THE FREEMAN

IDEAS ON LIBERTY

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PERSPECTIVE

On Savings

Men can produce very little with physical labor alone. Only when they begin to use their minds to make tools does their labor become more productive. And the development of tools starts with "rainy-day savings," that is, by consuming less than is produced and setting aside some food, clothing, and shelter to tide the toolmaker over while he invents and produces.

Improving production is a very slow process. However, the productivity-increasing tools of inventors make it somewhat easier to consume less than is produced. Little by little producers were able to increase their savings. Instead of accumulating only "rainy-day savings," such as excess supplies of food, clothing, and shelter, they began in time to produce *capitalist savings*—extra tools and machines to be used later in production. In this way our ancestors created the vast accumulations of capitalist savings on which we all rely: huge power projects, automobile plants, coal and iron mines, oil tankers and pipelines, carefully cultivated farmland, textile mills, and so on. Most of our material welfare is the outcome of the ingenuity and thrift of our ancestors.

—*From Bettina Greaves' Economics II course at the New York Institute of Credit*

Tangled Web

"O, what a tangled web we weave, when first we practice to deceive." In *Marmion*, Walter Scott wasn't writing about economics. Nevertheless, deceit in market pricing has certainly led to "a tangled web" of waste and malproduction.

The modern economy is rife with examples of production gone awry when market prices are artificially held down or artificially supported. Wartime price controls led to empty grocery shelves and black markets. Tenants in rent-controlled apartments

enjoy housing and a privileged position, while would-be tenants face a severe shortage of apartments.

Price supports, on the other hand, lead to the production of unwanted commodities. For example, the Swiss and Austrian governments pay farmers to grow wheat on the slopes of the Alps for esthetic reasons. The wheat never matures in that cold environment, but presumably tourists enjoy the fields of waving grain. In this country, we support the production of commodities that cannot be sold at the subsidized prices. Recently, when surplus dairy products became an embarrassment, our government began slaughtering 1.6 million dairy cattle. Among the latest disclosures of an artificially subsidized surplus was a *wheat* glut in Saudi Arabia, where the government has been paying wheat farmers almost five times the world price.

If production were left for entrepreneurs to plan, to serve consumers on the basis of free market prices, supply and demand would always tend to balance. There would then be no serious shortages of rental housing or gluts of wheat or dairy products. Those who try to deceive the pricing system fail to appreciate the valuable knowledge to be gained from freely fluctuating market prices.

—*BBG*

Air Traffic Control

Economic Outlook, published by the Chamber of Commerce of the United States, offers an interesting comparison of private versus public management of air traffic control:

"Air traffic control in the U.S. is provided by both the Federal Aviation Administration (FAA) and by private contractors at smaller airports. For the smallest FAA tower authorization, the FAA spends about $1 million to install and about $275,000 a year to operate and maintain a tower. Private firms provide the same services for about $120,000 per year, including amortization of their original capital investment. When a private operator assumed the responsibility for operating the Farmington, New Mexico, tower, its contract was for $99,000 per year compared to the $287,000 that it had cost the FAA."

For further insights into private versus public management, see Dale M. Haywood's article on page 274 and Tibor R. Machan's article on page 270.

FEE Columns

Freeman articles are reaching a growing audience of newspaper readers around the country. John W. Sommer's "Disasters Unlimited" (April *Freeman*) has been reprinted by the *Houston Chronicle, The Washington Times,* and the Waterbury (Connecticut) *American*. An adaptation of Dennis Bechara's "The Continuing Plight of Agriculture" (May *Freeman*) has appeared in the *Waterbury Republican* and *Pacific Business News*.

In Brazil, interviews and stories about FEE are becoming almost a regular feature in the popular news magazine, *Visao*. Latest to appear is a reprinting of William S. Kern's "Catholic Social Teaching and the U.S. Economy" (December 1985 *Freeman*).

As FEE expands its publishing program, we would appreciate it if you would call our attention to any of our articles you may see. We would especially appreciate it if you would send us a clipping.

Reprints Available

We are pleased to offer reprints of James L. Payne's "It's Not Our Money," which appeared on page 213 in our June issue. Prices are 50¢ each or 25¢ each on orders for 10 or more.

THE FREEMAN
IDEAS ON LIBERTY

The Political Economy of Educational Vouchers

Public financing of education means political control.

by Dwight R. Lee

Dr. Lee is a professor of economics at the University of Georgia, where he holds the Ramsey Chair of Private Enterprise.

The crisis in public education is real. As judged by any reasonable measure, the quality of public education is declining as the cost of public education is increasing. The desire for reform in public education is genuine. Parents want a good education for their children, and taxpayers want an honest return for their dollars. Unfortunately, a realistic appraisal of why meaningful reform in public education is so badly needed also points to why meaningful reform is so unlikely to occur.

The underlying problem with public education is, quite simply, that it is public. As long as education is provided publicly, it will be controlled by, and for the benefit of, public education professionals. The reason for this is straightforward.

As opposed to market decisions where each consumer exerts direct and decisive control over the services he chooses to purchase, no one individual has decisive control over the political decisions which determine the publicly provided services all consumers are required to "purchase." Seeing no advantage in becoming informed and active in pursuit of objectives over which he has no direct control, the typical citizen-consumer quite rationally devotes little effort to influence public education policy. In contrast, suppliers of public education have significant political influence over public education policy by virtue of the fact that they are organized through professional associations, have a concentrated interest in decisions affecting public education, and are widely perceived as education experts. The political dominance of supplier interests over consumer interests gives public education professionals the opportunity to control the policy of the public schools. The special interests that comprise the public school lobby have taken full advantage of this opportunity to promote their private purposes while neglecting the public's desire for the efficient provision of quality education.

The implication here appears to be clear. Achieving genuine educational reform would seem to require a policy which shifted control of education from suppliers of education to consumers of education. It is this view of the crisis in public education that has motivated the call for educational vouchers.[1] The idea behind educational vouchers

is straightforward. Instead of government financing education by actually supplying educational services, publicly funded vouchers would be given to the parents of school-age children to spend at the school of their choice (as long as the choice is approved by government). As envisioned by its proponents, this voucher system would transfer control to the consumers of education. Educators would be forced to compete for the consumers' educational vouchers and therefore cater to the consumers' educational demands. Only those schools providing quality education, as determined by the consumer, at low cost would survive. It is also predicted that the variety of educational approaches would increase to reflect the range of educational preferences among the public. Also, with diversity replacing uniformity in education, market choice would replace political combat as the means of expressing educational preferences.[2]

Educational Vouchers and Political Realism

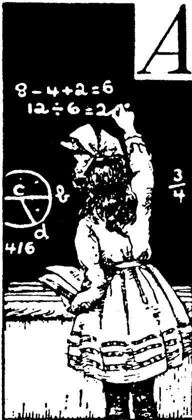
This case for educational vouchers would be sound if it were indeed true that the root of the problem lay in the control of public school policy by professional educators. But this is not the case. Educator control of public education policy is a symptom of a more fundamental problem: the public funding of education. The flaw with the voucher system is that it attacks the symptom of the problem without addressing the source of the problem. Under the voucher system public education remains public education, and nothing fundamental has changed.

Proponents of educational vouchers have assumed a benign political setting for their proposal—one which if it indeed existed would largely eliminate the need for vouchers in the first place. Once vouchers were issued by government, consumers would supposedly be in complete control, as the public school lobby would somehow have been politically neutered. The only political influence that would be in evidence is the restriction that vouchers be used to purchase education only from approved schools. And presumably this influence would be exercised in a politically impartial way. The political arena would suddenly become a setting in which the education consumer is in control; the public school lobby is dormant; and quality education is provided efficiently because it is in the public interest to do so. Obviously in such a political setting educational vouchers would perform as advertised.

The prognosis for vouchers is completely different, however, when a realistic view of politics is accepted. As long as education is funded publicly, decisions on educational policy will be made politically. As long as decisions on educational policy are made politically, the interests of consumers will remain diffused and unorganized, and dominated by the focused and organized interests of the public school professionals. Given this fact of political life there are only two possibilities for educational vouchers. The first possibility is that educational vouchers will be benign because they never will be considered seriously. The second possibility is that educational vouchers will become politically acceptable—in which case they will be no better, and probably worse, than the educational approach they replace.

Consider a voucher proposal which, if enacted, would indeed be in the best interest of the public as consumers of education. In other words, the voucher proposal would accomplish exactly what propo-

nents of educational vouchers envision: the transfer of control over education to consumers from suppliers. One does not have to be clairvoyant to predict how the public school lobby would respond to such a proposal. They would oppose it for the obvious reason that their power and privileges would be undermined by a voucher system which worked the way it is supposed to work. This opposition is sure to be effective for the same reason that lies behind the case being made for vouchers—the ability of education professionals to control education policy when that policy is determined through the political process. What the voucher proponents have not yet recognized is that they are confronted with a Catch-22. They want an effective voucher system for the very reason that it is impossible to have one.



Unfortunately, this is not the end of the story. If it were, the idea of educational vouchers would be a rather harmless one. The problem is that there is a real danger that educational vouchers will become politically acceptable.

How will vouchers become politically acceptable if they pose such a threat to the professional educators who control the political agenda on educational policy? It has to be recognized that the public school lobby faces a second threat. That threat is public education's inferiority to the private education alternative, but this is a threat that the public school lobby can neutralize with the creative use of educational vouchers.

Compelling evidence of the inferiority of the public schools is found in the fact that private schools, charging full price for their services, are competing successfully against the fully subsidized public schools. And the number of parents who remove their children from the public school system is likely to increase. The public schools are surely not going to get better, and are very likely to get worse. The recent call for "reform" and the political rhetoric about "excellence in education" will do nothing to improve public education. Indeed, the pretense of reform has satisfied the political demand that something be done while leaving such educationally destructive forces as the National Education Association with more control than ever. On the other hand, the private demand that something be done will continue to find expression in parents' rejection of public schools. This rejection will surely increase as per capita incomes increase, even if the decline in the quality of public education is somehow arrested.[3]

The Response of the Public School Lobby

The public school lobby will respond to this threat of consumer rejection, but how? It will not, indeed cannot, respond by improving the quality of education and becoming competitive with private schools. This is not to be taken as a criticism of the individuals who teach in our public schools. Many of these individuals are competent, hard working, and personally dedicated to educational excellence. The problem is one of the flawed incentive structure that plagues the provision of all publicly financed goods and services.

If suppliers are to direct their efforts efficiently and persistently to the satisfaction of consumer demands, they require accurate information on what those demands are, and compelling motivation to respond to this information. There is only one arrangement whereby this information and motivation can be provided. That arrangement

"As long as education is funded publicly, decisions on educational policy will be made politically."

is the private market where consumers, by virtue of the fact that they are spending their own money as they see fit, communicate their preferences through changes in prices and patronage in a way that conveys wealth gains to those suppliers who respond appropriately, and imposes wealth losses on those who do not. By breaking the connection between the demand for education and the ability of consumers to control their own money in expressing that demand, public education has made it impossible for the public schools to provide quality education efficiently.

