THE
Freeman
IDEAS ON LIBERTY

DECEMBER 1966

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THE FREEMAN DECEMBER 1966
Vol. 16, No. 12

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THE Freeman

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DECEMBER 1966 **Vol. 16, No. 12**

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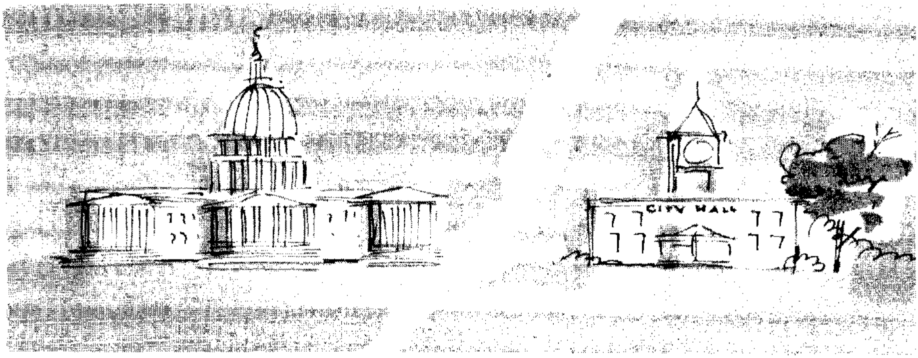

AMERICAN FEDERALISM: ORIGINS

GEORGE CHARLES ROCHE III

A DISCIPLE of Confucius once asked the ancient Chinese sage what his first act would be should he become emperor. Confucius replied that he would begin by fixing the meaning of words. What he was suggesting, of course, was that labels with consistent meaning are essential for effective communication. The label to be defined in this case is "federalism," more specifically, "American federalism."

In its narrower sense, federalism refers to the division of authority and function between and among the national government and the various state governments. But it has come to possess a wider meaning in American political history. The idea of constitutional limitations of power, of both horizontal and vertical divisions of power, of the representative nature of republican institutions, and of a national government strong enough to perform certain necessary tasks and yet not so strong as to become a threat to liberty, is perhaps better epitomized in its unique American historical setting by the word federalism than by any other single term. Above all, federalism in its American context conveys something of our high regard for regional, local, and individual diversity, widely varied yet capable of achieving a simultaneous national unity.

Such concepts as republican government or limited, constitutional government have come to be regarded as implying only restriction of power and seem to too many people to be entirely negative in character. The limitation of power in our republican, con-

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stitutional framework is vitally important, but such concepts may be more warmly received if they are approached not only in terms of what we *can't* do politically, but also in terms of what we *can* do politically. For these reasons, and with all due apology for expecting so much from the word, let us assume this broadened meaning of the word federalism for purposes of this discussion.

In fact, American political forms are unique, partially because of the great opportunities which America has enjoyed on this continent and partially from what Daniel Boorstin has described as "a peculiar and unrepeatable combination of historical circumstances."[1] To fail to consider these unique circumstances would be, to paraphrase Edmund Burke, a failure to consider our liberties as an inheritance. That inheritance is indeed the source of our liberty and we can ignore it only at great peril. This is precisely the failing of so many among us in this present-minded, antitraditional age of the collective mentality.

Americans are not given to political abstraction. In the modern era since the French Revolution, the planners – Rousseau, Marx, and the rest – have increasingly sought to remake society in their own image. In the face of this challenge, whether or not our present-minded, antitraditional intellectuals care to admit it, America has increasingly provided the modern world's best example not only of historical continuity but also of the benefits which stem from molding political institutions with one eye on the past. Again and again the world has learned to its sorrow that constitutions are easily written, but meaningless unless they are the product of a nation's historical experience.

Reconciliation of Freedom and Order a Continuing Problem

Man's political problem remains forever the same: the reconciliation of freedom and order. The uniquely American solution to this tension between freedom and order has been federalism, blending as it does these two contradictory elements, both so necessary for a creative society. Both the individual and his society profit when these creative forces are released by freedom and protected by order. This is another way of saying that man's creativity is enhanced by an equality of opportunity, an opportunity to be free to achieve and yet safe in his achievements.

The next problem of government centers on how to achieve this equality of opportunity

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[1] Daniel Boorstin, *The Genius of American Politics* (Chicago: University of Chicago Press, 1953), p. 1.

through (or in spite of) our political processes. Alexis de Tocqueville long ago saw clearly that there are only two ways of establishing political equality: "rights must be given to every citizen, or none at all to anyone . . . . it is, therefore, very difficult to discover a medium between the sovereignty of all and the absolute power of one man. . . . The Anglo-Americans are the first nation who, having been exposed to this formidable alternative, have been happy enough to escape the dominion of absolute power. They have been allowed by their circumstances, their origin, their intelligence, and especially by their morals to establish and maintain the sovereignty of the people."[2]

What, then, limits the sovereignty of the people? The American answer was a written constitution. The point of a constitution is to lay down fundamental principles limiting everyone, majorities as well as minorities, to playing the game by a fixed set of rules. As F. A. Hayek has phrased it: "A group of men can form a society capable of making laws because they already share common beliefs which make discussion and persuasion possible and to which the articulated rules must conform in order to be accepted as legitimate."[3]

What are these rules by which Americans have traditionally chosen to play the game? What concepts did the Founding Fathers espouse? How have these concepts been applied throughout American history? These are the questions we must answer if we are to understand and apply the American tradition of federalism.

The Roots of the American Political Tradition

"A government of laws, not of men." Such was the popular slogan of the generation of Americans that produced the American Revolution. By the second half of the eighteenth century, most American colonists were convinced that the men who ran the government should be limited by law in their exercise of power. One of the leaders of the North Carolina Regulators, writing shortly before the American Revolution, made the colonial feeling quite clear: "If we are all rogues, there must be Law, and all we want is to be Governed by Law, and not by the will of Officers, which to us is perfectly despotic and arbitrary."[4]

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[2] Alexis de Tocqueville, *Democracy in America* (New York: Vintage Books, 1958), Vol. I, pp. 55-56.

[3] F. A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960), p. 181.

[4] Clinton Rossiter, *The First American Revolution* (New York: Harcourt, Brace and Co., 1953), p. 130.

The two institutions through which the colonists hoped to achieve "a government of laws, not of men" were written constitutions and standing law. Though the American doctrine of constitutionalism owed a great deal to English precedents, the colonists had done much to broaden and extend the concept still further. A number of state constitutions were put into effect between 1776 and 1780 that clearly foreshadowed the Federal Constitution of 1787. Attempts at defining the specific area of governmental authority were already an old concept in America dating from the Mayflower Compact and the Fundamental Orders of Connecticut, both already on the books fully 150 years before our Federal Constitution. Most of these numerous American efforts in constitution-making also usually included specific acknowledgment of individual liberties and immunities, a concept that would eventually produce our Bill of Rights.

If Americans emphasized written constitutions, they also emphasized standing law, usually drawn from the English Common Law. This legalistic heritage simultaneously emphasized two concepts: the traditional liberties of the English subject and a strong emphasis upon the rights of property. American colonial history is filled with the discussion and implementation of these concepts.

If Americans early displayed a strong interest in laws and institutions limiting the exercise of political authority, they also pioneered in the development of self-sustaining institutions for local government. Since colonial government was so *local,* it is natural that it varied widely from colony to colony and region to region. But with all the variations in form that were present within the colonies, one fact remains clear: the colonists were to a very large extent running their own affairs.

As Charles M. Andrews, dean of American colonial historians, has concluded: "In the development of American political ideas and social practices the influence of the popular assembly . . . is the most potent single factor underlying our American system of government."[5] What impact did this local self-government have? In the words of Clinton Rossiter, "these institutions taught the colonists one more sturdy lesson in freedom from pomp and arbitrary power."[6]

Limited and Local Power

The colonists, then, were achieving their "government of laws, not of men," first by strict legal limitation of governmental power

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5 *Ibid.*, p. 119.
6 *Ibid.*, p. 124.

and second by keeping the exercise of that power close to home. As England made its mid-eighteenth century attempt to tighten control over the colonies, the mother country violated both the ideals of limited governmental authority and local self-government, by increasing the arbitrary power of government while moving the exercise of that power further from the colonies. The colonists thought of themselves as good Englishmen, and many of them worked to maintain their political tradition while still remaining Englishmen. This is the basis of the federal system operating within the British empire that Franklin advocated in his Albany Plan of Union in 1756.

There need be no doubt of the vitality of the American tradition of federalism in colonial times. We need only compare the liberties of the individual and the strength of self-government in the English colonies of the seventeenth and eighteenth centuries with the centralization and arbitrary exercise of governmental power present at the same time in the French and Spanish colonies of the New World. Tocqueville grasped the essence of the political heritage that gave strength and validity to the American experiment: "The general principles which are the groundwork of modern constitutions, principles which, in the seventeenth century, were imperfectly known in Europe and not completely triumphant even in Great Britain, were all recognized and established by the laws of New England: the intervention of the people in public affairs, the free voting of taxes, the responsibility of the agents of power, personal liberty, and trial by jury were all positively established without discussion. [Thus occurred] . . . the germ and gradual development of that township independence which is the light and mainspring of American liberty at the present day. . . . In America . . . it may be said that the township was organized before the county, the county before the state, the state before the union."[7]

A Revolution Prevented

When the British failed to see the colonial position, the American Revolution finally occurred. Yet in a very real sense Burke was right when he described the American War for Independence as "a revolution not made, but prevented." The radical change of the late eighteenth century was less in American self-government than in the Johnny-come-lately attempted British interference with that self-government. From the beginning of the War for Independence the colonists presented a most pe-

[7] Tocqueville, Vol. I, p. 41.

culiar aspect for revolutionaries. They appealed to tradition, the common law, British custom, colonial practice, and property rights; hardly a collection of radical ideals!

The antitraditional, present-mindedness of many modern scholars has produced a view of the American Revolution that overlooks the colonial American heritage of limited, constitutional government. Those who suggest that the American Revolution was only another egalitarian leveling process similar to the French Revolution must overlook the middle class and aristocratic leadership of the American Revolution, its respect for law and property rights, and its concern for maintaining a 150-year-old heritage of local self-government.

