug prescriptions, at a stage of medical
development when drugs are becoming more and more expensive. Yet again there are the problems involved in the return of hospitals to private management and control at the very time when, owing to the inadequacy of financing by taxation, they have been physically run down and need substantial development and renewal. However, the difficulties presented by these problems are not insuperable. To a large extent in their case it is the first step that counts; thereafter the difficulties will become less perplexing. The means test, for example, is now much easier to deal with than in the days of the Great Depression. Owing to the extension since the War of the system of personal taxation it is now possible in the great majority of cases to use tax records to determine levels of means and, unlike the case of public assistance before the War, it would not be necessary to make brothers and sisters, children and parents (except in the case of parental responsibility for minor children) share the burden of poverty. The other problems would call for much enlightenment and experimentation in administration. But the experience of private health insurance is already a valuable foundation, and this despite the fact that the marketing of such insurance has been of a very timid and modest kind. In new conditions of freedom one could expect much development in the scope and variety of private insurance, which would greatly facilitate the transition to the private supply of specialist and hospital services as well as those of general practitioners.

21. Provision for income in retirement is in some ways even more the Achilles heel of the British Welfare State than in the National Health Service. It still masquerades in large part as insurance, albeit subsidised insurance, but in fact it is becoming clearer and clearer that it is not. It is in fact a system of taxation of those below, and benefits for those above, retirement age, with only a tenuous connection between the two. In effect the taxation goes into the general funds disposed of by the Government and the benefits depend upon the willingness of the Government or the people to spare them out of current resources. The past contributions (i.e. taxes) borne by the beneficiaries do not determine the level of their benefits, though to some extent they do determine their qualification for them. Since those who do not qualify for retirement benefits may nonetheless qualify for national assistance, the effect of non-qualification is in many cases of no consequence. The system is complicated by the fact that the State concedes certain tax advantages to occupational pension schemes (i.e. schemes operated by employers for their employees, and to some extent also schemes operated by the self-employed), but different and generally lower tax advantages to straightforward life or endowment insurance. The values of these tax advantages depend on numerous factors and hence produce a hotchpotch of ill-planned or unplanned benefits.

22. The fact that the State pension is in truth a call on current resources unrelated to the beneficiaries' past contributions throws into clear relief the bankruptcy of the system if viewed as insurance. As the proportion of the population which is beyond retirement age grows, and the British population is ageing considerably, the current burden of the elderly on those of earning age will become heavier and heavier. Yet at one and the same time people are being encouraged not to save for their retirement by the promise of State pensions, are being prevented from saving for retirement by State-engineered inflation, and are allowed to weigh the current burden down because of the principle of universal coverage irrespective of need. The prospect for future pensioners is therefore bleak. Their dependence on the State will grow, but at the same time the irksomeness of providing for them will also grow.

23. The defects of the present system spring from the evils of inflation and the principle of universal coverage. Inflation is making it more and more difficult for people to make their own uninjured provision for retirement, while the principle of universal coverage ensures that the burden of producing satisfactory provision per head becomes intolerable. It may be said that the system of State provision cannot be held responsible for inflation. This cannot be accepted without cavil, for the expenditure of the Welfare State is itself a potent cause of inflation (it is wrong to consider it simply as a system of transfer payments, neutral in its effect on the price level), and the system of retirement benefits is a prominent feature of the economy of the Welfare State. As for universal coverage it clearly raises the total cost very substantially in order to make provision for people who could look after themselves. The recent development of graduated pensions over and above the basic universal pension will not remove this defect, even if the graduated pensions are rigorously fixed to an actuarial basis, which is unlikely.

24. A fully effective reform of the present system would require a genuine determination to bring inflation to an end. Whether this can be forthcoming or not is not a question which needs decision here, but what is certain is that it will not be forthcoming in the environment which exists, and is created by, the Welfare State. Even without the conquest of inflation great improvement would result from the abandonment of the principle of universal coverage. The adoption of a rigorous actuarial system would not be a suitable expedient because, pace Beveridge, the free market can provide actuarially-based retirement insurance as economically as the State, and the problem of those for whom actuarial payments would be too heavy would remain. The truth is that there is no genuine need for a State system of retirement provision. Either those beyond retirement age who are in need ought to be given National Assistance (under a humanely administered means test), or those whose incomes cannot sustain actuarial payments for minimum satisfactory retirement provision ought to be subsidised. This would leave the organisation of retirement provision in private and competitive hands, and the net product of a unit of expenditure would
be greater than that under the State system. Here too welfare would be increased by the retirement of the Welfare State.

25. Let us now turn to a view of welfare in housing in Britain. In one important respect housing is atypical. The State does not aim at universal coverage. Yet this does not reflect a true difference between the State's attitude to welfare in this case and that in others. The reason for the difference was the existence of a large stock of privately owned housing at the time when State intervention began. If, by way of illustration, the whole stock of housing had been destroyed in the War, the State would certainly have established a system of housing provision for all (naturally minimal, if not mean and nasty, in character), with perhaps the possibility of better private provision for a tiny few, if any, of those who might be prepared to pay for it. Indeed, for a considerable time after the War, private new building of houses was subject to licence, which was extremely difficult to obtain, and almost all house construction was for public provision.