But the public school lobby does not have to concern itself with providing better education at lower costs in order to beat back the threat it faces from the private school option. If the move to purely private schools begins to accelerate, the public school lobby can, and surely will, protect its privileged position against this competition by embracing educational vouchers. As strange as it will sound to advocates of educational vouchers, if the voucher approach to education ever becomes a serious political possibility, it will be as a means of reducing competition in education, not increasing it.[4]

The advantage the public school lobby will see in educational vouchers comes from the ability of vouchers to entice students back into publicly financed education. Consider the situation in which a large number of parents have taken their children out of the public schools. These parents will have the control over their children's education that can come only from private education, but they will be paying dearly for the privilege; paying for both the private education they have chosen and the public education they have rejected. Given this burden, parents of children in private schools will be susceptible to a proposal for educational vouchers. As presented by the advocates of vouchers, which will now include public school professionals, the promise will be continued freedom of choice in education without the obligation to pay twice. Such a voucher proposal will also sound appealing to the proprietors of private schools, who will mistakenly see it as a way of expanding the demand for their product by eliminating the discriminatory financial burden being placed on their customers.

Unfortunately, the reality of educational vouchers will be far different from their promise. Vouchers or no vouchers, as long as education is financed publicly, control over education will be exerted through political power, not through consumer choice. Educational vouchers may, for a time, give the appearance that consumers are exercising genuine choice. But consumer choice can, and will, be circumscribed by restrictions on the vouchers; restrictions that will reflect the interests of the politically organized public school lobby, not the interests of the politically unorganized public. One can predict with confidence that the choices educational consumers will have under any voucher system that is politically acceptable will in no way threaten the privileged position of the public school establishment.

This conclusion is based on more than just idle theorizing. We have experience with Federally funded educational vouchers at the experimental level. The Federally funded voucher experiment that ran the longest and has been deemed most successful was conducted in Alum Rock, California. As one would predict, restrictions were placed on these vouchers which minimized the competitive pressures they imposed on public school professionals, and which attempted to promote social objectives that had little to do with education. Teachers, for example, did not have to worry about loss of income if their enrollments declined. They were given priority in teaching jobs at other schools and were paid for makeshift work until such jobs became available. On the other hand, teachers who succeeded in attracting additional students were not rewarded with higher salaries. Those schools which parents preferred were not able to expand to meet the extra demand. Those students who did not get their first choice were simply assigned to other schools. A local employee certification council required that any private school had to satisfy a host of standards on such things as teacher education requirements, pay and fringe benefits, and faculty-student ratios. This control over entry was used to make it effectively impossible for any private school to enter into competition for the vouchers. The Alum Rock vouchers did nothing to threaten the suppliers of public education by passing genuine control to the consumers of education.

If educational vouchers become politically viable it will be because they can be used to reverse the expansion in genuinely private education. The public school lobby will see educational vouchers as the means to entice those who are attending private schools back into a public education system that will be no better than the one which they have rejected.

Conclusion

The special interests that comprise the public school lobby have been able to subvert educational policy to their narrow advantages with the same political influence that will be used to frustrate any reform that threatens those advantages. These special interests would be emasculated by a system of educational vouchers that worked in the way envisioned by the advocates of vouchers. It is for this reason that we will never get a voucher system that is worth having. If educational vouchers are in our future it will be because the public school lobby will see them as the best vehicle for maintaining or enlarging their special interest advantages. Educational vouchers will never serve to increase the range of freedom in education, and may do much to restrict it. □

1. For the purpose of this paper there is no advantage in distinguishing between educational vouchers and educational tax credits, and henceforth we will refer only to vouchers.
2. Milton Friedman, the leading proponent of educational vouchers, first made the case for vouchers in "The Role of Government in Education," in Robert Solow, ed. *Education and the Public Interest,* New Brunswick: Rutgers University Press, 1955.
3. It should not go unnoticed that increased wealth represents a major threat to the public education establishment. The wealthier parents become, the greater their demand for quality education for their children, i.e., private education for their children. The NEA's advocacy of economic policies calling for economically stifling regulations and taxes is not completely irrational from their perspective.
4. This point was first recognized by Gary North in his article, "Educational Vouchers: The Double Tax," *The Freeman,* (May 1976): 259-75.

Taxes and Unemployment

How do rising levels of taxation affect the rate of unemployment?

by Hans F. Sennholz

Dr. Sennholz heads the Department of Economics at Grove City College in Pennsylvania. He is a noted writer and lecturer on economic, political, and monetary affairs. This essay is a chapter from his forthcoming book on unemployment.

Tax exactions, in recent decades, have risen to heights that would have seemed incredible to our forebears. They have become a big, often the biggest, item of a family budget. To business, taxes now are an important determinant of decision making; they circumscribe the production process, specify the nature of business activity, direct its location, and signal failure or success. In the U.S., total tax exactions now exceed one trillion dollars in a three-trillion dollar economy. It is inevitable that, in such magnitude, taxes vitally affect many aspects of our economic, social, and political lives.

A tax is a compulsory payment by individuals to government. It differs from all other payments in its basic characteristics: (1) compulsion, (2) apportionment without close reference to individual benefits, (3) use of the proceeds by politicians and government officials. The intent of a tax levy may be *fiscal,* to raise revenue and defray the expenses and expenditures of politicians and officials, or it may be *economic,* to effect economic changes. It may be to effect changes in consumption patterns, stimulate business spending, provide jobs for the unemployed, redistribute income and wealth, or even reshape the economic system. But no matter what the intent may be, all taxes have economic effects; there are no neutral taxes.

Every tax that touches business tends to "regulate" business. Every business tax—whether it is a corporate income tax, a supplementary tax on undistributed corporate income, a capital stock tax, an excess profits tax, a severance tax, an unincorporated business tax, or a property tax—affects business activity. Similarly, personal taxes, such as payroll taxes, poll taxes, gift taxes, death taxes, commodity taxes, transfer taxes, sales taxes, motor vehicle taxes, fuel taxes, or taxes on imports, all leave their marks on economic production and distribution.

Under the influence of popular economic thought, governments now raise or lower taxes in order to prevent inflation, check business recessions, and promote economic activity and growth. When economic output is approaching the limits of capacity and people want to spend more than is offered at stable prices, taxes are supposed to exert a powerful restraining force and close the "inflationary gap." In the opposite situation, when a recession is threatening to paralyze economic activity and unemployment is descending on many labor mar-

kets, government is supposed to lower taxes while maintaining or even increasing spending. Government is to create deficits and finance them by borrowing, which is said to add to the people's disposable income and propensity to consume. In short, taxation together with deficit spending and credit expansion are supposed to be a powerful force for full employment.

Economic reality differs radically from such crude notions of taxing and spending. Ever since governments the world over sought to close the "inflationary gap" and practiced contracyclical policies, the rates of inflation have soared and the cyclical movements of business have become more numerous and severe. Taxation obviously cannot alleviate inflation as long as government engages in money creation and credit expansion; but it may aggravate the rise in prices by exacting and consuming business capital and thereby reducing the supply of available goods.

Similarly, taxation is utterly incapable of alleviating the business cycle. Once economic production is disoriented and maladjusted due to inflation and credit expansion, the readjustment, which is the recession, must run its course. To prescribe tax boosts in such situations is to make matters worse. To increase government spending and suffer yet larger deficits is to deprive business of urgently needed capital, prolong the recession, and cause more unemployment.

Improper Means to Dubious Ends

Few legislators are knowledgeable in economic matters, which explains why tax legislation may bring forth more unintentional than desired effects. A levy may fall far short in revenue or surpass all expectations. It may be designed to equalize income and wealth, but actually create more inequality. It may seek to provide equal opportunities, but actually prevent changes and bar opportunity. A tax may be imposed to improve the economic conditions of working people, but actually make them worse. It may be intended to fight inflation, but actually aggravate it, to overcome the business cycle, only to exacerbate it. It may be inflicted to alleviate poverty, but actually worsen it. It may be foisted on business in order to stimulate activity and employment, but actually bring forth economic stagnation and unemployment.

Surely, there is no tax purposely and willfully designed to cause economic stagnation or unemployment. But whatever their objectives may be, the levies imposed rarely are the proper means for the chosen ends. In particular, taxes imposed for the purpose of economic stimulation and full employment actually bring about stagnation and unemployment.

Students of labor and labor markets judge a particular levy according to its effect on the demand for and supply of labor. A tax levy, or changes thereof, may affect the demand for labor, influence the quantity and quality offered, or act on both. Like any other obstacle to production it may cause economic stagnation and breed unemployment. Taxation has such consequences whenever it renders human labor uneconomical. It may do so by raising the cost of labor above its marginal productivity, that is, above the addition to output attributable to the last worker employed whose cost equals the value of his output. Above this point, the loss incurred from the employment of labor forces employers to discharge workers.

Fiscal theory distinguishes between two modes of taxation bringing forth unemployment:

(1) Taxes, levies and fees that directly raise the cost of labor, such as Social Security payroll taxes, unemployment compensation taxes, workman's compensation assessments, and so on. They are called "employment taxes."
2) Taxes, levies and fees that lower the productivity of labor by preventing capital formation or consuming capital outright, such as steeply progressive corporate and personal income taxes, capital stock taxes, business license taxes, death and gift taxes, and other levies on capital. We may call them "business taxes."

For a tax to bring forth unemployment it must raise the cost of labor above the value of its productive contribution. If, for any reason, it fails to do so because other factors oppose and offset it, the unemployment may not materialize. Inflation, for instance, may temporarily erode real wages while eager legislators are adding costs. Rampant inflation throughout the 1970s facilitated prompt downward readjustments of real wages, at least in nonunionized industries, although government was continually boosting employment taxes.[1] In unionized industries, inflation usually triggers additional wage demands that prevent the offsetting adjustment. The boosts in employment taxes together with new demands for higher pay and less work bring about mass unemployment.

In a free society institutional unemployment is an alien, unnatural phenomenon. The market order, which forces capital and labor to adjust continually to consumer demand, offers employment opportunities to everyone willing to work. Free prices, which reflect consumer values and choices, guide the adjustment process. At the free market rate of labor there can be neither surplus nor shortage of labor. Chronic unemployment always indicates extraneous intervention that makes labor uneconomical. It hints at permanent barriers such as minimum wage legislation, union wage rates and work rules, government rules and regulations, and last but not least, prohibitive taxation. Both government and labor unions are laboring diligently to maintain and even raise the barriers.

Employment Taxes

To help finance Social Security benefits, the federal government imposes a series of payroll taxes that now yield almost $300 billion a year. Taxes in such magnitude obviously are an important element in the cost of labor affecting the demand for labor. They usually consist of two sets of levies—one claims a share of employee income, the other a share of employer profits. The former is deducted from a worker's pay and remitted by the employer to the Internal Revenue Service, which credits it to his account. It reduces a worker's take-home pay and net income; it is a part of labor cost borne directly by the worker. The employer's share, too, constitutes a part of labor cost, but differs from employee withholding in that a boost directly and immediately raises total labor costs and thus exerts an influence on the demand for labor. To the employer levy must be added the employer's cost of collection, remission, and compliance. Every employer report on earnings in covered employment, every labor questionnaire, adds to labor cost.

Many politicians and officials are ever anxious to boost employee benefits and increase employer obligations. To analyze their motives is to reach into the haze of politics. Some lawmakers may actually believe that they, in Congress assembled, wield the power to exact income and benefits from employers and bestow them on workers. They depend on tax collectors, judges, juries, and police to enforce the laws they devise. Other politicians whose paramount concern is re-election, usually promise anything and everything the electorate may want to hear. But no matter what the motivation may be, every new levy raises the cost of labor and causes some unemployment.