The attempt to make the Declaration of Independence into a Declaration of the Rights of Man amounts to little more than an attempt to misread a bill of indictment against the king, written in the language of British constitutionalism, until it is twisted into some sort of manifesto for the overthrow of the old order. It was precisely the preservation of the old order for which the colonists were striving. One of the pamphleteers of the Revolution, James Otis, epitomized this colonial stance in his *The Rights of the British Colonies* (1764) when he advocated what might be called "revolution by due process of law." The Declaration of Independence itself attacks usurpation and centralization of authority, calling it tyranny: "He has erected a multitude of new offices and sent hither swarms of officers to harass our people and eat out their substance. He has combined with others to subject us to a jurisdiction foreign to our constitution and unacknowledged by our laws."

"Endowed by Their Creator"

Even though the colonists were drawing on 150 years of historical experience in asserting their position, they were also building upon that heritage to produce a very different sort of nation than the world had previously seen. This was the *real* American Revolution. For the first time in history, no authoritarian control would be tolerated in this new political order. "Men are endowed by their Creator with certain inalienable rights," the Declaration of Independence announced to the world.

If men are endowed "by their Creator" with these rights, it follows that God and not government is sovereign, and therefore that government must be without authority to interfere with "certain inalienable rights," such as self-government and sustenance; that is, the right to freedom, and the right to property as a means of making that freedom meaningful. What the Declaration of Independence outlined was made specific in the Constitution's Bill of Rights which placed restrictions not upon the citizen but upon the government, limiting the role of governmental power over the individual citizen in some 46 specific instances.

The interim between the Declaration of Independence and the Constitution clearly foreshadowed the coming federal constitution in the development of state constitutions and the various bills of rights attached to them. The Founding Fathers derived their principles of limiting government and protecting individual rights from a belief in natural law; that is, a belief that God had ordained a framework of individual dignity and responsibility that was to serve as the basis for all human law and as the root assumption behind a written constitution.

Conforming Man's Laws to the Natural Order

Professor Edward S. Corwin's *The "Higher Law" Background of American Constitutional Law* has examined this basic American assumption in considerable detail. Such an assumption is quite different from the "consent of the governed" theories that motivated the French Revolution and its aftermath. The difference, quite simply, is that Americans were assuming certain fixed principles that limited *anyone*, majorities included, in the exercise of their power. The Declaration of Independence has spoken of "the Laws of Nature and of Nature's God" and of a "firm reliance on the protection of Divine Providence." A few years later, the Preamble to the new Constitution was to begin, "This nation under God. . . ." Thus, the liberties of the individual were felt to be inseparable from a belief in an authority above man. Viewing America several decades later, Tocqueville agreed with the American experiment when he suggested that "liberty cannot be established without morality nor morality without faith."[8]

This deeply abiding faith in God as the ultimate source of human dignity presupposed that man was insufficient unto himself, that some abstract blueprint for a perfect society might ultimately prove disastrous even if advocated by a majority of men. So, unlike the documents of the *philosophes* and their French Revolution, the Declaration of Independence and the Constitution were firmly grounded in specific historical instances and carefully avoided the vast egotism

[8] *Ibid.*, Vol. I, p. 12.

always evidenced by men who would remake the world.

The distinguished group of men who came together at Philadelphia in 1787 were up against the same old political problem: freedom and order. As James Wilson expressed it, "Bad governments are of two sorts – first, that which does too little; secondly, that which does too much; that which fails through weakness, and that which destroys through oppression."[9]

The Confederation period had shown the new union of states that a central government was necessary, that power was required to run a nation effectively. The Founding Fathers provided that power to establish a system which has survived repeated internal and external crises in the last 180 years.

People are fond of pointing out how much America has changed. In terms of historical continuity, it is more remarkable how much America has remained the same through two centuries of existence in a world torn with violent political upheaval. We still have a President, a Congress, a Supreme Court, and Electoral College, a network of separate state and local governments, and most of the forms passed on to us by the Constitution. Surely, despite all our problems and despite the changes which have occurred within our system, great strength must be embodied within such a lasting framework.

The Diffusion of Power

The key to that constitutional vitality, the answer to the dilemma that all power was to be distrusted and yet had to be exercised somewhere for the nation to survive, lies in the familiar concept of "divided powers" and "checks and balances." This diffusion of power made our system a representative republic rather than a democracy. The Founding Fathers are, of course, scrupulously clear on this point, and a statement of such an assumption occurs repeatedly in both the debates of the Constitutional Convention and the later public statements of the participants.

Felix Morley has originated a valuable distinction to clarify the word "democracy." He divides the concept into *political* democracy and *social* democracy. Viewed in this light, it is clear that the innumerable roadblocks thrown up in the path of the majority by the Founding Fathers in their writing of the Federal Constitution and their creation of American federalism were not intended to set up a political democracy. Yet

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[9] James Burnham, *Congress and the American Tradition* (Chicago: Henry Regnery Co., 1965), p. 64.

America has traditionally been the land of great social mobility and individual opportunity, that is to say, a *social* democracy. Thus, the American tradition of federalism has deliberately limited the exercise of political power, not to suppress individual liberty, but to enhance it. Put another way, the very real success story of America has hinged upon the limitation of political power rather than its exercise.

This nation has been consistently hostile to monopoly power, whether social, religious, or political. The Constitution outlawed titles of nobility (social monopoly) and an established church (religious monopoly), and made a particular point of outlawing excessive centralization of political power, as for example in the Ninth and Tenth Amendments to the Constitution:

Ninth: "The enumeration in the Constitution of certain rights shall not be construed to deny or disparage others retained by the people."

Tenth: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively or to the people."

The American federal system was already quite well developed by the time of the Constitutional Convention. The thirteen colonies were separately established and by the time of the War for Independence had developed widely differing political and social customs. Only a system of federalism that recognized and protected these diversities could hope to unite the various factions and units. But that unifying effort was only one of the reasons for the American federal system. As Felix Morley explains it: "But behind the determination to keep the rights of the several states inviolate, was the even deeper determination to protect the citizens of these states from centralized governmental oppression. That is why the Republic was established not only as a federation of semi-sovereign states, but also as one of balanced authority in which it would be extremely difficult to establish a nationwide monopoly power of any kind."[10]

"Inefficiency" by Design

On the whole, the system has worked. The tendency of one branch of government to gather all power unto itself has usually been slowed by the inertia of the other centers of power. Critics of the system call this inefficiency, but it is an inefficiency which has

[10] Felix Morley, *Freedom and Federalism* (Chicago: Henry Regnery Co., 1959, Gateway ed.), p. 9.

produced and preserved a greater productive capacity for the satisfaction of human wants and a greater area of individual freedom than any other system in the history of the world. The key to this system of American federalism has been the recognition that government is *not* the source of rights for the individual and that extension of governmental authority is therefore a potential menace to human rights.

To accept the modern statist position that the government is the source and protector of human rights is ultimately to reduce the individual to the level of a mass man, simply because it removes all qualitative distinctions between and among individual citizens. When this happens, human personality and the institutions built upon widely differing human personalities are swept away in a nameless, faceless, pointless whirl. It is just such a tragedy that the American system of federalism was designed to prevent.

In fact, American federalism has gone a good deal further than the mere structure of federalism itself requires; for example, in the horizontal as well as vertical separation of political authority. The obvious advantage of federalism has rested in its ability to avoid dangers inherent in government by remote control. So long as local affairs are reserved to the greatest possible extent for the localities themselves and so long as the people are both interested in and capable of understanding and handling their own problems, then the philosopher's stone has indeed been discovered and a large measure of both freedom and order are possible.

The weakness in federalism, its susceptibility to centralization in time of crisis, is also very much in evidence. Yet in the face of this weakness, American federalism has remained tremendously successful. Again in the words of Felix Morley: "The reason lies in a simple paradox. By the adoption of arrangements strongly negative toward the power of government, the Republic has so far permitted and encouraged its citizens to act affirmatively in their own interest. Many Americans do not realize that when first attempted this political plan was extraordinary. . . ." [11]

One might add that all too many Americans still do not understand how truly extraordinary such a system actually is. ◈

[11] *Ibid.*, p. 1.

An article to follow next month will deal with the history of American Federalism.

INTEREST RATES ARE RISING

HANS F. SENNHOLZ

"INTEREST RATES are too high," complained J. Dewey Daane, a member of the Federal Reserve Board. But he added, high interest rates are "inevitable" if monetary policy is going to have to carry all the burden of fighting inflation.

In agreement with remarks made by Senator Douglas, Mr. Daane pointed out that "interest rates are high historically." Some are at the highest levels in 40 years. But Senator Douglas, vice chairman of the Congressional Joint Economic Committee, which has recommended guidelines for monetary policy and reform, warned that rising interest rates may precipitate a depression. To counter a foreign run on U.S. gold in 1931, the Senator said, the Federal Reserve twice raised interest rates "and deepened the depression. I certainly hope you don't again raise interest rates to keep European hot money in the U.S." President Truman was reported having expressed similar fears.

These are some of the arguments that are filling the air in the political war over interest rates. What are the economic principles, if any, that affect and determine the rates? And what is the proper role of government in this important aspect of economic activity?

It is true, today's interest rates are higher than those of the recent past. Bankers acceptance rates are now quoted between 5⅝ and 6 per cent, Federal funds rates between 5½ and 6 per cent, call money lent to brokers on Stock Exchange collateral at 6 to 6½ per cent, commercial paper 5⅞ to 6⅜ per cent, certificates of deposit 5¼ to 5½ per cent. The Treasury's sale of one-year bills recently brought investors an average yield of 5.844 per cent, the highest ever recorded

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on any Treasury bills. Corporate debentures now yield 5½ to 6½ per cent, first mortgages 6 to 7 per cent.

All these rates are gross market composite rates consisting of three different parts. An economist who analyzes interest rates invariably finds the following components:

(1) originary or pure rate,
(2) debtor's risk premium,
(3) inflationary risk premium.

All market rates, whether acceptance or mortgage rates, certificate-of-deposit rates or debenture rates, have these components, which evidence different characteristics and flow from different sources.