26. The treatment of housing in Britain is also exceptional in that it embodies a degree of illogic, inequity, discomposure, and hypocrisy of extraordinary dimensions. The system of State intervention is broadly twofold. On the one hand the local authorities, on the basis partly of local and partly of national taxation, provide housing for a very substantial number of people at belowmarket rents. On the other hand an even greater number of people live in privately owned housing at rents which are controlled and thus held down by law to below market levels. Among the local authorities there are many who grade the rents of their tenants according to the tenants' means, but even in those cases the highest rent demanded merely produces a market return on the historic cost of the housing provided and this is almost always below the true market price. In the vast majority of cases the rents fail very far below, and in many cases very far below, even in return on historic cost. Yet it is absolutely clear that the majority of local authorities' tenants could afford to pay a full market rent. If one takes family incomes into account, many of these tenants are actually better off than a large proportion of the unfortunate people who are outside the system of State provision and have to pay the full price, usually by way of mortgage interest and have to pay the renting of furnished accommodation (which is much less tightly controlled than unfurnished), of their housing. Thus local authority housing is a means of unnecessary subsidisation of very substantial proportions at the expense of the taxpayers and others, many of whom are worse off than the beneficiaries. The inequity is aggravated by the fact that luck and local circumstance play a largely determining role in the selection of the beneficiaries. Thus inequity and waste go hand in hand.

27. The system of rent control over privately supplied housing probably produces even greater inequity and waste. In broad terms, and subject to some recent amendments which widen the scope of controls (and thus intensify their evils) but also make them more flexible, the system holds rents down to 1939 levels, and in some cases even to 1914 levels. The selection of the beneficiaries and victims of these controls depends upon the pure accident of the ownership and tenure of the housing before the War, except to the extremely limited extent that the most expensive housing, which amounts to a tiny proportion of the whole, is outside control. Here the inequity amounts to an enormity, which is matched only by the hypocrisy which pervades almost all public discussion of rent control. The subsidy to rent-protected tenants is entirely arbitrary, has nothing to do with the means either of the tenants or of the landlords, many of whom are much poorer than their tenants; while persons who may be poorer than protected tenants may have to go to the limited free market in housing where prices are higher than they would be if there were no rent protection owing to the deadly effect of the system upon the market supply of new housing. The hypocrisy which has gripped the nation in these matters is exemplified by the fact that most tenants take a high moral tone about their rights, although they themselves would not dream of investing their own resources in any form which yielded them a below-market return. Indeed many of these tenants have no compunction in raising their own incomes by subletting part of their accommodation at a profit if they can (and it is permissible under the law in many cases), or by using the market power of labour monopolies, to which they may happen to belong, to raise the price of their labour. Yet the high moral tone of these tenants is more or less endorsed by the greater part of the rest of the public, which sees neither the hypocrisy of the matter nor the damage which it does to non-beneficiaries.

28. The worst effect of State intervention in housing has been to destroy the incentive to produce housing for letting. Almost all privately built housing is for owner-occupation. The victims are all those who might otherwise have benefited from a plentiful choice of housing for rent, produced by a vigorous and resilient industry obliged to attend itself to the needs of the market. Compare the situation in housing with that in all other consumer durables. Television sets, refrigerators, washing machines and the like are plentiful and get cheaper and cheaper as they get better and better. If they had been subjected to price control and the haphazard selection of the beneficiaries thereof, they too would be in short supply, expensive, and technically backward. No case is clearer than housing to show how the Welfare State is the enemy of welfare. If welfare is truly our aim, nothing is more urgent than to sweep away the intervention of the State in the provision of housing. There is no need for the State either to provide housing itself or to interfere in the free market bargains between owners and tenants. In this field as in others, the sole proper role of the State is to stabilise the incomes, but not directly the housing, of those who are too poor to be able to afford the minimum level of accommodation consistent with human dignity.
29. State provision for income in unemployment is now 55 years old in Britain. It began as a system of modestly subsidised insurance, limited to a small number of occupations where fluctuations in employment were thought to be a severe disability to the workers concerned. At that time all other workers provided for their risks of unemployment either by private saving or by subscriptions to trade unions (or, of course, in some cases by recourse to private charity). The provision by trade unions for their members had the important side-effect of making them cautious and responsible in the processes of collective bargaining, for if they pushed wages too high their success receded upon their unemployment funds. Since these modest beginnings the State coverage has become universal for employed persons and the true insurance element in the system has dwindled to insignificance. The most recent trend of the system is to cap universality of coverage with income-related benefits, thus increasing the potential cost. The pre-1914 side-effect upon the behaviour of trade unions was long ago (i.e. at the end of the first World War) reversed by the State’s assumption of responsibility for their members’ unemployment benefit, and this had a most unfortunate influence on trade union behaviour in the 1920’s, when they were largely responsible for the height of the level of unemployment.

30. The effects of a system of unemployment provision clearly depend upon the level of unemployment, which in turn depends in part upon public policy relating to employment. Since there has been full employment for the past 25 years, unemployment provision has not been of great fiscal consequence though it has had the effect of strengthening local rigidities in the labour market in the relatively less prosperous areas. Its direct influence upon the people’s welfare has not been always beneficial, but the questions remain whether, employment being full or not, it is proper for State coverage to be universal for employed persons, and whether the provision should be on a true insurance basis or not. The answer to the first question is a clear No. There are very many people who are perfectly capable of providing for their own unemployment. The answer to the second question is that where true insurance is possible there is no role for the State. However, since it is in general the poorest workers who are most likely to suffer from unemployment, the cost of their true insurance might be prohibitive. Hence it is proper for the State to subsidise unemployment insurance, limiting itself to those with incomes below a certain level, plus possibly some of those with higher incomes who are in occupations exceptionally subject to unemployment. In the case of trade unionists there is a case for giving them, even though otherwise qualifying, either no subsidy at all or a reduced one, so that trade union funds might be put at risk in collective bargaining and the attractions of trade union membership lessened.

31. The great social service of education has been left to the last. In some ways it is the most important and the most representative of the features of the Welfare State. On the other hand State (or other public) provision of education long antedates the Welfare State, unless it is seen as the germ of the Welfare State. Britain is a country where private provision for education remains important, even though it covers only a small minority of the people, owing to its link with the alleged class structure of the country, or owing (to put the same matter in another form) to the fact that the very best education in the country is private. State provision is universal, in the sense that it is available to all, though not all accept it; and there is now a tendency of growing strength to destroy or emasculate the remaining private provision, on grounds of social class, so that the State system may become truly universal.