The magnitude of the unemployment depends on the size of the exaction and the adaptability of labor. A quick downward adjustment of other labor costs—wages, fringes, or both—offsetting the new exaction, may keep unemployment at a minimum. To resist the adjustment, however, is to let the consequences run their course. The loss-inflicting submarginal labor is laid off, suffers the pain and agony of joblessness, and in time searches for other employment.

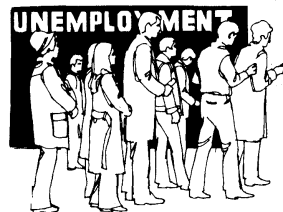
The competition of the unemployed creates a tendency for wage rates to decline to the point where the reduction offsets the new exaction. In the end, the worker pays for every penny of fringe benefit exaction no matter how it is labeled or packaged. When seen in this light, the Social Security system and all the other labor benefit systems merely are mandated schemes of wage redistribution that permit politicians and government officials to manage and redistribute labor income. The workers bear all costs of wage withholding, accounting, and remission to the Social Security Administration.

The Impact of Benefit Mandates

In a labor-intensive industry in which labor costs comprise a large share of production cost, the impact of benefit mandates is likely to be painful and severe. If labor costs are made to rise by one per cent, unemployment may rise by two or three per cent. In a capital-intensive industry in which the payroll represents a small share of production cost, the effect of a benefit boost will be less pronounced. A one per cent rise may boost production costs by a small fraction of one per cent and unemployment by a lesser amount. In every case, labor is rendered unemployable whenever its cost is boosted forcibly above its productivity rate.

Unemployment compensation taxes by both federal and state governments are classic examples. When general business activity declines, unemployment benefits, which are state expenditures, tend to increase automatically. State governments promptly react by boosting employer exactions, which in turn boost the unemployment rates. Moreover, unemployment compensation undoubtedly affects the supply of labor as any subsidy sustains that which it subsidizes. Higher benefits tend to reduce incentives to effort; since some states have removed most restrictions on benefits to strikers, the benefits invite and encourage strikes, which raise labor costs and create more unemployment. The strongholds of labor unions are the centers of unemployment.

Labor is rendered unemployable whenever government forcibly raises its cost. The Occupational Safety and Health Act of 1970 (OSHA) is estimated to have added tens of billions of dollars to the cost of labor. It contributed significantly not only to rising unem-



ployment, but also to the economic stagnation of the 1970s, the visible decline in American ability to compete in world markets, and the extraordinary rise in goods prices. Similarly, the Employee Retirement Income Security Act of 1974 (ERISA), which made it easier to qualify for pensions, substantially raised the costs of private pension plans. The Equal Employment Opportunity legislation of 1964 and 1967, which forced employers to engage workers according to racial criteria rather than considerations of suitability and productivity, raised the cost of some labor. In every case the new legislation brought some unemployment to the very labor it meant to benefit.

Business Taxes

The Federal tax system relies primarily on payroll and income taxes. Boosts in payroll taxes bring forth unemployment directly and immediately, provided other cost reduction does not mitigate the tax boosts. Income taxes have similar results whenever they consume savings and prevent capital formation. In particular, steeply progressive rates retard economic development and produce unemployment by discouraging saving, investment in business expansion, and work effort, especially on the part of capitalists and entrepreneurs. In 1986 income taxes paid by individuals and corporations are estimated at $433 billion, or 54.5 per cent of estimated budget receipts. Social insurance taxes consisting primarily of payroll taxes levied on wages and salaries are estimated to yield some $289.4 billion, or 36.5 per cent of total income. Excise taxes on products and services are expected to provide $35 billion, or 4.4 per cent of the total, and estate and gift taxes, customs duties and miscellaneous receipts $36.3 billion, the remaining 4.6 per cent of budget receipts (*Budget of the United States Government,* Fiscal Year 1986, p. 4-3).

For many Americans steep tax progression is a maxim of "social justice" that renders to every man his due. Although men are by nature unequal in talent, labor, and virtue, many dream about equality of economic and social conditions. They would, in the name of social justice, reduce society to an average level, using the political process and government, the apparatus of force. Fiscal and budgetary objectives take second place to social and economic considerations that make government apportion its levies according to the principle of "ability to pay" and allocate the benefits according to political need and merit. Government seizes income and wealth from individuals who own and earn more than the average, from taxpayers known to save and invest their savings. Unfortunately, government consumption of the funds reduces the amount of capital invested per worker employed, lowers the productivity of labor and depresses wage rates. Workers resisting the reduction face disemployment. They may encounter yet greater difficulties if taxpayers, instead of meekly suffering the confiscatory levies, decide to enjoy and consume their capital. The consumption breeds waste and invites mismanagement—dissipating more capital, depressing wage rates further, and causing more unemployment.

Business taxes are rising continuously. The windfall oil profit tax of 1980, the largest single tax ever imposed on an industry, is estimated to yield $5 billion in 1986.[2] Boosts in excise taxes on airport and airway users and telephone service are estimated to yield $2.4 billion. A 5 cent per gallon increase in the excise tax on gasoline and diesel fuel, and other provisions of the Highway Revenue Act of 1982 are expected to

raise business costs by more than $6 billion (*Budget of the United States,* Fiscal Year 1986, p. 4-18).

Federal estate and gift taxes are estimated to yield $5.3 billion dollars in 1986. There are few taxes that are more destructive to labor income and employment than such levies. They expropriate economic wealth that is employed almost exclusively in the production of goods and services for the people, giving them employment and consumer products. Death duties force the heirs to sell parts or all of the testator's estate. Of course, the business they must sell or the stock they must liquidate are not consumed; they merely change ownership. But the liquid capital received for the property is surrendered to tax collectors and consumed by government. The consumption reduces the amount of capital invested per worker, lowers the productivity of labor and depresses wage rates. If the workers resist the necessary wage adjustment they face unemployment.[3]

Fiscal Justice

Most Americans applaud the new levies on business. They look upon business capital as evidence of unearned personal wealth that should be seized and distributed. Why should anyone be richer than the average wage earner? Viewing business capital with unveiled envy, they do not understand that capital is a requisite of all production, a tool that renders human labor more productive.

They do not know that capital is not a gift of nature, but the product of individual saving and investing. To seize it and consume it is to impair labor productivity, reduce wage rates, and destroy jobs. To distribute it among workers or hand it to politicians and government officials amounts to the same. And yet in politics, envy that covets another's income and hates the wealth it cannot reach, is setting society on fire and destroying the people it possesses. The common cry of "social justice" is but the smoke of envy; it pollutes the moral fiber of society.

It is difficult to argue about justice in fiscal matters, for it is doubtful that any exaction that depends on brute force, that apportions without reference to individual benefits and that delivers the proceeds to politicians and government officials, can ever be morally right and equitable. Justice consists in doing no injury to men. How can a confiscatory income tax or estate tax be called "just" when it inflicts great injury on taxpayers? Justice is depicted as blind; taxes exact income and wealth from some people for the benefit of others. Legislators aim their levies at certain groups and classes of taxpayers. They target their levies at producers, distributors, banks, chain stores, and many other classes of taxpayers. Surely, neither a corporate income tax nor a "windfall profits tax" on petroleum production can be said to be blind. The essence of justice is impartiality; the substance of taxation is partiality and partisanship. Justice gives to every man his own; taxation takes from some to give to others.

Taxation is a simple business. Anyone can devise new levies and add to the old. He may receive support from lobbyists who would use the instruments of government to promote their own interests by hampering and hurting others. Lobbyists for independent retailers argue for higher taxes on chain stores, coal miners plead for higher taxes on oil producers, American oil men for higher taxes on foreign producers,

and so on. The tax boosters in turn depend on the support of the reformers who wax eloquent on equality and justice.

Oppression and rebellion are never far apart. When the burdens reach confiscatory levels the public may unite and demand tax reductions. As long as the number of taxpayers exceeds the number of tax boosters, and taxpayers organize as effectively as the boosters normally do, a tax rebellion may succeed in lowering particular levies.

Most of the time, however, the public is divided on the issues. The tax boosters thus may turn a tax rebellion into a tax reform movement. They may divide the public and turn its attention from the oppression to the distribution of the burden. They may succeed in turning a rebellion against government into a taxpayer feud that must be settled by government. In short, the people are persuaded to seek "new justice" by assigning "fair shares" and "closing loopholes."

The tax reform battle is akin to the entitlement battle. Springing from the same ideological and philosophical roots, both signal the growing role of government in our lives. Taxation and unemployment are painful symptoms of this role. □

1. Maximum Social Security levies on employers since 1970 ($):

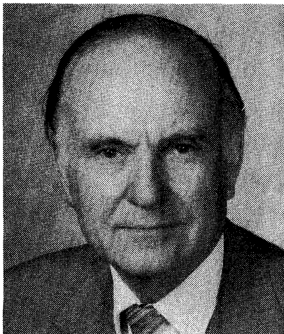
1970 - 374	1976 - 895	1982 - 2,171
1971 - 405	1977 - 965	1983 - 2,392
1972 - 468	1978 - 1,071	1984 - 2,532
1973 - 632	1979 - 1,404	1985 - 2,792
1974 - 772	1980 - 1,588	
1975 - 825	1981 - 1,975	

Source: William H. Hoffman, Jr. and Eugene Willis, eds., *West's Federal Taxation: Comprehensive Volume,* 1986 Annual Edition (New York: West Publishing, 1986), p. 1-18; also *Budget of the United States Government,* Fiscal Year 1986, p. 4-16.

2. Although the tax is called a "windfall profits tax" the exaction actually applies to the price increases above the 1979 controlled prices, not to profits. For many years Federal controls kept oil prices far below market prices. When oil production and distribution came to grief, sinking into stagnation and shortages, the controls were lifted reluctantly and markets were permitted to function again. But the difference between the controlled price and the free market price was expropriated by the windfall profits tax. If there were truth in politics, the tax would probably be called "a double-header exaction," at first by controls and then by taxation.

3. Cf. Sennholz, *Death and Taxes,* 2nd ed. (Cedar Falls, Iowa: Center For Futures Education, 1982), p. 48 et seq.

Money and Freedom
by Hans F. Sennholz



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The Industrial Revolution: Working Class Poverty or Prosperity?

How the industrial revolution raised the quality of life for workers and their families.

by John Majewski

John Majewski is an economics major at the University of Texas at Austin. He is currently serving as a summer intern with the Institute for Humane Studies. Following graduation in 1988, John hopes to pursue a Ph.D. in economics. This paper was awarded second prize, college division, in FEE's Freedom Essay Contest.

Since it began approximately two centuries ago, the industrial revolution has captured the minds of an endless number of historians and economists. An era of relatively laissez faire economics, the period between 1760-1850 is for many academics the key to unlocking the secrets of economic growth, technological change, and economic development. But, for defenders of the classical liberal tradition of free enterprise, the industrial revolution is important for more insidious reasons. Writers such as Dickens, Engels, and the Hammonds have made the terms industrial revolution and capitalism synonymous with degradation of the working class. Pessimistic interpretations of the industrial revolution have led to the popular acceptance of what R.M. Hartwell terms the "theory of immiseration"—a belief that unrestrained capitalism was making the rich richer and the poor poorer during the industrial revolution (Hartwell, 1974). For the general public, the horrors of the industrial revolution prove the horrors of capitalism.