Originary Rate

The originary rate or basic component flows from a psychological factor which economists call "time preference." Suppose you inherited $1,000 and were given the choice between payment now or 10 years from now. Which of the alternatives would you choose? Or suppose you have a choice between a certain amount of cash on hand or a one-year promissory note absolutely guaranteed by the Bankers' Trust. Which is more valuable to you? In both cases you and everyone else would prefer the present good over the future good because we all discount the latter as against the former.

This difference in valuation is the source of interest. He who exchanges a present good for a future good commands a premium, called interest, because the present good is more valuable than the same good available or accessible only in the future. In the words of Böhm-Bawerk, the Austrian economist who first elaborated the causes of interest, "We systematically undervalue our future wants and also the means which serve to satisfy them. That is a sad fact–of that there can be no doubt. Admittedly, it is so to a degree varying between extremely wide limits in particular peoples, or at different stages in life or in individual men and women. We encounter it in markedly flagrant form in children and savages. In their eyes the most trifling pleasure, provided only it can be seized at the moment, counterbalances the greatest and most lasting future advantages. How many an Indian tribe, in its foolish eagerness for pleasure, has sold to the palefaces the land of its fathers, the reservoir of its means of sustenance, in return for a few barrels of 'firewater'! The same sort of action, unfortunately, can be observed in the very midst of our own highly civilized countries. The laborer who goes out on Saturday night and pours his week's wages down his gullet, only to spend the remainder of the week starving with wife and child is, sad to say, the blood brother of those Indians! But the same phenomenon in lesser measure and in refined form is, I venture to say, something not unrepresented in the experience of any of us, not even men of the greatest prudence, the highest principles and the maturest deliberation."[1]

This observation reveals that spendthrifts, who prefer present enjoyment over future provision and income, display relatively high interest rates. But even the frugal saver who is making provisions for the future is discounting the future. Considerations of the brevity and uncertainty of human life cause him to make a deduction from the value of future goods in accordance with the degree of uncertainty. Only God who lives in eternity can ignore time preference and interest.

Differing Circumstances

A related factor that gives rise to a difference in value between present and future goods is the difference between the relation of supply to demand as it exists at different points in time. If a person suffers in the present from a real or assumed lack of certain goods, he will place a higher value on immediately available goods than on the same quantity of future goods. In cases of temporary distress or of the incidence of calamity, a farmer's crop failure or a bad fire, heavy expenses because of a death or sickness in the family, or the loss of employment, we all will place a lower value on future dollars than on ready cash which will keep us out of the worst of troubles.

This particular psychological factor explains why prosperous individuals generally manifest lower interest rates than people in want and poverty. Poor people generally display a greater willingness to borrow money for present consumption, to purchase wanted goods "on installment," than the thrifty individual who refuses to burden his future with present consumption.

It also explains why American interest rates tend to be much lower than the rates in other countries, especially in the undeveloped areas of the world. Where people are dying from want and starvation, as in Asia and Africa, present consumers goods are selling at a great premium over future goods, saving for the future is painfully difficult, and little capital is formed. If their central banks, or sometimes even commercial banks, nevertheless post rates in

[1] *Capital and Interest*, Vol. II. (South Holland, Illinois: Libertarian Press, 1959), pp. 268, 269.

line with American and European rates, they are deceiving the public. At the present the central bank of India is quoting 5 per cent, Burma 4 per cent, Ceylon 4 per cent, Tunisia 4 per cent, Egypt 5 per cent, El Salvador 4 per cent, Honduras 3 per cent, and so on. But the going rates of time preference in these poor countries probably lie between 20 and 50 per cent, which makes the stated rates fictitious and meaningless. No capital other than U.S. foreign aid, which the beneficiary governments usually appropriate to themselves, can possibly be offered at posted rates so far below the general time preference rates.

Debtor's Risk Premium

Another component part of the gross market rate quoted in credit transactions flows from the risks involved in every loan. In every act of lending there is an element of entrepreneurial venture. A credit transaction is always an entrepreneurial speculation which can possibly result in failure. The lender may lose a part or the total amount lent. This is why every interest stipulated and paid in loans includes not only originary interest but also a risk premium which is entrepreneurial profit.

There is a broad structure of interest rates for loans of different types and of varying maturities. U.S. government securities usually yield the lowest return because they are believed to carry the lowest risk to the lender. The high degree of safety and marketability and the short maturity make the 90-day Treasury Bill desirable as a reserve for banks and for temporary employment of surplus funds by corporations. Federal funds probably rank next in the degree of safety. Broadly defined, they are sight claims on the Federal Reserve Banks consisting of balances maintained with the Reserve Banks by member banks.

Bankers acceptances also enjoy a high degree of safety, and consequently carry a low entrepreneurial risk premium in their gross market rates of interest. They are drafts drawn by individuals or business firms on a bank which "accepts" the drafts and thereby becomes the principal debtor. Also commercial paper, which consists of generally unsecured one-name promissory notes of well-known business concerns with strong credit ratings, enjoys a similar reputation of safety and marketability.

And finally, near the bottom of the list of loans of different types and of varying maturities, entailing the greatest entrepreneurial risk and potential profit or loss, are various consumer loans to debtors without assets or known credit ratings. This is why such debtors may pay gross interest rates of 12 per cent or more on installment loans for the purchase of new automobiles, television sets, refrigerators, and the like.

In every loan there is an element of entrepreneurial venture which acts upon the gross market rate of interest. The differences in the degree of loan risk explain not only the broad structure of interest rates in the United States, but also the much higher rates that prevail abroad. In addition to the higher originary rates mentioned above, the risk in other countries with less favorable business climates greatly exceeds ours. Where business honesty is rare, or private property is in constant jeopardy, where socialistic governments seize and confiscate private wealth or freeze it in blocked accounts, the entrepreneurial risk is very great and gross rates of interest are very high. This is why few American money lenders would accommodate a borrower in China, Russia, Cuba, Egypt, India, or the Congo at a loan rate of even 50 per cent.

Inflationary Risk Premium

In recent decades the gross market rate of interest has acquired yet another component: an inflationary risk premium. Professor Mises calls it "the price premium" (*Human Action,* p. 538 *et seq.*). Federal Reserve Governor Daane unwittingly referred to this premium, which has been rising steadily in recent decades, when he observed that "interest rates are high historically."

Whenever the monetary authorities resort to inflation and credit expansion and consequently goods prices start to rise, the gross rate of interest tends to adjust to the monetary depreciation. That is to say, whoever expects a rise in prices is ready to allow a higher compensatory gross rate than he who expects no increase in prices. On the other hand, the lender who expects inflation will grant no loan unless he is compensated for the loss in the purchasing power of his capital. The expectation of rising prices thus makes the gross rate of interest rise, while an expectation of falling prices would make it drop. The inflation premium comes into existence when many people begin to buy in order to take advantage of the inflationary trend.

The rate of premium is determined by the expected rate of monetary depreciation. If this rate is assumed to be 2 per cent, the gross market rate of interest will rise by 2 per cent. If prices are expected to double because of monetary depreciation, the inflationary risk premium will amount to 100 per cent, and the gross market rate of interest will soar even higher.

Government Intervention

This characteristic of the price premium makes the gross rate of interest highly volatile and erratic, which has given rise to considerable confusion. Some writers on economics even deny the validity of any logical interdependence, believing that the interest rate directly springs from government policies and manipulations. Still others blame bankers and money lenders for any upward move of the market rate.

Serious students of economics are convinced that the chief reason for the upward surge of American interest rates in recent years has been the rampant 1961-1966 inflation which caused most prices to rise and the price premium to emerge. Central bank credit was expanded from $29.1 billion on December 31, 1960, to $43.9 billion at the end of 1965. At the present (September 5) it stands at $45.2 billion. Except for the World War II inflation, this has been the most phenomenal expansion of our currency since the Civil War. Consequently, goods prices have been rising sharply. The consumer price index has been hitting high after high in practically every month.

Managed Currency

Stable monetary conditions are of the greatest importance to the steady development of business and banking. When currency and credit begin to fluctuate, an element of uncertainty is injected into both domestic and international business with disruptive effects on all phases of economic life. The erratic movements of the gross market rates of interest create a great degree of uncertainty and often signal the coming of a business recession.

Managed currency aims at influencing business conditions by means of the monetary powers of the Federal government. Money and credit become instruments for executing economic, fiscal, and social policies of the government, which usually aim at creating and prolonging a feverish boom. The monetary policies of the Great Society Administration were very successful in kindling a long and boiling boom through accelerated currency and credit expansion. The price we all must pay now for this popular policy is monetary depreciation and rising interest rates.

The discount rate is one of the instruments of currency management. It is the rate of interest charged by the central bank – the Federal Reserve System – on loans to member banks. At the present this rate stands at 4.5 per cent on advances secured by government obligations and discounts of, and advances secured by, eligible paper.

Realistic Rates, or Not?

It makes no sense to speak of "high" or "low" discount rates. We can conceive only of rates that are below the market rate, or concur with this rate, or are above the rate established by the capital market. If the Federal Reserve sets its discount rate below the unhampered market rate the demand for its accommodation will rise, which will cause the Federal Reserve to inflate its volume of discounts and advances. That is to say, if the gross market rate stands at 5 per cent and the Federal Reserve discount rate at 4½ per cent, the latter will be inflationary as it induces member banks to borrow newly created central bank funds. If, in a run-away inflation, the gross market rate of interest should rise, to let us say 100 per cent, any discount rate below 100 will be inflationary. During the 1923 run-away inflation of the German Mark the Reichsbank charged 95 per cent and yet rapidly inflated the German currency through its discount instrument.

If the central bank establishes a discount rate that concurs with the market rate, no demand for its funds can possibly develop as the market funds offered will equal the market demand. In fact, such a discount rate forces the central bank into inactivity, which may conflict with its avowed goal of currency management and boom policy.

If, finally, the central bank should set a discount rate that lies above the market rate, the situation will be similar to the one just described. But in case the member banks were indebted to the central bank because of prior discount expansion, a reflux of funds to the central bank will develop, which is tantamount to deflation. After long periods of inflation central banks have occasionally conducted deflationary policies through discount rates that lay above the market rates.