32. The case of education differs from that of the other services for the liberal in that the issues concern the rights of children, not adults. The advocacy of market methods and solutions rests in part upon the right of choice of adults. Where children are concerned their own choice cannot carry significant weight; while the choice of parents, though deserving a great deal of weight, cannot be decisive unless all parents can be trusted to provide the minimum education which is their children’s right. It is for this reason above all others that the tendency towards the State financing, and to some extent the State provision, of education took root amongst liberals in the 19th century.

33. This fundamental difference between education and other services may justify State compulsion (i.e. insistence on provision for all children and possibly even State financing. But in principle it does not justify State provision, and this is where the crunch comes between the Welfare State and its opponents. On this it is not necessary to do more here than to draw attention to the path-breaking work of our fellow Mont Pelerin, Dr. E. G. West (1), who has patiently sought out and examined every argument for State provision and has found it wanting. The way to improvement in welfare in this field is by the liberation of education from the shackles of State provision, with the retention of State financing and some supervision of parents’ market choice. As in the case of other services, the relative importance of State financing would decline as general affluence rose.

34. Our examination of the particular activities of the Welfare State enables us to return to the claim that the right of all to call upon the State for these services is, or ought to be, a badge of citizenship. The claim is false. It is also through and through totalitarian. It takes the attributes of the family and ascribes them to the nation. Welfare services are different in fundamentals from the administration of justice, the protection of life and property, and similar

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(1) See «Education and the State» by E. G. West, Institute of Economic Affairs, London.
proper and necessary functions of the State. They are not of the kind which inspire men to the spirit of all for one and one for all. On the contrary, in the hands of the State they produce envy and hatred. The Welfare State is a disastrously wrong turning which Western countries have taken in search of welfare. The first condition of the successful pursuit of welfare will be the destruction of the Welfare State.

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Risunto — Si dice che i liberali si interessano dello stato assistenziale. In realtà, i liberali si sono sempre interessati allo stato assistenziale, inteso come dispensatore di un benessere oggettivo, ma per essi è altamente desiderabile il principio del sacrificio della libertà in cambio del benessere. Anche se i liberali anteporgono lo scopo della libertà a quello del benessere, essi respingono le pretese del loro avversario di produrre maggior benessere del libero. Gli antiliberali e totalitari evidentemente non riescono a fare quanto dicono: le assicurazioni degli antiliberali e totalitari consistono nei riscatti ottenuti da paesi nei cui Stati dimostra che l'intervento dello stato nel senso di impedire i processi del mercato, riduce il benessere. I liberali non pensano che si debba negare qualsiasi assistenza statale ad individui di una società libera che soffrono di disgrazie eccelenziali. Le loro obiezioni si rivolgono contro le pretese basate su argomenti inadeguati ed e-

WELFARE WITHOUT THE WELFARE STATE

by Yale Brozen (*)

Economics has been characterized as the dismal science. However, the two questions occupying economists belies that description. Classical economists concerned themselves with the means for enlarging income — with the causes of the wealth of nations — and with the determinants of the distribution of income. Neo-classical economists focus somewhat more narrowly within these larger questions. They concern themselves with the causes of waste and how to improve welfare by eliminating waste.

The classical group did not neglect the analysis of causes of waste. They dealt with the welfare consequences of state intervention in international trade — the effects of the imposition of tariffs and of trade and navigation acts. They also pointed to the welfare consequences of state intervention in the internal economy — interventions such as the creation, by royal grant, of monopolies of soap, playing cards, salt, etc.

The fact that classical and neo-classical economists thought progress possible—that the lot of man could be improved by enlarging resources and by better utilizing the available resources—makes economics an optimisitic science. It was Malthusian demographic propositions that led to the characterization of economics as a dismal science.

Malthus, and footnotes to Malthus added by Marx, the Weibs, the Fabian socialists, and the proponents of the iron law of wages, created the notion of a permanently depressed class doomed to a subsistence level of life. This was a major excuse for proposals for intervention by the state, although it is hard to see how believers in Malthus and in the iron law of wages could conclude that redistribution of income would cure poverty. All it could do, if the logic of this view is accepted, would be to doom everyone to poverty instead of the laboring classes alone.

Many modern interventionists use the same state excuse for state action as nineteenth century Marxists and the Fabian socialists (2). The modern version propounded by these dismal «scientists» argues that automation is dispensing with the need for labor services and that cybernation is leading to the development of «a permanently depressed class... in the United States» (3). Old clichés apparently never die nor do they fade away.

(1) Professor of Business Economics, Graduate School of Business, University of Chicago.
(2) «... over 20 per cent of the American population is eled from the abundant economy and this percentage will grow... in coming years». R. Tho-

(3) R. Tho-

(4) R. Tho-

(5) See Y. Brozen, Automation and Jobs (Chicago: Graduate School of Business, University of Chicago, 1960), p. 22, for
Another source of the appellation, "dismal science", or a least of its continuity, is the economists' habit of dashing cold water on the desires of some romanticists for programs which they apparently believe cost nothing. Economists who point to the fact that there are costs to be considered — that there is no free lunch — are very dismal people. Economists have also demonstrated, in many instances, that the costs (the alternative benefits sacrificed) of some of the programs dear to the hearts of these romanticists are greater than the benefits which will be produced. This makes economists not only dismal people but also, apparently, the allies of those who would oppress the common man.

The impatient reformers who want to move the paradise to be expected in the hereafter up to two weeks after the next election (4) — and their natural allies, the politicians who want something to offer to bribe voters — regard any examination of costs and consequences as a very dismal exercise. By pronouncing the inanition, "dismal science", they hope thereby to dismiss reasoned analyses and empirical investigations.

What is it that our impatient reformers seek to achieve? Do economists dash cold water on their proposals because they are not in sympathy with the goals of the proponents of the welfare state? Or do economists react so dismal for other reasons?