But it is not only laymen who perceive the industrial revolution in terms of "dark, satanic mills." A brief glance at almost any university history or English textbook reveals that most academics who do not specifically study the industrial revolution accept without reservation the view that capitalism led to a deterioration of living conditions for the working class. For example, a text commonly used in college British literature classes describes the industrial revolution in these terms:

> For the great majority of the laboring class the results of the policy (of laissez faire) were inadequate wages, long hours of work under sordid conditions, and the large-scale employment of women and children for tasks which destroy body and soul. Reports from investigating committees on coal mines found male and female children ten or even five years of age harnessed to heavy coal-sledges which they dragged crawling on their hands and knees . . . (*Norton Anthology,* p. 3).

Such harsh interpretation of the industrial revolution has directly affected public policy. The industrial revolution has become a successful battle cry for detractors of capitalism. The specter of working-

class poverty and misery during the industrial revolution has been and still remains an important justification for government intervention into social and economic affairs. A vast amount of legislation, from minimum wage to antitrust laws, owes its existence to the anticapitalist mentality created by pessimistic views of the industrial revolution. As Nobel laureate F.A. Hayek pointedly argues, the industrial revolution portrayed by the pessimists is the "one supreme myth which more than any other has served to discredit the economic system to which we owe our modern day civilization" (Hayek, pp. 9-10).

This paper will attempt to show that the pessimistic interpretations, however popular, are unfounded. It will be argued that the quantitative (material) standard of living improved as real wages rose, while falling mortality rates indicate that the qualitative (sociological) standard of living also improved. Although there was considerable social and economic disruption throughout the revolution, this paper will try to show that these problems were caused by various government interventions, especially the Napoleonic Wars. Far from being a cause of misery and despair, this essay concludes, capitalism in the early nineteenth century improved the standard of living and set the stage for the modern comforts that we enjoy today.

An Increase in Real Wages

As noted above, the pessimistic case is widely accepted by both the general public and academia. However, it is fair to say that the majority of modern economic historians who study the industrial revolution believe that at least a slight increase in the material standard of living occurred. Since the introduction of reliable statistical evidence in Sir John Clapham's *An Economic History of Modern Britain* in 1926, it has become increasingly obvious that real wages rose. The evidence is now so conclusive that one historian has confidently declared that "unless new errors are discovered, the debate over real wages in the early nineteenth century is over: the average worker was much better off in any decade from the 1830s on than any decade before 1820" (Williamson, p. 18).

The evidence vindicates such confidence. Although money wages remained stable, the prices of manufactured and agricultural goods plummeted as entrepreneurs struggled to deliver consumers low-priced goods and services (Hartwell, 1971, pp. 326-27). Although the extent of the increase in real wages is hotly debated, the most recent evidence suggests that blue-collar real wages doubled between 1810 and 1850 (Williamson, p. 18). McCloskey, although emphasizing a much longer period of time, also concludes that real wages increased significantly. He argues that real wages rose from an average of £11 per capita in 1780 to £28 per capita in 1860 (McCloskey, p. 108).

As one can imagine, the increase in real wages resulted in significant improvements in the standard of living. An excellent example is the changes in diet that occurred. Per capita consumption of meat, sugar, tea, beer, and eggs all increased. An even better indication of the rising affluence was the great increase of imported foods. Per capita consumption of foreign cocoa, cheese, coffee, rice, sugar, and tobacco increased. Meanwhile, meat, vegetables, and fruits, long considered luxuries, were by 1850 eaten regularly (Hartwell, 1971, pp. 328-29). In fact, the average weekly English diet of 1850—five ounces of butter, thirty ounces of meat, fifty-six ounces of potatoes, and sixteen ounces

of fruits and vegetables—is quite similar to the English diet of today (Hartwell, 1971, p. 330).

Although such improvements obviously are important, they take on added significance when considering the large population increase that took place during the industrial revolution. Because of a fall in the death rate, the population of England and Wales rose 1.25 per cent per year between 1780 and 1860, an annual expansion that translates into an unprecedented threefold increase (McCloskey, pp. 105-108). Rising real wages (and consequent increases in food consumption) coupled with a rapidly rising population was a first in European history. The Malthusian trap of geometrically increasing populations outstripping arithmetically increasing food supplies had finally been broken. Whereas more people invariably resulted in less food per person throughout earlier European history, the industrial revolution provided more food per person. Breaking the bonds of Malthus is perhaps the crowning accomplishment of capitalism in general and the industrial revolution in particular.

Untenable Arguments

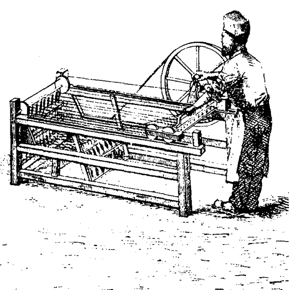
Considering the preponderance of evidence indicating substantial improvement in real wages, it is clear that the arguments of early pessimists, such as Engels, have become untenable. Clearly, the material standard of living did not plummet. With the advent of reliable statistical evidence supporting real wage increases, sophisticated pessimists began to emphasize the qualitative effects of industrialization. Openly admitting that the working class enjoyed higher wages, more food, and better clothing, these pessimists argue that the cost for such gains in material wealth was dear. They contend that the evils of child labor, sordid working conditions, increased pollution, and various other discomforts outweighed any progress due to increasing real wages. E.P. Thompson, in his influential book *The Making of the English Working Class,* succinctly summarizes this new pessimistic position, arguing that, "By 1840 most people were 'better off' than their forerunners, but they suffered and continued to suffer this slight improvement as a catastrophic experience" (Rude, p. 67-68).

The pessimistic quantitative versus qualitative position is open to considerable criticism. For example, many of the poor conditions cited by the pessimists existed well before the industrial revolution. Preindustrial society was very static and often cruel—child labor, dirty living conditions, long working hours, and a host of other ills associated with nineteenth century capitalism were just as prevalent before the industrial revolution. Although by today's standard conditions were indeed poor, they were no worse than living conditions before the revolution (Hartwell, 1971, pp. 339-341).

A second general problem with the new pessimistic position is that it fails to take into account the significant improvement in life expectancy that took place. The great population explosion that happened during the industrial revolution was fueled by a steep fall in death rates. Even in cities, where living conditions are said to have been the worst, mortality rates improved somewhat (McCloskey, pp. 105-106). Deteriorating living conditions and longer life spans are difficult positions to reconcile. Clearly, improving mortality rates indicate that the standard of living rose during the industrial revolution.

Besides the two general arguments outlined above, the qualitative pessimistic position can be refuted by a close look at its specific charges.

Technological unemployment and underemployment. It has been long held by many pessimists that the wage increases of the industrial revolution were eroded away by extremely high unemployment and underemployment rates caused by the introduction of labor-saving technology. Although there were some pockets of technological unemployment, the calculations of Williamson suggest that the unemployment rate was at most eight per cent per year, and was probably far lower (Williamson, p. 22). Furthermore, the stable money wages between 1820 and 1850 indicate that there was little competition from unemployed workers that would have lowered wages (Hartwell, 1971, pp. 318-319). As for underemployment, the tremendous shift from agriculture, which provided only seasonal employment, to the more stable manufacturing sector, led to decreasing underemployment (Hartwell 1971, p. 323).



Pollution and Urban Conditions. Another popular argument of the pessimists is that the real wage increases were merely "bribes" to workers forced to endure polluted and unsanitary urban conditions. According to this line of reasoning, the gain in real wages was simply a means of luring workers to the horrid working conditions of the cities, and did not constitute a net gain in wealth. Although it is certainly true that urban conditions during the industrial revolution were appalling, the aforementioned improvement in mortality rates indicates that conditions were not bad enough to grievously affect the health of the city dwellers. Secondly, the workers voluntarily moved into urban areas, suggesting that the "opportunity cost" of pollution and various other urban discomforts *did not* outweigh the gains in real wages.

Child Labor. Another qualitative argument brought forth by the pessimists is that children were forced to endure long hours of work in unhealthy conditions. Although the existence of child labor cannot be denied, it is clear that most pessimists have overstated both its magnitude and the effects on the health of the children involved. In fact, much of the evidence for the pessimist's case comes from the very famous, yet very inaccurate, reports from the government committees investigating the factory system. Almost all of the "condition of England" novels by Dickens, as well as the works of Engels and the Hammonds, have been in large part based on these committee reports (Jefferson, p. 189). Politically motivated and seriously defective, the evidence in these reports is marred by the fact that the doctors who testified against child labor in the factories had not even been in a factory and refused to testify under oath (Hutt, pp. 161-167). Moreover, the great improvement in mortality rates seems to indicate that either child labor was not extensive as before or was less harmful. Indeed, it was the great improvement in productivity instigated by the industrial revolution that has enabled Western societies to banish child labor.

Capitalism and "the spirit of the age." Perhaps the most common yet most difficult to define charge made against capitalism and the industrial revolution is that the working class was filled with "spiri-

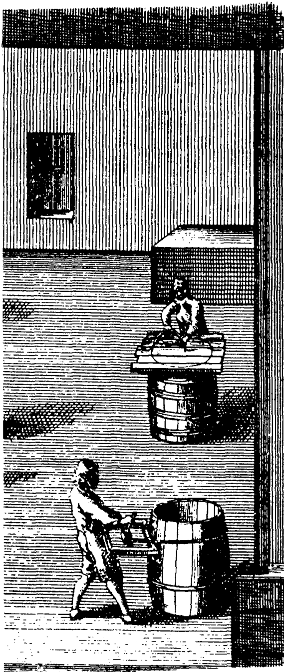
tual" loss. According to this argument, rural farm workers were torn from their roots and thrust into the industrial towns and cities, thus losing sense of their heritage and individualism. However, the very fact that workers moved voluntarily from rural to urban areas once again suggests that the advantages of more material wealth outweighed the "opportunity cost" incurred from the move. Moreover, many friendly societies, workers' societies, and voluntary organizations developed during this time, throwing the whole notion of "isolation of the individual" into dispute (Ashton, p. 137).

Any sociological costs endured during the industrial revolution must be counterbalanced against the many sociological benefits. For the first time, there was a sense of hope and optimism. The industrial revolution spawned the attitude that progress could be made and problems could be solved. Perhaps it is worth quoting Hartwell at length on this point:

> The new attitude to social problems that emerged with the industrial revolution was that ills should be identified, examined, analyzed, publicized, and remedied, either by voluntary or legislative action. Thus evils that had long existed—child labor, for instance—and had long been accepted as inevitable, were regarded as new ills to be remedied rather than old ills to be endured (Hartwell, 1971, p. 343).

Government Intervenes

As the above analysis demonstrates, the industrial revolution resulted in a significant improvement in the quality of life for the working class. However, progress was slow, uneven, and sometimes nonexistent during many periods. For example, in the early stages of the revolution growth was minimal, resulting in little or no improvement for the working class (Williamson, p. 162). Is capitalism to blame for this slow rate of progress? To the contrary, it was the many forms of government intervention, not capitalism, which slowed British economic growth during the industrial revolution.