There is no indication that the 4½ per cent discount rate presently in effect lies above the market rate. In fact, the volume of Federal Reserve discounts and advances to member banks swelled from $490 million at the end of 1965 to $719 million at the end of August, 1966. This expansion of Federal Reserve credit through the discount instrument proves the 4½ per cent discount rate to be inflationary. Although it is admittedly higher than at any time during the last 35 years, it nevertheless lies below the market rate.

Moreover, the present discount rate is probably much more inflationary than the modest expansion of Federal Reserve discounts seems to indicate. Instead of raising its rate to the market equilibrium rate, e.g., 6 or 7 per cent which would be very unpopular and conducive to political repercussions, the Federal Reserve System now relies on "moral suasion" to manage the credit demand. That is to say, the central bank discount rate has lost its former significance to "moral suasion" which constitutes "qualitative" credit control. Our monetary authorities prefer an inflationary discount rate; but when credit demand swells to embarrassing proportions, they regulate and allocate their own inflationary funds through "moral suasion," that is, distribute them to favored borrowers. In the words of William McChesney Martin, Jr., Chairman of the Board of Governors of the Federal Reserve System: "As a tool of credit regulation, moral suasion in its narrowest meaning can be taken to refer to purposeful influence on credit extensions by the banking and monetary authorities through oral or written statements, appeals, or warnings to all or special groups of lenders. Generally speaking, such influence is exercised through policy statements released through the press and other publications, correspondence, speeches, and testimony before Congressional Committees. Moral suasion, however, can also be said to embrace what is sometimes called direct action and direct contacts with individual banks or other financial institutions."[2]

The "Federal Funds" Rate

Because of the discount rate's loss of significance, we now look on the Federal funds rate as a revealing indicator of actual monetary policy. The term "Federal funds" refers to the amount of reserve balances the individual member banks have in excess of legal requirements and are willing to lend to banks deficient in reserves. Deals in Federal funds are day-to-day loans between banks made through the transfer of reserve balances on the books of the Federal Reserve banks. The Federal funds rate is the rate paid by banks for the use of such reserves. It is published daily by such newspapers as the *Wall Street Journal* under the heading "Money Rates."

In recent weeks this Federal funds rate has fluctuated wildly between 1 and 6⅜ per cent, indi-

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[2] Marcus Nadler, Sipa Heller, and Samuel S. Shipman, *The Money Market* (New York: The Ronald Press Co., 1955), p. 166.

cating a nervous and erratic monetary policy. But mostly the rate has hovered around 6 per cent, pointing at a money market similar to that of 1929, prior to the infamous stock market crash.

Interest Rates in Boom and Bust

We need not here emphasize that the rapid inflation of money and credit during the last six years has initiated the trade cycle with all its phases from boom to bust. We have enjoyed a long and pleasant boom. In the terminology of our central planners, the annual rate of gross national product gained 10 to 20 billion dollars every quarter. The increase is expected to bring GNP soon to an annual rate of more than $700 billion. This gain, according to the Commerce Department, indicates a business expansion which in its sixth year "has already become the longest expansion of the postwar period."

A mere glance at some monetary reports immediately reveals the secret of the Great Society boom. Total commercial bank credit (loans and investments) has risen at an 11.5 per cent annual rate. Loans have risen at a 17.3 per cent rate. Since the beginning of the Kennedy-Johnson era, the American money supply plus time deposits has risen 8.8 per cent annually, and the supply of Federal Reserve currency approximately 10 per cent annually. It is obvious that the boom was built on inflation and credit expansion.

The boom causes economic malinvestments and maladjustments. The money and credit expansion artificially lowers interest rates, falsely indicating growing supplies of savings and genuine capital. This falsification of interest rates causes many a businessman to embark upon expansion and modernization projects. The boom is born from illusion and lives on more illusion through ever-increasing supplies of money and credit. When goods prices begin to rise on account of this inflation, the gross market rate of interest must adjust upwards to allow for the price premium. But in addition, the feverish boom activity at rising prices and costs augments the demand for working capital of nearly every enterprise. Interest rates soar unless the central bank feeds the boom with ever larger injections of money and credit. In this case the boom accelerates, goods prices soar, and the price premium in the gross market rate of interest continues to climb.

If the currency is not to be destroyed completely, the inflation must come to an end. But when the monetary authorities finally refrain from further currency expansion, the readjustment, i.e., recession, necessarily sets in. Also, in this case, interest rates ascend because of spreading uncertainty and fear. In periods of crisis and crash the gross market rate may no longer embody an inflationary risk premium, but usually is magnified by the entrepreneurial component here called "debtor's risk premium." Only when the economy has completed its readjustment to market data, and the disastrous effects of previous inflation have been alleviated through new capital formation, does the gross market rate of interest return to "normal."

Other Controls the Government May Try

It seems improbable that present monetary authorities would deliberately invite readjustment or recession rather than return to full-speed inflation. Without inflation, the Great Society would immediately sink into deep depression under the growing burden of government. It is true, the present rate of inflation of approximately 10 per cent annual currency and credit expansion may not suffice to sustain a boiling boom, which may cause it to falter occasionally. But accelerated inflation might restore it again temporarily. Of course, if the Great Society Administration should decide to repeat the dreadful blunders of the Roosevelt New Deal, if it should continually raise business taxes and deliver American business into the lethal grip of hungry labor unions, anything may happen.

Accelerated inflation may be accompanied by new government controls that aim at fighting the inevitable inflation symptoms. Besides a "price stop" one might expect various credit controls designed to prevent the flow of inflation funds to certain individuals and direct it at others, especially the government and its favored groups. Toward this end the Federal government may resort to the following credit control instruments: (1) further restrictions of security loans, (2) further increases in margin requirements, (3) suspension of the borrowing privilege of individual banks from their respective Reserve banks, (4) further limitation of eligible paper, (5) stringent control of consumer credit, (6) control of real estate construction credit, and (7) more moral suasion.

Under such controls the interest rates, which are manifestations of the market order, are replaced by official credit allocation and rationing. Of course, the interest phenomenon, which flows from the very nature of man, cannot be suppressed. ◈

FIAT MONEY INFLATION IN FRANCE

ANDREW DICKSON WHITE

Editor's Note: The course of current financial affairs in the United States, as in most of the world in 1966, calls for reviewing once again Andrew Dickson White's classic analysis of fiat money inflation in France at the time of the French Revolution. The noted historian and diplomat was serving as the founder and first president of Cornell University when he first delivered the paper as a lecture in 1876. He revised and enlarged it in 1912.

In an introduction to a 1959 edition of White's essay, Henry Hazlitt notes that "what chiefly strikes today's reader is the astonishing similarity of the arguments put forward by our own contemporary inflationists to those of the inflationists of eighteenth-century France. Not less striking, of course, is the similarity in the actual consequences of paper money inflation in revolutionary France and inflation everywhere in the modern world. . . .

"But just as the French of 1790 had failed to learn the lessons of the inflation of seventy years before, in John Law's time, so the present-day world has failed to learn the lesson of the assignats."

The following excerpts from *Fiat Money Inflation in France* are but samplings. The full story is available in the 124-page booklet from the Foundation for Economic Education, Irvington-on-Hudson, New York, 10533. $1.25 paper; $2.00 cloth.

WHENEVER any nation intrusts to its legislators the issue of a currency not based on the idea of redemption in standard coin recognized in the commerce of civilized nations, it intrusts to them the power to raise or depress the value of every article in the possession of every citizen....

The question will naturally be asked: *On whom did this vast depreciation mainly fall at last?* When this currency had sunk to about one three-hundredth part of its nominal value and, after that, to nothing, in whose hands was the bulk of it? The answer is simple. I shall give it in the exact words of that thoughtful historian from whom I have already quoted: "Before the end of the year 1795, the paper money was almost exclusively in the hands of the working classes, employees and men of small means, whose property was not large enough to invest in stores of goods or national lands. Financiers and men of large means were shrewd enough to put as much of their property as possible into objects of permanent value. The working classes had no such foresight or skill or means. On them finally came the great crushing weight of the loss. After the first collapse came up the cries of the starving. Roads and bridges were neglected; many manufactures were given up in utter helplessness." To continue, in the words of the historian already cited: "None felt any confidence in the future in any respect; few dared to make a business investment for any length of time, and it was accounted a folly to curtail the pleasures of the moment, to accumulate or save for so uncertain a future." (Von Sybel, *History of the French Revolution*, vol. iv, pp. 222-338)....

Just as dependent on the law of cause and effect was the *moral* development. Out of the inflation of prices grew a speculating class; and, in the complete uncertainty as to the future, all business became a game of chance, and all businessmen, gamblers. In city centers came a quick growth of stockjobbers and speculators; and these set a debasing fashion in business which spread to the remotest parts of the country. Instead of satisfaction with legitimate profits, came a passion for inordinate gains. Then, too, as values became more and more uncertain, there was no longer any motive for care or economy, but every motive for immediate expenditure and present enjoyment. So came upon the nation the *obliteration of thrift.* In this mania for yielding to present enjoyment rather than providing for future comfort were the seeds of new growths of wretchedness: luxury, senseless and extravagant, set in. This, too, spread as a fashion. To feed it, there came cheatery in the nation at large and corruption among officials and persons holding trusts. While men set such fashions in private and official business, women set fashions of extravagance in dress and living that added to the incentives to corruption....

Thus was the history of France logically developed in obedience to natural laws; such has, to a greater or less degree, always been the result of irredeemable paper, created according to the whim or interest of legislative assemblies rather than based upon standards of value permanent in their nature and agreed upon throughout the entire world. Such, we may fairly expect, will always be the result of them until the fiat of the Almighty shall evolve laws in the universe radically different from those which at present obtain. ◈

FOREIGN AID

AN INSTRUMENT FOR PROGRESS?

PETER T. BAUER

FOREIGN AID is clearly not a necessary condition of economic development. This fact is obvious from the history of the developed countries, all of which began poor and have invariably progressed without government-to-government aid. It is clear also from the history of many underdeveloped countries – Hong Kong, Japan, Malaya – 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 which emphasize the continued low living standards in the recipient countries and insist on the need for indefinite continuation of aid at present or higher levels.