Welfare statist are as diverse a group as any other. It is, therefore, difficult to ascribe to them any creed on which there is monolithic agreement. There are some goals, however, which apparently have a high priority with most. The most recent, and the oldest, around which they conclave is the elimination of poverty and of temporary distress by state action. A few poetic souls among the socialists, such as George Bernard Shaw, have suggested that poverty be eliminated by shooting the poor.

Although the elimination of poverty is a goal which the welfare statist have appropriated as if it were their own discovery, economists of a liberal persuasion (in the European sense of liberal) have long held this same goal (5). It is the means for accomplishment on which liberals and interventionists (welfare statist) differ rather than the goal.

The modern welfare statist, at least in the United States, even appears to subscribe to the statement that, "The common man or average family has a far greater stake in the size of our aggregate income than in any possible redistribution of income" (6). This is certainly the opposite an empirical refutation. Also, R. D. Freyman, Poverty: Definition and Procedures (Washington: American Enterprise Institute, 1965).

(4) I owe this phrase to George Stigler.
(5) e g., the chief motive of their [the Physicists] study was... to diminish the suffering and degradation caused by extreme poverty. They thus gave to economics its modern aim...» ALFRED MARSHALL, Principles of Economics (London, McMillan and Co., Ltd., 1920), Eighth Ed., p. 797.

of the refrain of the English welfare statesmen of the late 19th century. They thought that the economic problem was not one of increasing production but only one of redistributing the available output. Growthmanship and the urge to direct the economy in paths which maximize the rate of economic growth have become common to the welfare states. Economic growth is now an important goal among the welfare states as well as the achievement of greater equality in the distribution of income.

In addition to these goals, there is a very large group among the welfare states who are also in the thing to say that we consume the right things. Cars with tail fins, heroin and other narcotics, useless (however the term may be defined) drugs, the sight of ugly (however that term may be defined) or run-down buildings and junk yards, books which are improperly advertised, inartistic television programs, and abstract paintings are proscribed. Orchestral and dance performances, provided they are of the proper variety, representational paintings, statues, visits to state owned parks (unless they are outside the national boundaries), and the consumption of educational and medical services are promoted.

The most influential groups promoting the interventionist or welfare state are not those who believe in the welfare state because of ideals relating to the improvement of the lot of the poor and the distressed. The promotion of the brotherhood of man by compressing the differences among them into a semblance of economic equality is not what has attracted the most powerful groups supporting intervention. They are a disparate lot, each interested in enhancing its own material status, even at the expense of others provided some drop of material gain emerges for it. Taxicab owners, in the name of improving the condition of taxi cab drivers, persuade city councils to limit entry into the taxicab business. Northern textile mill operators and unions, in the name of helping the southern worker, with the aid of the welfare statist, bludgeoned Congress into passing minimum wage legislation. Real estate operators, contractors, and building trade unions, in their passion to improve the housing and condition of slum dwellers, eagerly promote governmental appropriations for urban renewal. Railroad, trucking, and large line interests, in the name of providing essential transportation services for small business men and farmers on a non—discriminatory basis, support transportation regulation with indefatigable zeal. The special interests, from sheep rancher to stockbroker, find the welfare statist to be handy, if unwitting, allies. These allies serve as front men and as a smoke screen to obscure their intent and the damage they do to the general welfare when they use the state to serve their special welfare goals.


This melange of specific measures is certainly recognizable to most economists—well, at least to 60% of university economists in the case of the minimum wage law, judging by recent poll of members the American
Economic Association (7)—as damaging to the general welfare. A minority recognizes that these measures cause some of the poverty which concerns us. We need not tarry long over the fact that these measures damage the general welfare, on net balance, although they may enhance a host of welfare. Of course, when I say that the general welfare is damaged, I include in the general welfare the welfare of the benefited groups. The damage to others is greater than the gain to those benefited.

I should add that abolition of a large group of these measures simultaneously could produce a net benefit for any one of the groups which would lose from the abolition of the specific measure directed to its welfare and benefit. The producer of price supported cheese and milk (a measure obviously designed to help the poor who consume cheese and fluid milk) could find himself selling in an even higher priced market (at the farm gate) or producing at a lower cost if transportation regulation, minimum wage laws, union supporting legislation, tariffs, etc. were abolished along with agricultural price support programs.

Some of these measures, which may have produced short run benefits for a selected group in the past, may now damage the very people they once benefited. Textile workers, for example, may have had a rise in wage rates relative to what they otherwise would have been paid after the passage of tariff legislation imposing import duties on textiles. However, wage rates earned by textile workers in the United States today are lower than they would be absent tariffs. Our export industries today are high wage industries. To the extent that tariffs limit the dollar earnings of those who could otherwise sell more to the United States, they have limited the demand for U.S. exports. This limits the number of jobs at high wage rates in the export industries. As a result, U.S. export industries are not recruiting textile worker as aggressively as they would absent the tariffs, textile workers are not shifting as rapidly as they otherwise would to high wage jobs in export industries, and their wage in textile work is lower than it would be if export industries were bidding more aggressively for their services (8).

Although we know that minimum wage laws hurt the poor by costing them jobs, that agricultural price support programs hurt the poor by raising the prices of their food, that transportation regulation hurts the poor by preventing industry from moving to disadvantaged regions where the poor live and increases the cost to the poor of migrating to the regions where better paying jobs can be found, that union supporting legislation hurts the poor by permitting union power to grow to the point where it can be and is used to restrict the entrance of the poor into higher paying occupations, that urban renewal appropriations hurt the poor by forcing the slum dweller out of low priced housing into higher priced housing, that regulation of the field price of natural gas increases its price and the price paid by the poor for cooking and heating fuel, that usury laws make it more difficult and expensive for the poor to obtain loans, that subsidizing subway fares benefits property owners in mid-town locations rather than the poor who ride the subways (9), where is the welfare statistic who opposes these measures and calls for their abolition? Most do call for the elimination of tariffs. Ordinarily, however, the welfare statistic simply argues with greater urgency for more poverty programs, more job training facilities and support, more generous relief programs, still more subsidies for the items he regards as important in the budgets of the poor, more government grants to educational institutions and more educational establishments operated by the state, longer periods of compulsory school attendance, etc., instead of calling for the elimination of government programs which create or prolong the poverty he condemns. The welfare statistic could do much for the poor by working to abolish the measures that add up to a state—of—many welfare and lowered general welfare.