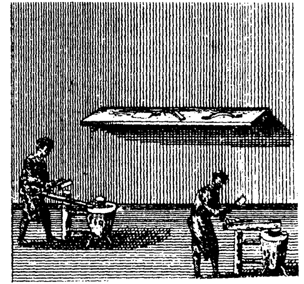


Perhaps the most important of these many interventions that hindered progress was the long period of intense war during the early years of the revolution. From 1760 to 1815, Britain was constantly engaged in war, either against France or the American Colonies. In fact, between 1780 and 1810, England was in the midst of a massive military build-up that was unmatched until World War I (Williamson, p. 163). Early commentators were quick to recognize the debilitating effects of this military build-up on the English economy. The historian J.E. Thorold Rogers, for instance, observed that the cost of the Napoleonic Wars was high indeed:

> Thousands of homes were starved in order to find the means for the great war . . . the resources on which the struggle was based, and without which it would have speedily collapsed, were the stint and starvation of labor, the overtaxed and underfed toils of childhood, and the underpayed and uncertain unemployment of men (Rogers, 1891, quoted in Hartwell, 1971, p. 326).

Modern statistical evidence and economic theory lends support to such observations. Government war spending and borrowing increased interest rates, thus "crowding out" private investors who des-

perately needed capital to construct new factories, build better canals, and design new inventions. Growth was present during the war, but it was excruciatingly small. In the long run, this meant fewer jobs and lower wages for the working class.



But, for the common man, the war had more painful and immediate consequences than slowing the rate of economic growth. Various government schemes to finance the war debt led to monetary instability and uncertainty. This monetary instability, coupled with severe harvest failures, led to rapidly increasing food prices throughout the Napoleonic Wars (Redford, pp. 89-93). In fact, food prices soared upward by more than twenty-five per cent (Williamson, p. 187). Considering that the British working class then only earned on the average little more than £11 per year, it is no wonder how these developments led to hardships and deprivation that invariably resulted in social unrest.

Although decidedly the most important, war was not the only form of government intervention that decreased the quality of life. Government monopolies, such as the East India Company and Cutler's Company, served to lessen economic efficiency and growth. The entire area of foreign commerce and trade was forced to contend with massive government regulation (Ashton, pp. 138-39).

Notwithstanding the popularity of pessimistic interpretations, the evidence of increasing real incomes and improving mortality rates indicates that significant improvement took place in the standard of living of the working class. These factors and other evidence also suggest that most qualitative aspects of the quality of life at least remained stable, and probably improved. This progress took place despite constant warfare and other counterproductive forms of government intervention that significantly hindered improvement.

While these immediate effects should not be overlooked, the real benefits of the industrial revolution are enjoyed by those living in today's world of comparative luxury and splendor. The industrial revolution was the "great discontinuity" that built the foundations for our modern society (Hartwell, 1971). It has led us into an age without the famines, epidemics, and other disasters that continually plagued preindustrial societies. Perhaps the only way to fully appreciate the impact of the industrial revolution is to look at those in the modern world who have yet to undergo industrialization. The fate of the hungry and disease-ridden peasants in such areas as Africa and India is perhaps the most forceful and convincing argument in favor of capitalism's industrial revolution. □

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Toward Free Banking

Moving toward a fully deregulated financial system.

by Donald R. Wells
and L.S. Scruggs

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This article is based on a paper presented to the Southwestern Economics Association in San Antonio, Texas, on March 20, 1986.

Most economists consider money to be a special good that should be controlled by the national government. But advocates of free banking consider money a private good which, as any other good, must meet the market test of acceptability. Let us consider the advantages of free banking, and see how such a system might be implemented in the United States.

Under free banking, no government agency would grant a charter to allow a bank to operate. Banks would be free to begin operations as they saw fit, just as other businesses. They could acquire funds from any source: equity, deposits, banknotes, or other liabilities such as debentures; and pay whatever market conditions dictated on these sources. They could then use these funds in the manner most profitable to the bank as long as they avoided deception or fraud. They would hold whatever reserve they wanted—cash, securities or claims on a clearinghouse—wherever they wanted to hold it. Loans and securities would not be subjected to interest controls, nor would investment in any particular industry be mandated or forbidden. If so desired, banks could even acquire equity positions in other firms. The only role for government would be to prosecute fraud and enforce contracts, including settling disputes in court. Banks would not be subjected to government audits or made to pay any special taxes not levied on other businesses.

Money did not originate through some governmental body authorizing its use, but rather by the public and the market deciding what was mutually acceptable. Free banks could continue to offer to exchange their recognized and highly tradeable liabilities for the less well-known and less marketable liabilities of others. Traditionally, banks have persuaded the public to use banknotes and checkable deposits as money. The right to issue these notes and deposits was never a government prerogative, but the common right of all (Breckenridge 1895, p. 196). In the quasi-free-banking systems of the past, banknotes and deposits were normally convertible; that is, redeemable on demand in some reserve asset that the bank could not create, such as gold or silver. Central banks entered the picture and eventually monopolized the issuance of currency, leaving deposit creation to commercial banks.

Since currency became an outside money which banks could no longer issue, they could not exchange one liability for another—deposits for banknotes—as the public desired, but instead were forced to use up reserves or borrow from the central bank to placate public demand for currency. The ability to issue their own notes permitted banks to ease public fears about bank runs and to reduce funds tied up in till money, since unissued banknotes were not a liability on the bank's balance sheet, but were instantly available. This was especially helpful to Canadian and Scottish banks in minimizing the cost of operating branch offices (Breckenridge, p. 387; Beckhart 1929, p. 377; White 1984, p. 40).

Banks in an unregulated system would be free to open and close branches wherever they wanted. Branching allows banks to diversify their loans geographically and industrially, since banks would be in a position to acquire loan customers all over the country. An increased need for banking services in a particular area of a nation is met more readily by a new branch of an existing bank than by a new unit bank, which requires new directors and managers. Furthermore, within a given financial center, reserves can be moved among branches of one institution more quickly and cheaply than among institutions.

Branching would not be required, of course, but would face the test of the market. Experience from both Scotland and Canada shows that unit banks found it difficult to compete with larger branch banks and were frequently absorbed by them (Breckenridge, p. 146; White 1984, p. 36).

Many specialized thrift institutions, such as savings banks, savings and loan associations, credit unions, and trust companies, originated because commercial banks were legally barred from, or voluntarily eschewed, a particular field of lending. Free banking implies no restrictions on bank lending or investing; hence specialized thrifts would be necessary only for loan categories systematically shunned by banks.

Limit on Credit Expansion

Unlike the current arrangement, whereby the central bank controls the ultimate expansion of the money supply through its control of the money base, bank loan expansion under free banking would be controlled by the exchange of notes and deposits through clearinghouses. Banks that expanded their lending more rapidly than others would face adverse clearings and would be forced to curtail their lending unless they possessed more cash reserves than their rivals. These reserve assets could be deposits in the clearinghouse, gold, silver or some other "outside" money, such as Federal Reserve Notes (FRNs), which would be frozen in supply as were Greenbacks after the Civil War. If the Federal Reserve (Fed) were abolished, existing FRNs could serve as base money in a free banking system.

An individual bank could increase its reserves by a lending policy more restrictive than that of its rivals. The expanding bank would find its notes and deposits presented for redemption in reserve money; the more restrictive bank would gain reserves, as a smaller volume of its liabilities would be presented, by other banks, for payment through the clearinghouse.

However, the reserve base in an entirely free banking system could expand only if new reserve money entered from the outside. Since no

FRNs would ever again be printed, the only avenue open would be an influx of gold or silver from other areas or from mining. But no central bank could expand the money base at will, imparting monetary disturbances to the economy.

Since no bank would be legally required to maintain any specific reserves, each bank would hold only the amount of the reserve assets indicated by its experience and liquidity preferences. Thus, if all banks in the system were to expand their lending by the same percentage, the check on them would *not* be adverse clearings, since each would be receiving from every other roughly the same amount of notes and deposits. Instead the expansion would be checked by each bank's desired holding of reserves plus the public's desired ratio of base money to notes and deposits. If the public trusted banks it would be unlikely to convert notes and deposits to specie or FRNs, but such a conversion would act as a brake on bank expansion.

White (1984, p. 44n) found that Scottish banks, during the late 1700s and early 1800s, were able to reduce their average gold reserves from 10 per cent and higher to 3.2 per cent as these banks gained more public confidence. In any case, credit expansion is limited in a free banking system, since the public will hold only a finite amount of any issuer's distinctive notes and deposits. But under our current system, there is no limit to expansion by the central bank, because the supply of its monopoly money will create its own demand, as the public has no choice but to hold whatever amount is created to support a higher level of nominal income and prices (Yeager, p. 42).

Transition to a Free Banking System

The first step to achieve a free banking system is to remove all legal obstacles to the production of "outside" base money plus all restrictions on private banking. The legal impediments to the production of outside money, according to White (1984a, pp. 297-98), include: (1) a prohibition on the minting of private coins; (2) a sales tax on the purchase of commodity monies; (3) a capital-gains tax on the holding of non-dollar currencies; and (4) uncertainty regarding the upholding by courts of the payment of a contract in anything but dollars, even when gold is specified. Removal of these barriers would signify that the field is open to any type of innovation that might seem profitable to undertake.

Simultaneously, Congress would have to abolish the Fed, freeing the existing supply of FRNs (the Bureau of Engraving can replace worn bills). The Fed would dispose of its assets, after buying back its stock from the member banks. Termination of the Fed could proceed as follows: (1) cease open-market operations and discounting; (2) require the Fed to buy back its stock from member banks by crediting their reserve accounts; (3) send all government securities and gold certificates to the Treasury for cancellation; (4) move the Treasury account to the commercial banking system; (5) let foreign central banks move their accounts wherever they wish; (6) phase out the Fed's check-clearing system, perhaps over one year, as deregulated commercial banks establish branches nationwide and assume the clearing function.

Private Banking. Equally important, however, would be total deregulation of private banking, concurrent with dismantling of the Fed. The immediate steps should be: (1) allow free entry with no charter needed from any governmental agency; (2) grant freedom to branch

anywhere; (3) abolish reserve requirements; (4) remove restrictions on the type of assets held; (5) abolish limits on interest rates paid or charged; and (6) allow banks to issue distinctive banknotes or even fractional token coins.

The freedom to enter without charter should reduce the forced difference between banks and thrift institutions. The unlimited branching will further erode this distinction as mergers occur between banks and thrifts. In addition, unrestricted branching will expedite the replacement of Fed check-clearing with private clearing. Unlimited branching will also lead to the end of correspondent relationships among banks and the holding of interbank deposits, a feature peculiar to the unit banking system. When allowed to branch, as in Canada and Scotland, banks hold insignificant amounts of the liabilities of other banks, and are insulated from contagious bank runs.

The abolition of reserve requirements would permit banks to escape the implicit tax with which they have been burdened since the beginning of the National Bank System during the Civil War; they could then earn profits on all of their assets, rather than about 90 per cent of them. A fixed percentage required reserve is the least liquid asset a bank has. When banks are permitted to hold any amount of reserve they want, their anticipated liquidity needs are the sole determinant of the amount and location of those reserves.

As an example, before the Bank of Canada was founded in 1935, Canadian banks faced no reserve requirements but held as desired reserves: outside money, call loans in New York and London, securities and commercial paper, and deposits in foreign banks (Beckhart, p. 430). Cash reserves were normally 10 per cent of total liabilities, but fluctuated between 8 per cent and 15 per cent. Banks watched the balance sheets of their rivals: the stronger ones kept the weaker in line by refusing to take checks drawn on them or refusing to lend to them in a crisis (Breckenridge, p. 433; Beckhart, p. 485). Most of the outside money (specie and Dominion Notes) was kept at the financial centers; the branches used mostly unissued banknotes as their till money. Since unissued banknotes are costless, this economy measure helped subsidize some of the branches in remote areas.