India is perhaps the most familiar example. Thirteen years after the beginning of Western aid and the inception of the five-year plans, the country experienced in 1964-65 the most acute of its recurrent, almost annual, food and foreign exchange crises. For a long time advocates of foreign aid to India, Professor Walt W. Rostow among many others, insisted that the turning point was just around the corner, and that after only an additional limited injection of aid the country would reach "self-sustaining growth"–to use the popular, though largely meaningless, catch phrase. For years now India has been depend-

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ent on large-scale foreign aid and gifts of food, without which there would have been mass starvation in 1964-65. External dependence has now come to be taken for granted. Algeria, Burma, Ceylon, Indonesia, and the United Arab Republic are among other countries with acute domestic economic difficulties after prolonged foreign aid.

Analogy with Marshall Aid

Marshall aid to Western Europe is often instanced in support of the potential value of foreign aid to poor countries. Its experience suggests the exact reverse. The economies 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 favorable 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 program in four years. Almost all the aid represented the cost of food and raw materials and was essentially an emergency program. 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 recognized by the widely-held assumption that aid to poor countries must be continued for many years to come.

The large-scale expenditure by the United States government on the surviving Navajo Indian population (a large group with a territory of its own) may appear more relevant to the assessment of foreign aid than is the Marshall plan. Very large sums, amounting to thousands of dollars a head, have been spent in an unsuccessful attempt, extending over decades, to improve the material position of these Indians. This experience reinforces the conclusion suggested by more than a decade of foreign aid to poor countries: foreign aid is not a sufficient condition of development, and is indeed unlikely to promote it substantially. If a poor country has failed to develop without aid, its provision alone is unlikely to lead to development.

Poverty and Pauperization

The flow of sustained indefinite aid implies an obvious and yet widely ignored danger—the pauperization of the recipients. A pauper is one who relies on unearned public assistance, and "pauperization" accordingly denotes the promotion and acceptance of the idea that unearned doles are a main ingredient in the livelihood of nations. This danger of foreign aid is reinforced by the practice of linking it to the balance-of-payments difficulties of the recipients. Foreign aid and its relation to these payments crises clearly undermine the status and prestige of the self-reliance required for material progress.

This danger of pauperization which derives from the advocacy and flow of aid is enhanced by the prevalence in many underdeveloped countries of certain attitudes and customs, notably the recognized status of beggary and the absence of social stigma in the acceptance of indiscriminate charity which is conspicuous in South Asia. Indeed by now the pauperization of some major recipients of aid is a reality rather than a danger. The recent economic history of India can be summed up as progression from poverty to pauperism.

The likelihood of the pauperization of the recipients is increased when the gifts are indiscriminate or unconditional on efforts by the recipients to improve their position. This applies to the operation of foreign aid. The advocates, administrators, and recipients of aid insist that it should be given without strings on the policies of the governments or the economic conduct of the population. The only significant exceptions are the preferential treatment of countries in balance of payments difficulties or governments engaged in comprehensive development planning. As I shall argue, these conditions will not improve the prospects of recipients becoming independent of external assistance.

External Grants and the Growth of Resources

The contrasting experience of the rapid success of Marshall aid and the ineffectiveness of prolonged aid to poor countries is ultimately related to differences between the impact of resources provided in the form of aid and that of resources produced locally or obtained in exchange for the current or expected proceeds of local production. When resources are both generated and used locally, the required conditions for further economic development are likely to be present in the form of suitable human qualities, social institutions, and economic opportunities.

Building up resources (in which formal education may or may not play a part) both requires and advances social and economic processes that serve to develop qualities, attitudes, arrangements, and institutions, the presence of which promotes the effective use of the resources generated. When, however, the increase in the resources takes the form of the inflow of free or subsidized aid from abroad, the essential process of generating them is lost.

Here, as in many other spheres of human life, time, experience, and perhaps other qualifications and requirements of achievement, cannot be bought. A social process cannot be telescoped without affecting both its nature and the outcome of the process. And we are not discussing machines, pieces of equipment, but human society or, more often, collections of societies. Development is indisputably a social process requiring much more than the provision of money from abroad.

The Impact of Aid

When foreign aid is given by one country to another, it is received not by the people, but by the government: it does not go to individuals or firms in the private sector, but to the central government. This necessarily increases the weight of the government in the economy, which in turn must increase the concentration of power, even if the recipient government does not intend this result. And if, as often happens, the government does wish to extend its power, the increase in its resources helps it to do so, chiefly but not only by extending the public sector and by enabling the government to control the economy more closely.

These effects are enhanced by the influential support or even pressure in the donor countries for comprehensive development planning and compulsory saving by the recipient countries, i.e., for government determination of the direction of economic activity outside subsistence agriculture and for special taxation to finance government expenditure. These policies have come to be regarded in the donor countries as a condition of economic development in poor countries, and their adoption by recipient countries is accordingly considered as an earnest of their intention to promote it. This belief is unfounded. The historical evidence both of developed countries and of underdeveloped countries suggests more nearly the reverse. Development planning was not used in the early history of the now developed countries of the West. Nor was it employed in the many underdeveloped countries which progressed rapidly in recent decades, such as Japan, Hong Kong, Malaya, Thailand, and a number of African and Latin American countries. Only in the Soviet economies is it an essential element of economic organization, and the texture of these societies reflects its pervasive effects.

However, comprehensive development planning has been specified as a criterion or even as a condition for the receipt of aid by some of the most influential advocates and administrators of American aid, including Professors Max F. Millikan, Walt W. Rostow, and John P. Lewis. It was also specified as a condition of aid in President Kennedy's special message on this subject in 1961. In various aid programs, including those of American aid to India and Turkey, the flow of aid is closely linked to comprehensive development planning.

Moreover, the amount of aid is often geared to the shortfall of resources required for the plan, particularly as reflected in the balance-of-payments difficulties of the country. This criterion not only encourages, or even forces, the governments to engage in comprehensive development planning but also encourages them to make their plans as ambitious as possible. The governments are thus induced to pursue, or at least not discouraged from pursuing, an inflationary policy which eventually brings about balance-of-payments difficulties (under the prevailing system of fixed exchange rates). Balance-of-payments crises in turn serve as an effective basis for an appeal for aid.

Thus we have a situation in which aid depends on a means test, and the absence of means is regarded as a result of laudable endeavor. The link between foreign aid and payments difficulties is an important specific influence in the direction of the pauperization 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.

These are among the reasons why foreign aid promotes and intensifies the control of recipient governments over the economic and social life of their countries.

The Instruments of Control

The principal elements of comprehensive economic control in underdeveloped countries are familiar. They include: a large public sector and heavy taxation; the establishing of trading monopolies, including state trading monopolies in agricultural exports; extensive licensing of industrial and commercial activities; and the establishment of many government owned and operated enterprises, including state sponsored, organized, and run cooperatives.

These measures are often accompanied by substantial expropriation of private property in many underdeveloped countries of Asia, Africa, and the Middle East, notably Algeria, Burma, Ceylon, Indonesia, Syria, and the United Arab Republic (and to some extent India). And compulsory collectivization of much of agriculture is a common feature in countries as different as Algeria and Indonesia.

In addition, economic controls extend to close surveillance of outside economic contacts. External trade, capital movements, and immigration are closely controlled and restricted by most if not all recipients of aid. These flows usually serve as vehicles not only of physical commodities and financial transactions, but also of new ideas, crops, methods of production, wants, and attitudes. Perhaps most important, they can engender a new outlook toward material progress.

Some Economic Repercussions of the Flow of Aid

Some advocates of aid may not like the kind of society which emerges from their recommendation, but they nevertheless accept it as the price of rapid development. They might, so to speak, be ready to trade some or even much freedom and security of person and property for an increase in the flow of goods and services. They might support the policies outlined above in the belief that they promote economic progress. But do they?

The drastic policies often pursued in the name of comprehensive development planning, and promoted by foreign aid, do not augment resources: they only centralize power. Nor do they promote or strengthen the human qualities, attitudes, and social institutions conducive to progress. Indeed, as I have already suggested, for a number of reasons they are much more likely to obstruct than to promote the emergence and growth of such attitudes and institutions.

The enlargement of the resources and power of the government does, of course, enable it to expand some industries and sectors by a transfer of resources from other uses, perhaps even quickly and on a large scale. But this power does not in the least ensure development in the sense of an increase in the total flow of goods and services, let alone in those which make up general living standards, as is amply clear from the experience of centrally planned economies over the last few decades. Only too often increased activity and expanded industries are treated somehow as a net gain, a net addition to output, irrespective of the level of demand for the product and without regard to costs in terms of alternative uses of resources.

The government can also easily enough restrict consumption and increase investment expenditure. However, this objective could be achieved without close control of the economy by such means as a budget surplus or the encouragement of private saving and investment. Moreover, an increase in investment expenditure, especially in public expenditure made possible by high taxation or the imposition of direct controls, does not guarantee economic progress. It only ensures reduced living standards now without ensuring higher living standards later. In this effect it is somewhat similar to foreign aid, which certainly impoverishes the donors without necessarily enriching the peoples of the recipient countries.

Investment Expenditure and Economic Development

Government policies and public discussions on this subject are pervaded by the widely prevalent investment fetish, the belief that economic development depends essentially on investment, which is assumed to be highly productive. But a piece of expenditure does not become productive by being termed investment, in the sense of any expenditure other than on current consumption. There is no assurance that it will increase the total flow of goods and services compared with alternative uses of the resources, let alone that it will improve living standards. And in considering the net result of an increase in investment, it is necessary to examine the various repercussions of the collection of the funds and of other measures introduced to increase investment, especially government investment. For instance, the additional taxation or the restriction on the production or import of consumer goods required by the increase in investment often discourages or even prevents subsistence farmers from producing for sale. And investment can be productive only if it is embodied in physical capital combined with complementary human resources operating in an appropriate institutional setting and producing output for which there is an effective demand. In many different ways investible funds supplied by foreign aid are not complementary to local resources in the promotion of economic development in the sense of increasing their productivity.

It is by no means certain that

foreign aid does increase investment in the recipient countries. The various repercussions which I have already noted, particularly the imposition of extensive controls and higher taxation and the pursuit of inflationary policies which bring about payments difficulties, may serve to reduce private investment, notably direct investment in agriculture. Moreover, both the flow of aid and its method of operation encourage and enable the recipient governments to discourage the inflow of private capital.