Here, then, is an important difference in the means of the interventionist and the means suggested by liberals for assisting the poor to greater affluence. The interventionist proposes specific assistance measures for the poor. These essentially aim at trying to offset the damage he has unknowingly created with his pot pourri of state measures benefiting special interests. Job training programs, unemployment insurance, old age assistance, aid to dependent children, public aid, the Job Corps, volunteers in service to America, area redevelopment programs, to name a few items from the menu of the welfare state. In America, serve primarily to offset, for some groups, the damage done by earlier interventionist measures (10). The liberal on the other hand proposes to release each man's drive for self improvement and each man's willingness to contribute to the welfare of others when his activity also contributes to his own welfare. He proposes to remove barriers to self improvement and to private contributions to welfare. He proposes the provisions of opportunity for self development and the development of independence where the welfare statistic proposes measures which not only are less efficient but which contribute to an increase in dependency (11), slow the rate of growth, and restrict the rise in national income.

(7) Chase Manhattan Bank, Opinion Survey, University Economists (mult-illuminated, April 1960). Among the economists polled, 33% generally opposed minimum wage laws. The remaining 67% opposing the proposed increase currently before Congress did so because the boosts were too big or the timing was inappropriate.


(9) A discussion of the damage done by these various measures and references to several studies of their net effect can be found in Y. BROOKS, The Review of Traditional Liberalism, "The New Individualist Review", Spring 1965 (Vol. 4, No. 4).


(11) "Above this race of men stands an immense and tutelary power,
Welfare Generation By Non-State Activity.

Activities which improve the lot of the poor undertaken for self—interested reasons apparently are suspect to the welfare statist. The motive is wrong, therefore the results are unacceptable. Those furnishing cheaper provisions for the poor or job training and better paying jobs because they hope to profit by doing so are not acceptable.

Presumably, a Peace Corps volunteer who teaches an illiterate Brazilian to read without hope of profit is doing more for the illiterate Brazilian than General Electric do Brazil when it hires teachers to teach the illiterate members of its work force to read in the hope that it can reduce its supervisory costs and increase its profits. The end result is the same. Illiterate Brazilians learn to read. But the motive is different. Somehow that means that the Peace Corps volunteer has contributed to the welfare of poor Brazilians and G.E. has not. The Peace Corps volunteer was not motivated by self—interest (except to the extent that he desires travel and adventure and instant status at minimum cost) while G.E. was motivated by a lust for profit.

Many of the measures undertaken by the welfare state simply result in the substitution of state activity for private activity without any net gain in the welfare generated. The welfare state in its poverty program, is providing job training programs for the unskilled poor. Tax funds are being used to train taxi drivers, for example. Taxi companies, which were using their own funds to train drivers, have discontinued this activity. Tax funds are being used to train filling station attendants. The outlay by refiners to train attendants has been cut since the state has undertaken this task.

Does the expenditure of tax monies do more for the newly trained drivers and attendants than that of private funds? The answer to this question must become embarrassing to the welfare statist when tax funds are devoted to training ship stewards who then find no jobs available even for many with long experience. At least company funds are used for such training only if some use will be made of the investment in job training. But the welfare statistic seems to think no contribution to welfare occurs when profit motivated expenditures are made while a great contribution occurs if the funds are taken by the state and then expended under state auspices (12). Yet the net improvement in welfare even if we consider only the welfare of the poor is, in many cases, greater if the funds are left in private hands.

The welfare statistic apparently wants to produce economic growth, increased equality, and improvement of the lot of the poor by direct intervention and governmental direction rather than by using or permitting impersonal social forces to produce these same results. Some of them obviously do not understand how normal market forces and normal evolution can produce the desired results. Others, particularly the political types, may understand but wish to use direct measures in order to obtain credit for the results and build their power.

The recent investment tax credit legislation in the United States reducing taxes for those corporations which undertake certain restricted types of capital formation is an example of this dirigiste mentality and the production of results opposite those intended. If funds are used in the way the welfare statistic prefers them to be used, taxes are reduced. For others, they are not. This is highly discriminatory among investors as well as producing great distortions in the allocation of resources. The presumed intent of this measure is to produce more rapid economic growth. The wastes caused, however, may result in a lower rate of growth than the equivalent tax reduction in the form of an across—the—board cut in corporate earnings taxes.

The corporation which can meet fluctuating rates of sales with least expense by increasing inventories may instead, with the investment tax credit, invest in creating greater capacity to meet the need. It receives a tax credit for the investment in additional capacity but no credit for investment in carrying inventories to meet peak demands. The after tax cost of capacity, then, may be less than the after tax cost of carrying larger inventories. This may be the case despite the fact that the before tax relative costs are the reverse. Capital, as a consequence, is mislocated. Similarly, a corporation may choose longer lived equipment on which it receives a tax credit rather than shorter lived equipment on which it does not. It may do this although it is more economic, absent tax considerations, to choose shorter life equipment.

The recent English selective employment tax, which imposes a tax on establishments in which the majority of workers are not production line, manufacturing employees, has a similar effect. The British government has evidently reverted to an Adam Smithian view of what is productive and what is growth. Yet, we know that indirect workers may do more to increase manufactured output than indirect workers (13). The

(12) The Department of Interior, in its suit attempting to block the construction of a dam by the Virginian Electric Power Company for which it had received a license from the Federal Power Commission, argued it would be better if the dam were never built than to have it erected by a private group.