A similar situation could evolve in the U.S. under free banking. The cash reserves of banks would probably consist of FRNs at first, and then specie if the public displayed a preference for convertible banknotes and deposits. But secondary reserves would undoubtedly be invested in short term securities (such as Treasury bills, commercial paper, and bankers' acceptances) and call loans. No longer could banks consider themselves liquid merely because they could borrow outside money from a lender of last resort. Each would be responsible for its own liquidity, and any borrowing would have to meet the standards of the market.

It is also very important that banks again be allowed to issue banknotes if unregulated banking is to succeed. This enables banks to exchange one liability for another—deposits for notes—at the demand of the public, without disturbing the bank's reserves, or any other asset. In addition, these banknotes should be distinctive, not uniform as were the National Banknotes, and issued without pledging any specific asset, such as government bonds. Distinctive banknotes would meet the daily test of convertibility: Each bank would be anxious to

issue its own notes; upon receiving notes issued by others, it would return them to their issuers through a clearinghouse. To pay out the notes of another bank would be acting as a broker without fee; to hold them would be lending to the issuer without interest (Breckenridge, p. 407). Therefore, note exchanges act as a check on expansion just as check clearings do.

Allowing an unrestricted issue of banknotes, with no requirement to pledge certain assets such as government bonds, permits banks to supply the exact amount of currency that the public demands at the instant they demand it. Panics and bank runs can be avoided if the public is allowed to exchange one type of money—deposits for banknotes—when it wants. The panics of 1873, 1893, and 1907 in the U.S. resulted when the public could not convert their deposits to currency (Canadian depositors experienced no such difficulty). Many national banks in the U.S. found it unprofitable to hold the 2 per cent government bonds that were required to back their notes, thus were unable to issue enough notes to satisfy the panicky demand for currency. When banks tried to satisfy this demand by paying out their cash reserve (gold certificates, greenbacks, and other Treasury currency), they depleted their required reserves, and were forced to suspend payment.

Deposit Insurance. Another important step in achieving free banking is terminating the Federal deposit insurance that has existed since 1934. Deposit insurance was part of a system of strict regulation designed to save the unit bank system during the credit implosion of the early 1930s. It is rarely found in nations with a small number of large branch banks, even though Canada adopted a plan in 1967. But it is totally incompatible with free banking and thus would have to be phased out.

There are private options to government deposit insurance that should be explored. One such option could lie with the individual depositor. If uneasy about banking, this person could approach an insurance company about insuring his deposit. The insurer could diversify its risk by covering accounts up to a specified maximum in any particular bank, and then asking future clients to deposit in other banks where the insurer is covering smaller deposit volumes.

Another option lies with the banks themselves. They could alleviate public concern over safety by offering low-interest accounts with preferred claims on bank assets in case of liquidation. Another alternative, similar to the existing tax-and-loan account, would be to offer low-interest accounts backed by pledged securities. Other depositors would receive market rates but would have no special protection.

Banknotes vs. Deposits. Holding private banknotes rather than government fiat money would be a new experience for the current generation. Many may be reluctant to accept "funny money" at first, especially since holders of banknotes, unlike depositors, may not be customers of the issuing bank, but merely recipients of its notes in the course of business.

But banks could overcome the aversion to private banknotes in several ways. Banks could assume the risk for counterfeit notes. Scottish banks honored forgeries presented over the counter by innocent persons, but not those accepted by other banks and returned through clearings. This put the burden on rival banks to be on the alert for counterfeit notes. At any rate, counterfeiting is much more tempting

in a fiat-money system than in a free-banking system, in which the notes return quickly to the issuer (White 1984, p. 40). Banks could also offer to pay interest on any note not immediately redeemed in base money on demand.

Free banks could voluntarily offer multiple liability for stockholders if such proved reassuring to depositors and noteholders. Scottish banks operated with unlimited liability for their owners; Canadian banks and National banks in the U.S. formerly imposed double liability on their stockholders. The market might compel smaller, newer banks, but not large, well-established institutions, to impose multiple liability.

Banks could offer a mutual note guarantee exemplified by the Bank Circulation Redemption Fund (BCRF) that protected Canadian banknotes from 1891 until they were replaced by Bank of Canada currency. Banks contributed to a fund to redeem the notes of any failed bank, which notes were to earn interest until redeemed (Beckhart, p. 302). While this measure was successful in that the notes of even weak banks circulated at par all over the country, it put the depositor in a position inferior to that of the noteholder. In addition, this was not a voluntary arrangement but was mandated by the Bank Act of 1891. But in Scotland, when the Ayr Bank failed, other banks voluntarily advertised that they would accept Ayr notes, thereby bolstering confidence and gaining customers (White 1984, p. 32). A similar offer under free banking could include depositors as well as noteholders.

A Temporary Lender of Last Resort?

When a free banking system is established, reliance on a governmental lender of last resort should be avoided, even on a temporary basis. With the Fed abolished, it might be tempting to permit banks to borrow fiat money from the Treasury for a few years during the phasing out of the FDIC. Canadian banks were allowed to borrow Dominion Notes from the Minister of Finance in 1914 as a wartime measure, but this practice was not terminated when the war ended in 1918; it continued until the Bank of Canada began in 1935. Canada did not return to the gold standard until 1926, but this borrowing of base money from the government was incompatible with the gold standard, and the latter was abandoned in 1929 (Curtis 1932, p. 322).

A government lender of last resort is also incompatible with a free banking system, wherein each bank is to be responsible for its own liquidity. Free banks can borrow from one another at market rates, but a lender of last resort is needed only when one bank holds all of the outside money, as did the Bank of England during the 1800s (White 1984, p. 145). Under free banking, no bank would incur liabilities in some money that it could not issue.

Coinage. In addition to banknotes, private banks would also be responsible for new coins: full-bodied coins for reserves, and fractional, token coins for making change. The market gradually developed coins to expedite the assessment of the value of varying amounts of commodity money. Governments intervened to monopolize coinage to extract a profit for themselves. Coinage could have remained private, with inferior coins circulating at a discount (Selgin & White 1985, pp. 4-5). Private mints, faced with existing and potential competition, would have much less incentive to debase coins than would a state with a monopoly on coinage.

Establishment of a free banking system requires that the Treasury cease minting its token coins, just as the Fed must stop issuing currency. However, the Treasury could be allowed one last profit by selling all its gold at Ft. Knox at market prices, ending any conceivable government role in money creation. This seems easier than the Timberlake (1984, p. 189) proposal to give everyone in the country an equal share. The existing quantity of Treasury coins would be frozen, joining the existing FRNs as part of the base, and still used as a medium of exchange. Banks, however, would issue new fractional coins, as well as banknotes. Professor Hayek has hypothesized that local merchants might collaborate to sell through banks a set of uniform coins or tokens to be used in vending machines, perhaps replacing metallic coins with plastic ones bearing electronic markings discernible to cash registers and slot machines (Hayek 1978, p. 48n). If the many U.S. railroads could agree on a standard gauge for tracks, banks and retailers can agree on a substitute for Treasury coins.

Possible Concerns over Free Banking

To those who have experienced only a government monopoly of base money, and central bank manipulation of that base, free banking may seem too radical, even though the inflationary record of central banking must inspire a search for alternatives. If money creation were divorced from the government, politicians would have to pay for their spending with taxes or real borrowing, but not by government monetization of deficits.

Critics may fear free banking would be deflationary, as the money base could grow only through additions to the gold or silver stock, since the FRN quantity would be frozen. But this ignores the possibilities of financial innovations to economize on base money, higher money turnover rates, and increasing confidence in the ability of banks to honor redemptions by the public. One Scottish bank in the early 1800s was able to operate with specie reserves of only 0.5 per cent of assets, revealing that the public may not demand specie when assured of its availability (White 1984, p. 141). Each competitive issuer can observe the demand for his money and adjust the supply thereto, a task no monopoly issuer can accomplish. Each bank must balance the desires of its depositors, who fear a depreciating money, with those of its borrowers, who would object to an appreciating money. But free banking does promise to end the inflationary bias that has crept into most wage negotiations and other long-term contracting. It is a system that would be consistent with more flexibility of prices and wages.

Other qualms about free banking may afflict bankers themselves who have spent their entire careers in a regulated environment. Older bankers may resist the adjustment; but younger, perhaps better educated ones might find a new, unregulated setting to be a stimulating challenge. Many large retailers and brokerage houses already have in place nationwide offices from which a new type of banking business may be conducted. The field may become dominated by those who were not bankers prior to free banking.

Because the U.S. system currently has no nationwide banks, as other countries do, growth in the number of banks to a competitive level may take longer than it would under unlimited branching. However, the system is not burdened with governmentally encouraged banking cartels that would stifle competition, and most interest ceilings have

been abolished. But American banks are still subjected to governmental insuring and auditing, practices incompatible with free banking.

Fortunately, no private U.S. bank is a government pet, like the Bank of Montreal (BOM) or the Bank of England (BOE). No American bank would be the government's fiscal agent: Over 11,000 banks currently hold tax-and-loan accounts of the Treasury; if the Treasury closed its account at the Fed, no single private institution would play the role of the BOM or BOE. Vis-á-vis the banking system, the U.S. government would be neutral, having no independent Treasury funds to deposit at various times, as was the case before 1914.

Finally, free banking is most likely the system that would have emerged from normal market forces, had governments not interfered with banks and money by imposing specific bond-holding for note issue, mandating fixed percentage reserve requirements, forbidding branching across state lines, and creating a central bank to expedite inflationary governmental finance. □

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LIBERALISM:

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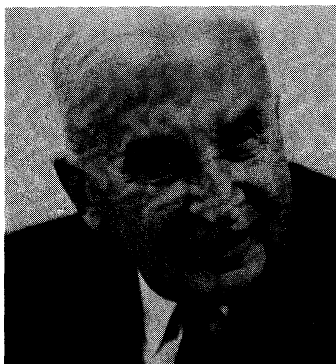

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The Ethics of Privatization

Without a firm moral defense, the move to privatize may founder.

by Tibor R. Machan

Dr. Tibor R. Machan is Professor of Philosophy at Auburn University, Auburn, Alabama, and Senior Fellow of the Reason Foundation and author, among other works, of *Human Rights and Human Liberties.* The book he edited for Random House, *The Main Debate: Communism versus Capitalism,* will appear in 1987.

This essay is based on a talk delivered February 19, 1986, before a Symposium on Privatization organized by the International Chamber of Commerce and the Institut Économique de Paris, in Paris, France.

Privatization springs from our Western liberal political vision, two-and-a-half centuries old. This vision conceives individuals and their voluntary institutions—churches, corporations, professional associations, labor unions, and the like—as the source of the values of civilization. The economy is capitalistic, based on the right to private property. The State is a supporting mechanism, as referees are to sporting events. The work of living and developing life's values are tasks for free human beings. The State serves them when conflicts arise.

But this Western liberal vision has lacked a moral defense. It has had the backing of experience and common sense, and has led to greater prosperity than alternative visions. However, the righteousness of Western prosperity—that it is deserved, not in need of apology—is felt to be uncertain. Thus the system to which prosperity is linked by common sense—capitalism—is generally left undefended, constantly called into doubt, never praised as is socialism in various intellectual circles, despite socialism's undeniable record of failure.