Foreign Aid and Private Capital

Foreign aid is likely to discourage the recipient governments from securing capital on market terms, which from their point of view may be both unprofitable and politically unwise if foreign aid is available, i.e., if investible funds are available gratis. And indeed, almost all recipients of foreign aid restrict the inflow and deployment of private foreign capital. During the last decade or so these restrictions have increasingly developed into expropriation of foreign capital, often accompanied by the expulsion of the owners and their employees. Examples abound in Africa and Asia. Governments which clamor for foreign aid because of lack of capital nevertheless severely restrict and circumscribe the inflow and operation of private capital.

Certain aspects of foreign aid, especially the criteria of allocation, have even encouraged the flight of private capital from the recipient countries. The donors encourage the recipient countries to impose extensive controls in the name of development planning. And as we have seen, they are also encouraged to pursue inflationary policies, since the amount of aid often depends on the payments difficulties of these countries. These policies engender a widespread feeling of insecurity, which in turn discourages the local population from saving and investing, and encourages the export of capital. Although capital exports are banned throughout practically the whole of the underdeveloped world, they are difficult to prevent. As a result, the inflow of foreign aid is matched by an outflow of both domestic and foreign private capital. And the outflow is of capital likely to be more productive than foreign aid funds, because its deployment is geared much more closely to local conditions, especially to consumer demand and to the supply of co-operant factors.

The Performance of Governmental Functions

I have just noted that the preoccupation with aid, investment, and development planning has served to divert attention from more important factors in development which are influenced by government policy. This same preoccupation has also served somewhat paradoxically to bring about a serious neglect of essential tasks of government. Governments seem anxious to plan but unable to govern. The neglect extends to such familiar and essential tasks as the maintenance of law and order, the effective management of the monetary and fiscal system, and the provision of basic transport and educational facilities. Indonesia is only one of the several poor countries where the government cannot maintain law and order but tries to control the economy closely.

The proliferation is familiar of heavily subsidized state airlines, steel mills, and industrial plants in African and Asian countries with illiterate populations whose activities are restricted by customs and institutions adverse to material progress. In India, with a huge illiterate and caste-bound population, the development expenditure on elementary education under the second five-year plan was less than one-half the cost of each of the three steel plants in the public sector under that plan. The administration of Hong Kong is one of the exceptions to the inclination of governments of underdeveloped countries to neglect essential functions (including the maintenance of law and order) while attempting closely to control social and economic life. This emphasis on government functions partly accounts for the rapid progress of that country. Indeed, Hong Kong is being gradually omitted from the category of underdeveloped countries in much the same way as Japan.

Framework of Law and Order

The promotion of a suitable institutional framework for the activities of individuals conducive to economic development is a task which few governments of underdeveloped countries have attempted to solve. In this sphere the activities of the recipients of foreign aid are largely confined to the expropriation of politically weak and unpopular classes (such as landowners, ethnic minorities, or successful traders) in the name of land reform, social justice, or the removal of exploitation, regardless of the repercussions of these measures on economic development or general living standards. Institutional changes favorably affecting the determinants of economic progress and thus promoting material advance are generally neglected.

Altogether the policies, attitudes, and outlays encouraged by foreign aid tend to lead to expenditures more likely to retard than to promote material advance. This applies both to foreign aid funds and to domestic resources whose deployment is diverted from uses more likely to lead to material progress.

Human Progress

In conclusion, I return to my main theme. Material progress depends primarily on the development of suitable human qualities, attitudes, and social institutions, and not on the inflow of external grants of money. Foreign aid does not affect the major factors behind the material backwardness of underdeveloped countries; the continued poverty of the recipient countries is therefore not surprising. The policies of the recipient countries have on the whole served to retard or obstruct possible advance. And while many of them would probably have been pursued even without foreign aid, its operation has encouraged and reinforced them, generally by the supply of funds and personnel and more specifically by the criteria of allocation. The suggestion that the peoples of the recipient countries are likely to be damaged by large-scale gifts to their governments is paradoxical and requires drastic readjustment of ideas. But I believe it is true, and that such a readjustment is accordingly necessary. The longer this readjustment is delayed the more difficult it becomes, both because of the entrenchment of vested political, administrative, financial, and intellectual interests, and because of the magnitude of the costs already incurred. The greater the sacrifices, the more difficult it is to question the principles in the name of which they have been imposed. ◈

The coming Serfdom in India

SUDHA R. SHENOY

THE MAJOR issue that divides liberals (advocates of liberty) from "liberals" (statists) is the question of the importance of economic freedom. As the statist sees it, economic freedom is the "freedom" of the few to exploit the many. The right to vote, on the other hand, is common to all men. Hence, for statists, the dividing line between democracies and dictatorships is drawn in answer to the question: Are elections free or not? But it will be noticed that totalitarianism is the implicit criterion here: any situation which is not yet totalitarian would be described as "free" by the statist.

As the true liberal sees it, freedom is indivisible. Hence, measures ostensibly aimed at the weak political minority of businessmen will in fact only prevent the market process from functioning as well as it might have done, and will confer on some people—i.e., politicians and administrators — a power over their fellow men otherwise exercised by no one; a power deriving from this group's ability to determine, *de facto* though not *de jure*, the uses to which resources may be put. This power, the liberal affirms, is of entirely another nature from the "power" alleged to be exercised by businessmen operating in a market context. Control over resources by businessmen is not only scattered among a much larger group of individuals; these businessmen themselves are in effect simply the agents of their fellow men in determining the use of these resources, via the market process of profit and loss. But where economic power is concentrated in the hands of a *politically* selected group, the chances for the emergence and establishment of a political opposition are precarious,

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to say the least. The statist overlooks the necessity for independent sources of material support for a political opposition; even though *some* opposition may seem to be present, the real criterion is the range of different views that would have emerged if economic power had not been so concentrated. In other words, freedom is more than one value among others; it is rather the foundation for a whole social order. Intervention embodies a principle that is diametrically opposed and must lead to the destruction of this social order (where it exists) and the establishment of an order founded on the principle of political exploitation: the politically strong exploiting the politically weak. In short, intervention leads to the suppression of *potential* political opposition and thus ends in totalitarianism.

India as an Oligarchy

This abstract and theoretical argument is vividly illustrated by the experience of India. Most statists regard India as an excellent example of economic planning combined with democracy. It would perhaps be more accurate to describe India as an oligarchy – in the Aristotelian sense of government of, for, and by the rich. These rich, however, unlike those who earn high incomes in a free market by supplying their fellow men's needs, have obtained their wealth via the very instruments of planning – permits, licenses, quotas, concessions, and contracts. In the first place, virtually all investible resources – i.e., savings and foreign aid – are forcibly drawn (via capital controls and taxation) into the preferred "industrial" sectors, both private and public. The industrial output thus artificially produced adds nothing to the flow of goods and services for the starving, ill-clothed, and unsheltered Indian masses – but those businessmen, civil servants, and others sharing in this forced expansion obtain high incomes (legal and illegal). Hence, we see that the output of coarse cotton bought by the masses has expanded the least, while the output of rayon – a luxury in India – has multiplied by *twenty-one* times over the last 15 years and three five-year plans.[1]

In the second place, even this private industrial sector is very closely controlled by a minutely

[1] The growth of the agricultural sector (from which 50 per cent of the national income is derived and which provides 70 per cent of total employment) is held down by yet another piece of interventionism: moneylenders' legislation. This forbids the pledging of land, though this is virtually the only pledgeable asset of the farmer, sets ceilings on the interest rates legally chargeable, and otherwise circumscribes rural moneylending.

detailed network of regulations: government sanction is required to start, expand, or close down an undertaking; permits are required for virtually all raw materials and certainly all imported machinery and components. Government regulations extend to such points as the manner of conducting board meetings and the width of *sari* borders in the case of mill-made *saris*. In effect all these controls and regulations have created and protected private monopolies in virtually all fields of nonagricultural production.

Thirdly, there is import and exchange control. No imports of any kind are permitted without a license, and imports of a wide range of commodities are banned altogether. Prohibitive tariffs have been imposed on a large number of other goods. All this means that Indian producers of import substitutes have a highly-protected sellers' market. To reinforce import control, all exchange earnings have to be surrendered to the Reserve Bank at the official price – which is well below the true market price. It is, of course, forbidden to send exchange or rupees out of the country in any form.

Fourthly, the government sector has continually expanded over the last 15 years – even though this sector provides the least employment and adds nothing to the real national income. The driving force here is public contracts; the larger the public sector, the larger are its contracts, and the larger, therefore, the rake-offs for the contractors and civil servants involved. (Where 100 rupees are accounted to be spent on a project, they never are. Some say 60 rupees are spent and 40 distributed; others would reverse the proportions – but no Indian would agree that the full amount was spent.)

Fifthly, there are innumerable other controls over the internal economic life of the country, ranging from controls over the movement of food grains between states, to those over the establishment of bus routes. All of these serve to increase the powers of officials over their fellow men.[2]

A Limited Private Sector

From all this, it will be clear how small is the sector of the Indian economy from which a political opposition can draw material

[2] As if all this were not enough, after the Chinese incursion of October 1962, the government passed the Defence of India Regulations (DIR) empowering it to arrest and detain without trial persons suspected of being dangerous to the public safety. Significantly, the DIR have been used virtually against persons known to be associated with the opposition: see *Swarajya* (Madras), *passim.*, for 1963, 1964, 1965. Although four years have passed, the DIR continue to be in force.

support, and how minute a portion of even this sector is independent of the government.[3] The industrial sector in India owes its establishment and continued existence to the government. In the absence of the forced draft of resources into it, and of exchange and import controls and tariffs, this sector's artificiality and unviability would be quickly and unmistakably revealed.It follows that though Indian businessmen technically may be independent of government and even complain of some types of intervention, in fact they must be included as part of the government sector.