An analysis of a measure proposed a few years ago in the United States which had this double purpose illuminates this point. A U.S. Senator proposed that every taxpayer be given a direct $20 credit on his income tax as a means of reducing the income tax paid primarily in the lower income groups. He argued that not only would this result in a much greater proportionate cut in the tax paid by low income people than of that paid by higher income persons, but, also, would stimulate consumer demand and increase production (and growth). To avoid any loss of revenue, he also proposed that the dividend tax credit then in force be eliminated. This would more than offset the effect of the $20 credit for middle and upper income groups, thus increasing their tax while reducing the tax on lower income tax payers. The net result, then, would be greater equality in after tax incomes as well as greater growth.

The Senator, however, failed to recognize the effect of the repeal of the dividend tax credit on the rate of saving and investment. With no recognition of the effect on capital formation, there was no recognition of the effect on growth, on productivity, on wage rates, and the consequences for income distribution.

The repeal of the dividend tax credit could be expected to reduce the rate of return to average recipient of dividends by at least 10%. The result would have been a decline in the rate of business capital formation of at least $3.5 billion per year (16). This would mean that capital per worker would rise more slowly—the reduction in the rate of rise being at least $50 per year. Since every $100 increase in capital per man raises his annual wage by $20, the lower rate of increase in capital would mean that in two years, the wage of a worker would be lower (compared to what it would have been) by the amount of his tax credit. He would have no net gain after two years. After ten years, his annual wage would be at least $100 less, a rather steep price to pay for a $20 credit. The worker would be worse off with this measure than without it, and economic growth would have suffered.

Both of these results would have been opposite those nominally intended. It may be, of course, that the Senator simply wanted to claim credit for apparently helping the small taxpayer and soothing the rich, treasuring appearances to hide the reality. I should add that the proposal has, in effect, been enacted. The 4% dividend tax credit has been repealed and an automatic $300 allowance for deductions has been enacted. These produce the proposed changes except that the higher bracket tax payers have not received even the $20 credit.

I should also add that the increasing equality normally resulting from capital formation has been slowed. Higher rates of capital for-

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(14) W. Baum, Industrialization and Economic Development in Brazil (Homewood, Richard D. Irwin, Inc. 1965).
(16) I am not arguing that total capital formation would be less by this amount. A part of the decline in business capital formation would be the result of diversion of capital to nonpecuniary uses whose return is not taxed.
nution raise the marginal productivity of labor more rapidly relative to average output. Increase the share of national income going to wage earners, and decrease inequality insomuch as recipients of labor income tend to fall in the lower bracket incomes while upper bracket incomes tend to come primarily from property. Higher rates of capital formation also tend to decrease inequality among laborers as well as among wage earners and recipients of property income.

The passion for equality, which appears to be the basis for imposing both property taxes and corporate earnings taxes on property income in addition to the personal income tax while only the personal income tax is imposed on wage income, would be better served by a neutral tax structure than the present non-neutral structure in use in most countries. With fewer attempts to use state power to compress the inequality in the distribution of income, inequality would diminish more rapidly. Low wage rates would rise more rapidly with a higher rate of saving and capital formation, and inequality would diminish with the rise in income of wage earners. Instead, the welfare statists strive to diminish inequality by slicing down the top with some redistribution to the bottom. Inequality has been diminished by the tax and transfer structure, but by less than it would be diminished in a short time by the evolution which would occur under a neutral tax structure with less intervention by such direct means as the numerous devices described above.

### Table 1

<table>
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<tr>
<th></th>
<th>Real Hourly Compensation</th>
<th>Real Hourly Output Index 1957-59 = 100</th>
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<tbody>
<tr>
<td>1957-59</td>
<td>DOLLARS</td>
<td>Index $ 0.11 = 100</td>
</tr>
<tr>
<td>1989</td>
<td>0.464</td>
<td>21.5</td>
</tr>
<tr>
<td>1990</td>
<td>0.621</td>
<td>37.6</td>
</tr>
<tr>
<td>1991</td>
<td>0.631</td>
<td>30.6</td>
</tr>
<tr>
<td>1992</td>
<td>0.947</td>
<td>44.9</td>
</tr>
<tr>
<td>1993</td>
<td>1.27</td>
<td>64.7</td>
</tr>
<tr>
<td>1994</td>
<td>1.75</td>
<td>83.0</td>
</tr>
<tr>
<td>1995</td>
<td>2.37</td>
<td>112.1</td>
</tr>
<tr>
<td>1996</td>
<td>2.62</td>
<td>119.0</td>
</tr>
</tbody>
</table>


The rise in real hourly compensation of workers in the United States, even when using the consumer price index with its well known upward bias as a deflator, has been proceeding in recent years at a rate which doubles it every 25 years. The rise in wage rates was more rapid than the rise in average output per man-hour prior to World War II, thus increasing the proportion of national income going to labor (see Table 1). The tax structure then was relatively more neutral and less progressive in its nominal rates.

If the rate of saving and capital formation in the United States were to move significantly upward toward the levels prevailing in Japan and West Germany, which it would tend to do if the tax structure were more neutral, the rise in labor compensation would speed up relative to the rise in output per man-hour. The trend toward a more equal distribution of income, which has been muted in recent years, would speed up as well as the rate of rise in per capita income.

It would be possible to move the tax structure toward neutrality with greater generation of welfare by the private sector if there were less welfare provided by the state. A slowing in the rate of increase in welfare expenditures would make it possible to reduce property taxes and corporate earnings taxes.