The relatively free portion of the globe could be even more prosperous, as the privatization movement has demonstrated. But again the case for this is made only pragmatically. Even the politicians are persuaded, temporarily, that the business of keeping nations reasonably wealthy should be left to the private sector. But because their belief rests on the view that making an economy more free will enhance the general welfare, there persists doubt about the more basic question: Is privatization a morally worthwhile, respectable idea?

The pragmatic case resting on successful production of riches is not the central defense of the West. Privatization itself must be embraced not merely as an efficient means to rescue economies but as a return to the West's initial commitment to set people free of each other's and their governments' oppressive actions.

It is vital to understand the moral case for freedom and privatization also for the practical value of it. Privatization entails some upheavals for various people. What of the employment dislocation involved in privatization? Vested interests are not sitting by without protests and arguments invoking compassion and equity. They charge privatization advocates of thinking only of the bottom line, the financial concerns

involved. Is that not ethically objectionable? Should some people be sacrificed to the advantages of privatization? Does not the state's involvement ensure more concern with fairness and justice? Sometimes it is argued that removing some service from the sphere of the state will mean that only where a profit can be made will the service be available. Is it right to neglect those who may not help to make a profit for the private business that takes over the service?

The idea that freedom of enterprise might again attain public respectability instills fear in the hearts of many spokesmen in newspapers, magazines, books, and radio or television talk programs. And their skepticism—whether sincere or malicious—can be extremely debilitating, unless their arguments are faced by a morally sound defense. The only thing that can accomplish this is a confident and intelligent moral defense of privatization.

Free trade needs to be shown as a noble, not just useful, policy. If the newest aspect of capitalism, privatization, is to remain a sustained public policy in the non-communist world and manage eventually to attract the thawing Soviet bloc as well, it must be shown to be morally justified. To win men's minds *and* souls, their concern with the basic question of whether some act or policy is consistent with how human beings *ought to live their lives,* in addition to efficiency considerations, must be addressed.

Prudence

I will start with the elementary observation that commerce is an aspect of life by which men and women aim at improving their and their loved ones' well-being here on earth. Commerce is the institutional expression of the virtue of prudence in human life.

A prudent person takes care of his economic requirements. It probably will not be his main goal in life, and prudence is by no means the highest human virtue: But it's clearly virtuous to attend to one's economic existence. And it is thus proper, also, to have this attention develop into an institution among human beings within their variously sized communities.

Any effort then to thwart commerce is open to serious moral question. When done by force, however, there is no doubt that something evil is being done. Prudence is a genuine, bona fide human virtue in almost every major moral system on earth. Furthermore, in any bona fide moral system the freedom to choose between right and wrong is an essential ingredient in the moral life of a person. If not free, a person cannot be held morally responsible.

Of course, prudence is not the only virtue. Many others, such as courage, honor, honesty, justice, generosity, moderation, and the like, are of equal or higher moral significance. Yet those, too, can be practiced only in a genuine free society. The freer the society, the greater one's opportunity to live in the way appropriate to a moral agent. The more the society allows some people to dictate to others how they must conduct themselves—including in the economic sphere—the more it limits human dignity, the range of a person's sphere of individual responsibility.

But this is not all there is to the story. What we have is sound, but there is not enough moral punch to it: It is all true but not sufficiently inspiring. We need to point out that the kind of life associated with commerce is not just permissible, but often honorable, even noble.

Adam Smith provided the clue in the following remarks:

> Ancient moral philosophy proposed to investigate wherein consisted the happiness and perfection of a man, considered not only as an individual, but as the member of a family, of a state, and of the great society of mankind. In that philosophy the duties of human life were treated of as subservient to the happiness and perfection of human life. But when moral, as well as natural philosophy, came to be taught only as subservient to theology, the duties of human life were treated of as chiefly subservient to the happiness of a life to come. In the ancient philosophy the perfection of virtue was represented as necessarily productive to the person who possessed it, of the most perfect happiness in this life. In the modern philosophy it was frequently represented as almost always inconsistent with any degree of happiness in this life, and heaven was to be earned by penance and mortification, not by the liberal, generous, and spirited conduct of a man. By far the most important of all the different branches of philosophy became in this manner by far the most corrupted.

Smith's remarks suggest that the ethics that supports capitalism and its current offspring, privatization, may be found in the U.S. Declaration of Independence. There the rights to life and liberty are linked with the right to the pursuit of happiness. To pursue human happiness in a diligent, conscientious, honest, and courageous manner, men and women everywhere require political and economic liberty. What must be stressed is, in Smith's words, that "virtue [must be] necessarily productive to the person who possessed it, of the most perfect happiness in this life."

That is the point of an ethical system, namely, to give a person meaningful, principled guidance in his life. And it is once such an ethics is identified that we learn it does not support socialism, fascism, communism, or some other collectivist system, but the free society with its legal system that protects freedom of thought, freedom of religion, freedom of trade, freedom of contract, and freedom of enterprise.

Economic Egoism?

Of course, capitalism has often been linked with the idea that men are selfish and that it is the only economic system that properly accommodates this fact. The cruder renditions of Adam Smith so interpret him. Most notably, of course, it was Karl Marx who linked the system of private property rights with callous selfishness, when he noted that "the right of man to property is the right to enjoy his possessions and dispose of the same arbitrarily, without regard for other men, independently from society, the right of selfishness." And many modern economists, too, link the system with this kind of crude, narrow egoism which they have inherited from the English philosopher Thomas Hobbes. They often do this in a desperate effort to make capitalism scientific, to pretend that some pure, normatively neutral, value-free analysis commands us to choose the system.

But, the narrow economic idea of egoism is false: People do not in fact automatically seek out what is best for them—if it were only so, we would live in a wonderful world. Nor do they always know what is best for them—that too would be very helpful if it were so. Rather,

people must work very hard to learn what is best for them and then try hard to obtain it. But this philosophy of humanist selfishness or individual happiness is something very different from what most people link with capitalism. It is demanding. Again, Adam Smith noted its nature quite clearly when he wrote that "It is not the love of our neighbour, it is not the love of mankind, which upon many occasions prompts us to the practice of . . . virtues. It is a stronger love, a more powerful affection, which generally takes place upon such an occasion, the love of what is honourable and noble, of the grandeur, and dignity, and superiority of our own character." As Smith shows, a genuine concern for ourselves is a demanding and indeed noble pursuit. Our task in life is to seek human excellence.

Here we get a clue to the answers to the several moral questions generated by privatization. Free trade is a necessary requirement of a dignified human life. We cannot justify compromising it even for such good causes as employment security, guaranteed welfare, concern with the possibly neglected minority whom it may not be profitable to serve, and so on. Such a compromise may appear to be appealing when one considers only the plight of the few who do not immediately benefit from privatization. But when we realize that a political-economic system must serve the morality of individual self-development, not of self-sacrifice, then clearly privatization is on sound moral grounds and its detractors must attempt to solve the few problems associated with it without compromising it.

Defending the Free Society

It is those who are doing the work within the free sectors of the world, including the newly privatized regions, who must defend it in our time. We cannot count on intellectuals—most of whom live off the state and are convinced that the state is superior in its intentions and capabilities to the agents in the free market.

The defense of the free society, including its newest manifestation, privatization, must be conducted on the philosophical front first. It need not exclude mention of the material benefits such a system tends to bring to people in any society. But what is more important is that it affords the freedom for everyone to make moral choices in life, including one's commercial endeavors, and that such choices are rightfully aimed at enhancing the welfare of the economic agents and those to whom they stand closest in society—family, friends, colleagues, neighbors, roughly in that order of importance.

Humanity is not some one body, one large person, whose welfare we must serve the way our livers and hearts serve the welfare of their owners. Humanity is you and me. If we are not free to do the most with ourselves, if we cannot be left to ourselves to seek human excellence in life, that task is not going to be achieved by anyone. Any contrary message rests on dreams, not on a clear awareness of the facts.

The privatization movement has a lot of promise and must go much further than it has already toward freeing up the economic lives of human beings. It should avoid promising panacea, however—it should not fall prey to the temptation of the utopians who think some system alone will solve all our societal problems. And most of all, the movement must stress its own moral legitimacy. Without that it will be a mere passing fancy. □

We Would Be Wise To . . .

How best to supply the goods and services consumers value most.

by Dale M. Haywood

Dr. Haywood teaches economics at Northwood Institute, Midland, Michigan.

During the past several decades, government has become a primary provider of education, mass transit, fire protection, garbage collection, road repair, and park maintenance. We may have been lulled into thinking that government is the *best* provider for such services. What's more we may have almost unconsciously come to believe that government can be the *only* provider of some of these goods and services.

But does government perform these economic roles as we assume it does? In those instances where government *is* doing the jobs, is it doing them at the lowest possible cost?

To answer our questions, we will examine two government-provided services: restaurant food preparation standards and air traffic safety. These services affect us all. They are also representative of most other government-supplied goods and services.

Federal, state, and local governments traditionally have sought to insure that employees in restaurants and other public eating places prepare and serve food at least as hygienically as the codes require. Governments employ a swarm of inspectors to enforce their complex web of regulations. Underlying this regulation/inspection system is the premise that if there were no regulations and inspectors, unscrupulous restaurateurs would harm unwary customers by preparing and serving food under unsanitary conditions. In theory, the regulation/inspection arrangement insures that this won't happen.

There is some evidence, however, that this is not the actual practice.

The Mirage. After years of complaints by owners of small businesses in Chicago of the day-to-day corruption they endured, *The Chicago Sun-Times* decided to investigate. The Better Government Association joined with the *Sun-Times* in its investigation. The strategy these two organizations chose was to buy a bar and restaurant and run it themselves. The newspaper's reporters became "waiters." Its photographers became "plumbers," who periodically visited the restaurant to make "repairs." They called their restaurant Mirage.

The *Sun-Times* people deliberately created health and safety hazards—and waited to see what would happen.

> In four months of operation, they found themselves encountering:
>
> • Payoffs of $10 to $100 grabbed by city inspectors who ignore health and safety hazards when the price is right.
>
> • Shakedowns by state liquor inspectors who demand whatever is in a tavern's cash register for their silence about liquor violations.
>
> • Tax fraud by accountants who conspire with taverns to cheat on state and federal taxes in a practice so widespread it may be costing Illinois $20 to $50 million in sales taxes alone.
>
> • Misconduct and negligence by public employees who loaf on the job, use city equipment for private gain and routinely demand cash under the table for what should be public services.
>
> • Illegal kickbacks, tax skimming and offers of political fixes from jukebox and pinball machine operators—including one former policeman who alone may be failing to report a half million dollars a year in taxable income.
>
> City inspectors marched through the Mirage, hands out and eyes averted, ignoring city code violations for $10, $50, $100 on the side. It was the payoff parade come to call (*Detroit Free Press*, January 15, 1978).

Yes, there probably are some unscrupulous restaurateurs. But the *Sun-Times'* experience with the Mirage proves that there are some unscrupulous health and safety inspectors, too. Such experiences may quite rightly cause us to doubt if *any* of governments' regulation/inspection systems do in fact accomplish what many of us assume they accomplish.

Is another layer of regulations and inspectors the answer? That's doubtful. Almost certainly there would be some dishonest inspectors among this group also. So a second group of "policemen" to police the first group of "policemen" probably wouldn't get us closer to our goal of hygienically prepared food in public eating places—or to any of the other goals of governments' regulation/inspection systems.