It is, therefore, hardly surprising that the opposition in India should be so small and that opposition parties should complain of a dearth of funds while the ruling party has no complaint in this regard. Naturally, virtually all businessmen are ardent supporters of the government. Again, a leading South Indian newspaper charged that government had used Journalists' Wages Boards and newsprint controls to penalize papers consistently opposing it; charges have also been heard that government departments have threatened to withhold valuable advertising from the opposition press.[4] And more recently, opposition M.P.'s have protested in Parliament against Criminal Investigation Department harassment – their telephones, they say, are tapped, their letters (even letters from their wives) are censored, and they are shadowed by C.I.D. plain-clothesmen.[5] When M.P.'s are treated thus, the ordinary citizen can hardly feel aggrieved when he finds that letters abroad – even registered letters – are opened in order to ferret out vio-

[3] The Fourth Five-Year Plan (1966-71) proposes, in effect, to reduce even further this minute independent sector: the government will extend its trading activities, especially in food grains; and taxes on income and wealth–already the highest in the world (see N. A. Palkhivala, *The Highest Taxed Nation in the World* (Bombay, 1965) – will be raised even further.

[4] See the editorial in *The Hindu* (Madras) 10 October 1959: "There are also certain considerations that the Prime Minister might have remembered while calling the Press to account, such as *the power the State has deemed fit to take to restrict the supply of newsprint, to control imports of machinery, to fix wages and salaries and working conditions in newspaper offices. These are calculated to make it extremely difficult for newspapers to be as free from extraneous influence as the Prime Minister would presumably want them to be. If there is any single strong inducement for newspapers to adopt a particular line on any matter, it comes from the Government.* If, in spite of this, a number of newspapers look with a critical eye on the formulation and implementation of various policies by the Governments at the Centre and in the States, the reason must be found in the policies themselves and not in any extraneous considerations. . . ." (italics added).

[5] See the report in *The Times of India* (Bombay) 6 September 1966.

lations of the Exchange Control Regulations.

Finally, the Essential Commodities (Amendment) Bill of 1966 is yet another straw showing the direction in which the political wind in India is blowing. As mentioned, food grains movement is controlled. Hitherto, the government could only impound food grains suspected of being moved illegally. But now the government can summarily confiscate both food grains and vehicles suspected of being involved in illegal movements; it is up to the poor merchant to prove his innocence.[6]

Perhaps the most ironic element in this whole situation is the role of foreign aid. Given in order to "feed starving orphans in Orissa" (as Milton Mayer would have it) or to "keep India from going communist" (as many Americans believe), it is in fact one major cause why orphans in Orissa are starving and why India is now so firmly set down the road to serfdom. This is because in India foreign aid provides the major portion of the finance for the Plans: for every rupee of internal resources, almost 2 rupees worth of resources comes from foreign aid. If aid is calculated at the official exchange rate for the rupee, its true economic value is understated – even allowing for the recent devaluation. It is only if aid is calculated at the free market exchange rate that its true significance emerges. Planning in India, as has already been pointed out, involves essentially a forced transfer of resources out of the uses where they would benefit the masses – i.e., the agricultural sector – into an artificially created and propped up "industrial" sector. It follows that agricultural output has lagged far behind all industrial outputs; consequently, the Indian people are hungrier after three Plans than they were before. Per capita availability of food grains has fluctuated downward over the last 15 years, and stands today at about 14 ounces per day. Meanwhile, since planning implies the concentration of economic and political power in the hands of the ruling clique, it has effectively smothered a wide range of potential political opposition. It would not be too much to describe India as a one-party state.

Democratic forms in themselves are meaningless. The right to vote can be effective only in the context of a whole network of other freedoms. Elections can be free only in the framework of a free market and the Rule of Law. ◈

6 Public speech by Mr. Minoo Masani, M.P., at Ahmedabad on 21 August 1966.

YALE BROZEN

WELFARE

> Every individual is continually exerting himself to find out the most advantageous employment for whatever capital he can command. It is his own advantage, indeed, and not that of society which he has in view. But the study of his own advantage naturally, or rather necessarily leads him to prefer that employment which is most advantageous to the society. . . . By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it.
>
> ADAM SMITH, *The Wealth of Nations*

ECONOMICS has been characterized as the dismal science. However, the two main questions occupying economists belie 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. Neoclassical economists focus somewhat more narrowly within these larger questions on 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, and so forth.

The fact that classical and neoclassical economists thought proggress possible — that the lot of man could be improved by enlarging resources and by better utilizing the available resources — makes economics an optimistic science. It was the discussion of Malthusian demographic propositions that led

This is from a paper which Professor Brozen of the Graduate School of Business, University of Chicago, delivered before the Mont Pelerin Society, Tokyo, Japan, September 9, 1966.

WITHOUT THE WELFARE STATE

to the characterization of economics as a dismal science.

Malthus, and footnotes to Malthus added by Marx, the Webbs, the Fabian socialists, and others such as 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, such as the members of the Ad Hoc Committee on the Triple Revolution, use the same stale excuse for state action as nineteenth century Marxists and the Fabian socialists, with some change in the supposed reasons for expecting a permanently depressed class growing ever larger.[1] 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."[2] Old clichés apparently never die nor do they fade away.

The Goals of the Welfare Statists

Welfare statists 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

[1] ". . . over 20 per cent of the American population is exiled from the abundant economy and this percentage will grow . . . in coming years." R. Theobald, *Free Men and Free Markets* (New York, C. N. Potter, 1963), p. 20.

[2] R. Theobald, "The Threat and Promise of Cybernation," *Main Currents*, September-October 1964, p. 5. See Y. Brozen, *Automation and Jobs* (Chicago: Graduate School of Business, University of Chicago, 1965), p. 22, for an empirical refutation. Also, R. D. Friedman, *Poverty: Definition and Perspective* (Washington: American Enterprise Institute, 1965).

goals, however, which apparently have a high priority with most. The most recent, and the oldest, around which they coalesce 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 statists 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.[3] It is the means for accomplishment on which liberals and interventionists (welfare statists) 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." This is certainly the opposite of the refrain of the English welfare statists of the late 1940's who 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 statists. Economic growth is now an important goal among the welfare statists as well as the elimination of poverty and the achievement of greater equality in the distribution of income.

Consuming What We Should

In addition to these goals, there is a very large group among the welfare statists who are also interested in seeing to it 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 ramshackle buildings and junkyards, 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, statuary, 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 wel-

[3] ". . . the chief motive of their [the Physiocrats] 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: Macmillan and Co., Ltd., 1930, 8th ed.), p. 757.

fare state are not those who believe in the welfare state because of any ideals relating to the improvement of the lot of the poor and the distressed or the promotion of the brotherhood of man by compressing the differences among them into a semblance of economic equality. They are a disparate set of groups, each interested in enhancing its own material status, even at great expense to others provided some drop of material gain emerges for it. Taxicab owners, in the name of improving the condition of taxicab drivers, persuade city councils to limit entry into the taxicab business. Northern textile mill operators and unions, in the name of helping the poverty-stricken employee and with the aid of the welfare statists, bludgeon 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 barge line interests, in the name of providing essential transportation services for small businessmen and farmers on a nondiscriminatory basis, support transportation regulation with indefatigable zeal. The special interests, from sheep rancher to stockbroker, find the interventionists 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 welfares.

More Harm than Help in Welfare State Programs

This melange of specific measures is certainly recognizable to most economists 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 welfares. 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 could find himself selling in an even higher priced market or producing at a lower cost if transportation regulation, minimum wage laws, union-supporting legislation, tariffs, and so on were abolished along with agricultural price support programs.

Some of these measures, which may have produced short-run benefits in the past, may now damage the very people they once benefited. Textile workers 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 probably lower than they would be without 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 and the number of jobs at high rates in the export industries. As a result, U.S. export industries are not recruiting textile workers as aggressively as they would without 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.

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,[4] where is the welfare statist who opposes these measures and calls for their abolition?

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[4] A discussion of the damage done by these various measures and references to several studies of their net effect can be found in Y. Brozen, "The Revival of Traditional Liberalism," *The New Individualist Review,* Spring 1965 (Vol. 3, No. 4).

Instead, the welfare statist simply argues more urgently 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 grants to educational institutions and more educational establishments operated by the state, longer periods of compulsory school attendance, and the like. The welfare statist could do much for the poor by working to abolish the measures that add up to a state-of-many-welfares 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 melange 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 partially offset, for some groups, the damage done by earlier interventionist measures.[5] 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 the barriers to self-improvement and to private contributions to welfare. He proposes the provision of opportunity for self-development and the development of independence where the welfare statist proposes measures which not only are less efficient but which contribute to an increase in dependency and a decline in the rate of growth and the level of national income.

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 statists. 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

[5] Estelle James points out that "a major rationale for future government activity is past government activity." Review of *The Economics of Vocational Rehabilitation*, *American Economic Review*, June 1966 (Vol. LVI, No. 3), pp. 640-42.

Brazilian to read without hope of profit is doing more for the illiterate Brazilian than *General Electric do Brasil* 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 proposals of the welfare statist simply result in the substitution of state activity for private activity without any net gain in the welfare generated. The welfare statist proposes job-training programs for the unskilled poor with the purest of motives – to uplift the downtrodden. He proposes the expenditure of tax funds to train taxi drivers, which reduces the outlay by taxi companies to train drivers. He proposes the expenditure of tax funds to train filling-station attendants, which reduces the outlay by refiners to train attendants.

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 statists 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 statist 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 aegis.[6] 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.

No Faith in the Directions Offered by the Open Market

The welfare statist apparently wants to produce economic growth, increased equality, and improvement of the lot of the poor by direct intervention and governmen-

[6] The Department of Interior, in its suit attempting to block the construction of a dam by the Virginia 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.

tal 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 this but either wish to use direct measures in order to obtain credit for the results or in order to build their power.

If economic growth is desirable, and that is the excuse for much interventionist activity and for many discriminatory or non-neutral tax laws, it is likely that as much or more will be generated (by the private economy) with fewer interventions and a more neutral tax structure than is the case in most countries which have inaugurated interventions and distorted their tax structure for the avowed purpose of stimulating growth.[7] Usually, these measures have a double purpose of achieving both more growth and more equality. Yet, they frequently negate both purposes.

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 less attempt 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 are attempting 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 direct means.