### The Non-additions to Welfare Produced by the Welfare State.

A very large portion of welfare expenditures in the United States is for the benefit of those who are taxed to provide the funds. As a consequence, the tax structure is imposing a very large burden with very little redistribution (17). Elimination of state use of funds to provide people with what they could and in most instances would buy for themselves if their funds were not taxed away would contribute to more rapid economic growth, a more rapid rise in the incomes of those who receive less than $1,000 per year, the official poverty line for families of four in the United States (a line which, when it was adopted, was approximately equal to the pay of full professors in Japanese universities), and an increase in the equality of income distribution through the forces of normal economic progress in free markets.

As Professor Lampman has remarked, with $100 billion of transfer red income in the United States, $81 billion of which is financed by taxes, «how can we explain the fact that there is any poverty left in the United States» (18). The explanation lies in the fact that a major part of the transferred income does not go to the poor. It goes to people in the form of services which they are quite capable of buying for themselves and money grants which have been described as «poverty programs for the well-to-do». The agricultural program (a poverty program for rich farmers) is an example of the latter. Free services provided by governmentally maintained educational institutions are an example of the former. In 1964, of the $28 billion of tax money spent on publicly ope-

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rated educational institutions. only 18% of the services were provided for the 28% of the population who are classed as poor on a pre-transfer income basis (only 18% of the population were classed as poor on a post-transfer income basis). In my own state, estimates have been made which indicate that the publicly operated universities take more from the poor in taxes than they provide to them in services. Charging the users of services of these universities their cost and removing their tax support would increase the incomes of the poorest part of the population relative to the incomes of those who are well off.

Since the $23 billion (1964) of tax funds spent on education provide only $5 billion of benefit to the 28% of the households classed as poor on the basis of pre-transfer income distribution, complete elimination of publicly operated educational establishments charging below cost tuition along with the institution of state payment of tuition for the poor could accomplish a $23 billion reduction in the tax burden. Since most of the funds for the operation of state schools come from property taxes and sales taxes, both of these tax burdens could then be very considerably lightened. This would move the tax structure toward neutrality and toward a lighter tax burden on the poor simultaneously. Reduced property taxes would also greatly encourage private urban renewal efforts.

As much as education serves to increase the income of those receiving these services (see Table 2), not even a $5 billion subsidy for the tuition payments of the poor is required. Loans could be made available to pay tuition with no repayment required from those who fall below the magic $3000 poverty line (with appropriate adjustment for family size). A privately operated educational lending system in the United States could be repaid from tax funds for loans made to clients whose income falls to rise above the appropriate level within a specified period after leaving school.

**Table 2**

<table>
<thead>
<tr>
<th>Mean Income of Males 25 to 64 Years Old, by Years of School Completed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 8 years</td>
</tr>
<tr>
<td>8 years</td>
</tr>
<tr>
<td>1-3 years high school</td>
</tr>
<tr>
<td>4 years high school</td>
</tr>
<tr>
<td>1-3 years college</td>
</tr>
<tr>
<td>4 years or more college</td>
</tr>
</tbody>
</table>


A number of other government enterprises presumably devoted to the task of redistributing income by providing subsidized or free services for the poor perform in much the same way as the publicly operated educational institutions. They provide a very large portion of their services to the well-to-do who are capable of purchasing these services with their own means. The Rural Electrification Administration provides subsidized electricity and telephone service for well-to-do farmers and suburbanites. Electricity for poverty stricken corporations such as the Aluminum Corporation of America and the Du Pont Company is subsidized by the tax free status of the Tennessee Valley Authority (27% of the price of electricity goes to pay the taxes imposed on privately operated utilities). Irrigation water for well-to-do farmers is subsidized by the Bureau of Reclamation and by the city poor who are over-charged for water to pay some of the losses on water furnished for agricultural purposes. Subsidized loans to home owners, to farmers, to small businesses, to maritime operators, to railroads, etc. are subsidy for the well-to-do. We are even proposing to subsidize middle income apartment renters—where a middle income is defined as $6,000 to $11,000 per year.

A very large portion of the welfare provided by the welfare state simply provides a substitute for what those who receive the services were buying for themselves or would buy in their present circumstances. To this extent, the welfare state has not increased the welfare available in our society. To the extent that the state provided substitutes are inferior to what people were providing or would for themselves, there is a welfare loss. Inasmuch as state provided services tend to be uniform and are not adapted to the desires of those receiving the services, a very large portion of these services are inferior to what people would purchase in a free market in which firms must compete for customers.

The Welfare Losses Generated by the Welfare State.

As indicated above, much of the officially defined poverty found in the United States is the result of attempts to increase by state intervention the share of the national income pie received by various groups. These interventions have taken such forms as controlling relative prices to make them different than they would be in a free market or by changing relative private costs by such means as differential tax rates. To produce some of the hoped for changes, the state has limited entry in some markets or delegated the power to private groups to limit entry. It has provided goods below cost, and increased the prices of other goods to above their social cost.

The deleterious effect on the size of the national pie of interventions which change relative prices and costs has led some liberal economists to suggest that it is preferable to increase the size of the slice received by various groups by direct income transfers. This, presumably, would have a less harmful effect on the size of the national income pie available for slicing. Such transfers are presumed to avoid shrinking the pie which has the result of shrinking the size of the slice received even when it turns out to be a bigger share of the shrunken pie.

What is too often forgotten is that even direct income transfers shrink the pie. The shrinkage will occur for reasons in addition to the non-revenue yielding burden of taxation. Income transfers conditioned
on the recipient falling below some designated income level also affect relative prices—the price of leisure relative to other goods. There is evidence that many of the poor in the United States are poor in pre-transfer income because they are paid to be poor. As Pigou once remarked, from what is understood everybody's income will... be brought up by state aid to, say $3 a week, it will, generally and roughly, be to the interest of everybody capable of earning by work any sum less than $3 a week to be idle and earn nothing. This must damage the national dividend (19).