Indeed, one can't help but wonder which is the more dangerous situation: (A) patronizing a restaurant with no suspicion about its sanitation practices because you believe that governments' regulations and inspectors are looking out for you, when in fact they are not, or (B) patronizing all restaurants with skepticism, because there is *no* effort by government to protect you. Mightn't consumers with attitude A be the more vulnerable?

Voluntary Market Responses

So how are we going to realize our goal of healthful food preparation in public eating places? Let's consider some voluntary, free market responses to John Q. Public's demand for safe restaurant food.

Bill Knapp's. Bill Knapp's is a chain of sixty restaurants that serve moderately priced food. The restaurants are located primarily in Michigan and Ohio. The owners of this chain have responded in various ways to the concern they believe their customers have for wholesome food. One of those responses is in the physical configuration of the restaurants.

The sixty stores have an identical floor plan. It's a huge T. Every diner enters at the base of the T. The host then ushers patrons to

Interior of Bill Knapp's shows T-shaped design.

seating in one of three areas: the base of the T, in a separate dining room that forms the left half of the top of the T, or in another dining room that forms the right half of the top of the T.

The kitchen is located at the junction of the base of the T and the top of the T. And it is largely exposed. Thus, irrespective of which of the three dining areas they are seated in, all guests get a good look at the kitchen en route to their tables.

It's impossible to say what portion of Bill Knapp's thirty-eight years of success is due to this kitchen-disclosure feature of the chain's restaurants. But is seems likely that this device is a significant factor.

The Embers. In Mt. Pleasant, Michigan there is a fine restaurant that's been satisfying its customers since 1958. It's called The Embers. At this restaurant, meals are moderately expensive. The owner of The Embers caters to a different segment of the market than Bill Knapp's.

The ambiance at The Embers contrasts sharply with the atmosphere at Bill Knapp's. Where at Bill Knapp's there is an openness, there is an intimacy at The Embers, with its numerous alcoves separating the diners from each other and giving them a sense of privacy. The kitchen is unobtrusive. Management seeks to make the preparation and handling of most of the food about as *inconspicuous* as possible.

So what's the free market mechanism protecting diners at The Embers? A simple invitation printed on the menu, an invitation to each guest to inspect the kitchen personally.

My wife and I had patronized The Embers several times. Each time, after reading the invitation to inspect the kitchen, I kept saying, "We ought to do that sometime." It was on our fourth or fifth visit that I overcame my inertia. As we were exiting, I asked the hostess when we might take the owner up on his invitation. She responded, "How about right now?"

The message in her response was, "We are proud of our kitchen at *all* times. It's not something we get in shape only when company is coming."

We took the on-the-spot tour and were favorably impressed. Obviously, there's no paying off the "inspector" under this arrangement.

Air Traffic Safety

Let's consider another economic service we all value, air traffic safety.

When commercial aviation was in its infancy, the private, for-profit airlines set up Air Route Traffic Control Centers in major cities in the eastern and northeastern regions of the United States. These facilities, basically control towers, provided a modest degree of air traffic control within a fairly short radius of the cities where they were located. This was a reasonable system for its time.

But when the federal government offered, shortly after the Great Depression, to take over the system and operate it for "free," the airlines quickly accepted. Since then, the Federal Aviation Administration (FAA) has assumed, among other duties, the major responsibility for air traffic control. In an article in *Private Pilot* (October 1984), Kevin Murphy reported: "From the rather primitive early efforts at control, air traffic control sprang into the full-fledged, all-encompassing system we have today, with control towers, air route traffic control centers, flight service stations and controlled airspace from top to bottom. No reasonable pilot can argue today that the modern ATC (air traffic control) system does wonders for collision avoidance, but they can argue about one thing: cost."

Just how costly is the air traffic control we are getting from FAA? Because there are a few privately owned, for-profit firms operating airport control towers in the United States we can answer this question. According to Murphy: "Private operators spend an average of $96,000 a year to staff and maintain a small airport tower, one third of the average FAA cost of $294,000 per year." Of course, price is just one dimension of an economic good. What about the quality of service provided by private firms such as Barton ATC and Midwest ATC?

"We're very happy with our control-tower service," says the manager of the airport in New Iberia, Louisiana. "The folks here always have acted and conducted themselves in a very professional manner. They're very easy to work with, and their level of performance is very adequate."

A Frontier Airlines pilot reports, "These are good people to work with. They'll give you anything you want. I've never had a problem with any of them."

No private firm has a government-guaranteed monopoly at any airport it serves. The manager of the airport in Enid, Oklahoma observes that the threat of being fired is a powerful stimulus to private air traffic controllers: "If controllers . . . don't do a good job, they won't be around next year."

Perhaps a still more significant tribute to the private ATC firms comes from the government itself. In 1983, the federal government sent a team to evaluate the Farmington, New Mexico tower operated by Midwest ATC. The team reported: "Midwest ATC is providing satisfactory ATC service and has an excellent working relationship with users and airport personnel, as well as other FAA facilities. The relationship between controllers and pilots is the best it has ever been."

The evidence is clear. Private, profit-seeking air traffic controllers do at least as good a job of providing safety in air traffic as their FAA

counterparts. And private firms can do it at a fraction of the cost. Wouldn't it make good sense to have the private firms, as the proven superior providers of air traffic control, operate *all* of this nation's control towers? According to a report cited in *Reason* magazine several years ago, the nationwide replacement of FAA towers with private towers would save United States taxpayers about $25 million per year!

Conclusion

Are governments always providing the economic goods and services we assume they're providing? If the service in question is sanitary food preparation, the answer is "no." The experience of *The Chicago Sun-Times* and the Better Government Association with the Mirage is proof of that.

Can the private sector provide this service? The answer is "yes." And when it is provided as Bill Knapp's and The Embers have provided it, it can contribute to the growth and longevity of those restaurants that deliver it.

One Principle. Where there is a free market, there is competition. The employees in competitive enterprises have to woo customers. In order to do so, they must be attentive to their customers' wishes. There are no exceptions.

So if the business is a restaurant and the wish is for hygienically prepared food, it is in the self-interest of the owner and employees of that restaurant to prepare food hygienically. And if customers want the same amount of hygiene, restaurants will provide basically the same standards of hygiene. If customers want different amounts of hygiene, restaurants will have different standards of hygiene.

Perhaps we would be wise to take a closer look at *all* the goods and services we are supposed to be getting from government. Maybe we're not getting what we assume we are in education, mass transit, fire protection, garbage collection, road repair, park maintenance, and so on. Maybe politicians, bureaucrats, inspectors, and other government employees are arbitrarily determining what we're getting, because they are shielded from the wishes of consumers.

In those cases where government is providing a valued service, is it doing so at the lowest possible cost? By contrasting FAA-supplied air traffic control with air traffic control supplied by private, for-profit firms such as Barton ATC and Midwest ATC, we discover the answer is definitely "no." There is a simple explanation for this.

A Second Principle. Whenever a job is done by a profit-seeking firm, there is someone who stands to gain if the firm makes a profit. That someone can improve the firm's chances of making a profit if he can hold down or cut costs. When someone is motivated to hold costs down, it's more likely that they will be held down. That motivation is stronger among the people who own and work at Barton ATC and Midwest ATC. Because the FAA is not a private, profit-seeking organization, that motivation is weaker among FAA employees.

Perhaps we would be wise to rely more on private, profit-seeking firms if we want to get the goods and services consumers most highly value—and be more certain of getting them at the lowest possible prices. □

How the West Grew Rich

by John Chamberlain

Students of Hayek, Mises, and Milton Friedman will find much that is an old story in *How the West Grew Rich* (351 pp., Basic Books, $19.95), but Nathan Rosenberg, a Stanford professor of the history of technology, and L.E. Birdzell, a lawyer, have collaborated to produce a book with certain subtle differences.

To begin, Rosenberg and Birdzell stress the geographical factors. The Europeans often trailed the Chinese in inventiveness, but the Chinese mandarinate was self-satisfied, thinking China, as the center of the world, had all it needed without building up foreign commerce.

Europe, on the other hand, was fragmented, a big peninsula that had its own smaller Scandinavian, Greek, Italian, and Spanish peninsulas, plus the British Isles just off the northwest coast. Water travel by sea and river between the fragments was easy. After the collapse of the western Roman Empire nobody, not even Charlemagne, was able to put the fragments together politically.

The feudal system resulted in attempts to sustain local autarchies, with all production centered on the manor, but there was always the question of the need for raw materials (iron for the soldier's armor, for instance), which meant that there had to be trade. The disintegration of political authority into the hands of often quarreling local barons resulted in many modes of travel and warfare. European pluralism came before capitalism. The necessity for trade called forth the early towns, a prerequisite for supplying needy barons and kings. The medieval church frowned on interest and had ideas about the "just price," but the traders in the towns were irked by limitations that affected their buying and selling. So the market system came into being, with free pricing replacing the fixed "just price."

Fad, Fashion, and Fascination

The market called for inventiveness. But Rosenberg and Birdzell warn their readers to beware of any direct causal relationship here. Their point is that man is curious and seeks knowledge for its own sake. In a time when agriculture was the occupation of the great majority, there was no special need for clocks. Planting and reaping were done by the sun. Nevertheless, horology became an early medieval fad. The making of clocks and watches, status symbols at the beginning, called for extreme mechanical ingenuity, which came long before the industrial revolution. One must allow economic need to include fad, fashion, and fascination with

complex mechanisms if one is to sustain the ordinary pattern of causal relationship of economic need to technological response.

Marx and Engels saw history as the displacement of one class by another. There is truth in this, but Rosenberg and Birdzell offer proof that the process is normally devoid of revolutionary sharpness. In England the landed aristocrats, who often had coal beneath their sheep runs, simply became part of a new *haute bourgeoisie*. And, working backward, the self-made bourgeois manufacturer often used his profits to buy his way into the landed classes. Where there is such an interchange, and with labor getting eighty or even ninety per cent of the gross national income anyway, there isn't much likelihood of sharp changes in modes of governing.

The steam engine made a great difference in modes of production, however. But even here Rosenberg and Birdzell insist there was a cushioning process. They tell us that the shift from cottage industry to factory production did not require the accumulation of vast quantities of capital. Arkwright's first Cromford mill was insured for only 1,500 pounds. Multi-story spinning mills were to come in due time, but the early factory owners had twenty years of often big profits behind them and hence no need for savings squeezed out of reduced consumption to extend their investments. It was true that consumption suffered in the early years of the industrial revolution, but this was because of the Napoleonic wars. The early factory workers in England had to scratch for housing because timber couldn't be imported from Scandinavia.

Rosenberg and Birdzell find it peculiar that some two hundred years elapsed between the time of Galileo and the full use of advanced scientific knowledge by industry. Most of the inventiveness of industry before 1880 came from skilled artisans who often lacked college educations. Henry Ford and Thomas Edison were simply inspired amateurs from the orthodox scientific point of view. Today, of course, industry is always ready to hire inventive scientists away from their universities.

When it comes to opening new perspectives *How the West Grew Rich* is a first-rate job. But it would have benefited from good editing of its often extremely redundant style. □

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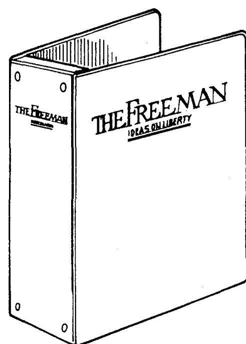

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