The Nonadditions to Welfare Produced by the Welfare State

Inasmuch as a very large portion of welfare expenditures in the United States is for the benefit of those who are taxed to provide the funds, the tax structure is imposing a very large burden with very little redistribution. Elimination of state use of funds to provide people with what they could and

[7] E. S. Phelps, *Fiscal Neutrality Toward Economic Growth — Analysis of a Taxation Principle* (New York: McGraw-Hill Book Co., 1965).

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 $3,000 per year – the official poverty line for families of four in the United States – 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 transferred 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?"[8] 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 publicly maintained educational institutions are an example of the former. In 1964, of the $28 billion of tax money spent on publicly operated educational institutions, only 18 per cent of the services were provided for the 28 per cent of the population who are classed as poor on a pre-transfer income basis (only 18 per cent 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 for the services of these universities and removing their tax support would increase the incomes of the poorest part of the population relative to the incomes of those who are relatively well off.

Relief for the Affluent

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. Electricity and telephone service for well-to-do farmers and suburbanites are subsidized by the Rural Electrification Administration. Electricity for poverty-stricken corporations such as the Aluminum Corporation of

[8] R. J. Lampman, "The American System of Transfers: How Does It Benefit the Poor?" (mimeographed, no date).

America and the Du Pont Company is subsidized by the tax free status of the Tennessee Valley Authority (27 per cent 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 overcharged 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, and so forth are subsidies for the well-to-do. We are even proposing to subsidize middle income apartment renters—where a middle income is defined as $8,000 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 provide 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 a consequence 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 from what would be found 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 effects 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 income transfers may shrink the pie by as much or more than the amount of income transferred. Income transfers conditioned on the recipient falling below some designated income level also effect 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, "If . . . it is understood that 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."[9]

When It Pays Not to Work

A study of the effect of the level of public aid payments on the number of persons requesting and receiving such payments in the United States in the 1950's 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 1950's who were "not on assistance due to zero wage alternatives" averaged nearly 50 per cent over the decade. The level of assistance payments may have accounted for as much as 87 per cent of those on public welfare rolls in one year.[10]

A study of experience with unemployment compensation in six states reached a similar conclusion. The higher the level of unemployment compensation relative to take-home pay from his last job, the longer an unemployed worker remained unemployed.

Still another example of the decline in self-support and national income resulting from income transfers is provided by a study of the economics of vocational rehabilitation. Vocational rehabilitation investment returns $10 to $17 in present value of enhanced future earnings for every one dollar invested. However, the net private return to the disabled is very

[9] *The Economics of Welfare* (London, 1952, 4th ed.), pp. 731-32.

[10] C. T. Brehm and T. R. Saving, "The Demand for General Assistance Payments," *American Economic Review*, Dec. 1964 (Vol. LIV, No. 6), p. 1017.

much less. As a consequence, most of the disabled choose not to invest in rehabilitation. Earning an income would mean the sacrifice of their social security disability payments, their public assistance receipts, or their workmen's compensation.[11]

Here, then, is a second element in the answer to Lampman's query, "How can we explain the fact that there is any poverty left in the United States?" despite $100 billion of transferred income. The more income that is transferred to the poor, the larger the number of people who will choose to be poor. A program to alleviate poverty such as direct grants to the poor creates more poverty to be alleviated. A reduction in the level of welfare payments will also reduce the amount of poverty.

Conclusion

Our sovereigns in the United States have been so intent on extending state benefits to each petitioner and have paid so little heed to costs, to the nonrevenue yielding burden of taxation, and to the consequences for general welfare that the welfare state as it is operating is reducing the general welfare. General welfare has been reduced by an amount such that the larger slice obtained by some is of such a shrunken pie that most of the successful petitioners are worse off. In addition, the goals of the avowed welfare statists 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 income, 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 statists. Even the recent medicare act seems to be resulting largely in the substitution of payments by the state for medical services for

11 Estelle James, *op. cit.*, p. 642.

those over 65 which were formerly paid for privately. The redistributive effect has been small while the illusion of state benefit has been large.

The welfare statists 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.[12] 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 ever 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 statists 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.

It is the free market which socialized the genius of Edison and Steinmetz 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 façade 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. ◈

[12] 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.

BLACK and Conservative

THE WORD has gone out in advanced "liberal" circles that George S. Schuyler, whose autobiography, *Black and Conservative* (Arlington House, $5.95), makes delightful reading, is just another "Uncle Tom" Negro. The reason for putting Mr. Schuyler in this category is that he has always taken a dim view of the "pied pipers" who lead "the lunatic fringe astray" by such tactics as disrupting traffic, tossing garbage on streets and lawns, and "sprawling on courthouse steps yammering spirituals and the slogan 'We Shall Overcome,' first popularized by the Castro forces." Three years ago Mr. Schuyler said this sort of thing, which easily edges into violence, would lead to the emergence of uncompromising "black power" leaders such as Stokely Carmichael and Floyd McKissick who, in turn, would provoke a dangerous backlash that might undo all the patient advances made by the Negro race since World War II.

Mr. Schuyler, of course, is getting no thanks today for his gift of accurate prophecy, but it is noteworthy that such old favorites of the "liberals" as the Rev. Martin Luther King are now warning their followers to avoid the provocativeness of extreme "black power" statements. What Dr. King is saying in 1966 is what George Schuyler was saying in 1964 – or, indeed, in 1934.

When the Stokely Carmichaels talk about "black power," their phraseology creates the impression that they mean political power that is unshared by whites. George Schuyler has all along advocated a different sort of "black power," the power of individual Negro economic ownership based on self-help. He has observed, correctly, that other minority groups in the nation – the Jews, the Italians, the Irish – achieved political and cultural freedom by putting individualist economics first. As long as a minority remains a beggar-caste, depending on handouts from a political source, it will possess no strength beyond its power of numbers as a pressure group.

Pressure groups with economic power behind them can sometimes do something of lasting value for themselves: they can force other groups to get off their necks. But when a group has only numbers to support it, it must deal away most of its real power to political brokers who are mainly interested in advancing their own fortunes. The pressure group that depends solely on its vote becomes the pawn of demagogues whose careers are best advanced by keeping their supporters in an abject state of living on political charity. This is the rule that has created the phenomenon of families that have been living on relief for three generations. If persisted in, it means that the central cores of our big cities will be just as badly off a generation hence as they are now.

Examples of Progress

In his *Black and Conservative* George Schuyler tells of his many southern tours. Sometimes they were made for his newspaper, *The Pittsburgh Courier,* sometimes they were in behalf of such organizations as the National Association for the Advancement of Colored People. Mr. Schuyler was properly outraged when he couldn't find a good lodging for the night, and he hated the demagoguery of the so-called Red Necks who kept their power by denying Negroes the elemental civil liberties that are supposedly guaranteed by the American Constitution. But he also ran up against the communists when they were pushing their policy of "self-determination for the black belt." With his sociologist's eye Mr. Schuyler saw that the communist tactic provoked a blind fear among whites. His researches in North Carolina brought him to conclude that "most of the Negro's difficulties and problems could be greatly ameliorated through his own efforts in cooperation with willing whites who recognized that such would be mutually advantageous."

In a notable passage in the middle of his autobiography, Mr. Schuyler says: "I had seen where this had been done on many occasions in real estate, insurance companies, and banks. There was no lack of 'communication' between members of the two 'races' who had anything to communicate. . . . Durham was an outstanding example of what Negroes could accomplish for themselves. It was headquarters of the North Carolina Mutual Life Insurance Company, the largest Negro-owned business in the country. There was also a flourishing bank, a fire insurance company, many successful smaller businesses, and the impressive North Carolina College for Negroes. There were numerous Negro-owned tobacco farms in the vicinity."

It has all along been George Schuyler's contention that if this sort of progress could be had in North Carolina, which is below the Mason-Dixon line, it could also be achieved in the cities of the North. He points out that the so-called "talented tenth" among the Negroes are great generators of capital funds. The earnings of ball players like Jackie Robinson and Willie Mays, singers like Leontyne Price and Marian Anderson, pianists like Mr. Schuyler's own talented daughter, Philippa, and entertainers like Sammy Davis, could, if deployed through Negro financial institutions, create new businesses and solve some acute real estate problems. Mr. Schuyler's ideas have been picked up by a few Negro leaders, but the diversion of the "Negro revolution" into political channels has had a depressing effect on the sort of thing that Mr. Schuyler saw flourishing in Durham, North Carolina, a generation and more ago.

Through His Own Efforts

The really encouraging thing about Mr. Schuyler's book is the proof it offers that a good man can rise, and have his effect on the American world, in spite of the most terrifying obstacles. Mr. Schuyler seized his opportunities where he found them. He spent a long time in the U.S. Army, serving at Schofield Barracks in Hawaii and training recruits at Camp Meade and other places during World War I. He found plenty of prejudices in the Army, and he fought actively against them when he could. But, with his happy and sardonic temperament, Mr. Schuyler refused to develop a martyr complex. He used the Army as a means of getting an education in realities. When he moved into the Negroes' world of Harlem, in New York City, by way of a temporary civil service job on Governor's Island in New York harbor, he was ready for the breaks.

The immediate future wasn't promising: Mr. Schuyler lost his job just when the short post-World War I depression was beginning, and he had to return to his childhood home in Syracuse for a time. He used the Syracuse interlude to read Marx, Engels, Plechanov, Kautsky, Hyndman, Edward Bellamy, and H. G. Wells, but a tentative association with the socialists in active political work soon disillusioned him. Returning to New York City, he ran into the Marcus Garvey Back-to-Africa movement. This seemed nonsensical to him, for the Negroes he knew had no desire to go to Africa when the "old country," to them, meant Virginia, the Carolinas, and the Deep South.

In deciding to fight for Negro rights at home, George Schuyler found his way to the office of A. Philip Randolph, a co-editor of an impecunious magazine called *The Messenger*. Randolph hired Mr. Schuyler to sweep the floor, open the mail, read proofs, handle subscriptions, run over to the *Brooklyn Eagle* job press, and distribute magazines to the newsstands. With a foot in the door, Mr. Schuyler was soon writing satirical articles for Mr. Randolph. The career that is so engagingly summed up in *Black and Conservative* was launched. ◈