A study of the effect of the level of public aid payments on the number of persons receiving and requesting such payments in the United States in the 1950s indicates that a very substantial proportion of those on the welfare rolls are «not on assistance due to zero wage alternatives». The higher the level of public aid to each recipient, the larger the number of people who choose not to work. The proportion on public aid rolls in the 1950s who were «not on assistance due to zero wage alternatives» averaged nearly 50% over the decade. The level of assistance payments may have accounted for as much as 57% of those public welfare rolls in one year (20).

A study of experience with an employment compensation in six states reached a similar conclusion. The higher the level of unemployment compensation relative to take home pay from their last job, the longer an unemployed worker remained unemployed.


(21) Estelle James, op. cit., p. 642.

The non-revenue yielding burden of taxation, and to the consequences for general welfare that the welfare state as it is operating is reducing to general welfare. General welfare has been reduced by an amount such that the larger slice obtained by some is of such a shrunk pie that most of the successful petitioners are worse off. In addition, the goals of the avowed welfare statist have been poorly served by our welfare state. Admittedly, there has been a net redistribution of current income in favor of the poor as a result of public assistance payments and the transfers within the social security system. However, even these measures have had undesirable consequences. They have produced a state of dependency which is being handed on within families from generation to generation. They have forced early retirement for many who would prefer to go on working, but choose not to do so since benefits would be sacrificed under the rules enforced. They have created the poor measured by pre-transfer incomes since it pays to be poor.

The small measure of redistributive success accomplished by our welfare state has been accompanied by great inequities, by a failure to stimulate growth (a debatable goal for a state, however acceptable as a matter of individual choice), and by a great waste of resources in attempting to force the consumption of items judged superior by the welfare statist. Even the recent medicare act seems to be resulting largely in the substitution of payment by the state for medical services for those over 65 which were formerly paid for privately. The redistributive effect has been small (except to increase the incomes of doctors, nurses and medical technicians) while the illusion of state benefit has been large. The welfare statist have succeeded in injecting the state into a multitude of activities ranging from city operated trash collection services to patronage of the performing arts, but it appears that at best they have substituted public activity for private (22). More likely, they have diminished the speed of movement toward the goals they profess to serve. At the very time when more symphonic performances under private support were occurring than ever before, more students were in college than even before, more people over 65 were receiving medical services and were insured against medical disaster than ever before, more effort was being expended on gardening landscaping, and other forms of beautification than ever before, the welfare statist found that not enough was being done and forced an enlargement of the state role in such activities. At the very time when inequality has lessened and poverty has moved closest to disappearance, the welfare statist suppress the means which brought about this happy state of affairs and inject the state, the device whose iniquitous effect on the wealth of nations was discovered two centuries ago and with whose declining role in economic affairs was associated the greatest flowering of affluence for the masses (23).

(22) One of the results of the poverty program in the U.S. is that many private philanthropic organizations have been stripped of skilled personnel who have been hired away to administer public programs.

(23) W. ALLEN WALLIS comments on the phenomenon of pressures to solve a problem mounting as the problem itself dwindle... In his «Neomercan...
It is the free market which socialized the genius of Edison and Stemmet and a multitude of others. The State has typically been a device for producing affluence for a few at the expense of many. The market has produced affluence for many with little cost even to a few. The state has not changed its ways since Roman days of bread and circuses for the masses, even though it now pretends to provide education and medicine as well as free milk and performing arts. It still is the source of monopoly privilege and power for the few behind its facade of providing welfare for the many—welfare which would be more abundant if politicians would not expropriate the means they use to provide the illusion that they care about their constituents.

Yale Brozen

Riassunto — Gli obiettivi dei sostenitori dello stato prevedenziale non sono molto diversi da quelli di coloro che preferiscono una società libera. Entrambi vogliono eliminare la povertà, sono in favore di una distribuzione più equa, favoriscono lo sviluppo economico e desidererebbero vedere la gente consumare le cose e giusti, se i loro obiettivi sono simili, in che cosa differiscono allora i due gruppi? I sostenitori della libertà mirano ad una maggiore riduzione della povertà e ad un più rapido sviluppo economico in società in cui lo stato interviene di meno. I sostenitori della società libera rimangono a perseguire lo sviluppo se gli individui preferiscono mangiare, bere ed essere felici piuttosto che risparmiare ed investire. Essi ricorrono alla persuasione anziché al potere coercitivo dello stato per incoraggiare il consumo di cose e giochi e il risparmio per lo sviluppo economico.

Perché i sostenitori dello stato prevedenziale chiedono interventi per obbligare alle otto ore al giorno, alla frequenza scolastica, alla redistribuzione del reddito, all'aumento dei redditi dei poveri, all'acquisto di rendite annuali e di assicurazioni mediche, ed instaurino sui sussidi per l'istruzione superiore, per l'elettrificazione euc, ecc. quando la maggior parte della gente ha ridotto il proprio lavoro a otto ore, la maggioranza dei ragazzi frequenta la scuola, la distribuzione del reddito sta diventando più equa, i redditi dei poveri sono aumentati ad un tasso molto rapido, la proporzione nei collegi di ragazzi fra i 28 e i 22 anni sta rapidamente crescendo ecc.?

Una prima ragione di ciò sta nel fatto che il sostenitore dello stato prevedenziale non conosce la storia. In secondo luogo egli è abituato a servire gli interessi specifici di alcuni gruppi che lo ingannano facendogli credere di servire il benessere generale dei poveri. Una terza ragione consiste nelle attività private che hanno migliorato le sorti dei poveri e che sono considerate con sospetto dal sostenitore dello stato prevedenziale perché la maggior parte di esse sono state intraprese per ragioni di interesse privato. Un quarto motivo è dato dal fatto che molti sostenitori dello stato prevedenziale hanno poche furbie nella varietà e preferiscono
IL POLITICO
RIVISTA TRIMESTRALE DI SCIENZE POLITICHE

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