# Some Disturbing Inhibitions and Fallacies

# in

# CURRENT ACADEMIC ECONOMICS

by

HARRY GUNNISON BROWN

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*by*

HARRY GUNNISON BROWN

*author of*

*The Teaching of Economics,*
*Basic Principles of Economics,*
*The Economic Basis of Tax Reform,*
*Fiscal Policy, Taxation and Free Enterprise,*
*The Economics of Taxation, etc.*

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# Some Disturbing Inhibitions and Fallacies
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# CURRENT ACADEMIC ECONOMICS

If there is occasionally a teacher who is eager to present the subject fully and fairly, he is quite likely to be limited in his opportunities of doing so by the prejudices of colleagues. Texts are selected and assignments arranged which all must use and follow. Dull and, from the point of view of the general welfare, *relatively inconsequential* topics are dwelt on for weeks. . . . . . . . . . . . . . . . . . . . . . . . . . . . *The situation is much as it would be in a college of medicine if the lecturers on cancer and on rabies were forced to devote their time chiefly to the subject of poultices and dressings and were allowed hardly any time for the explanation of surgical techniques, radium and X-ray treatment, and vaccination.* Thus, in economics, because important truth is denied or ignored, the students—and the public—are cheated. . . . . . . . . . No amount of money spent from the income of large endowments, to hire instructors or "tutors" to stimulate discussion in dormitories or other small groups, can compensate for leaving out of the work in economics *the most exciting and vital topics on which it can shed light.*

*If communism—or socialism*—and the incident regimentation *should win*, in the United States, in Western Europe, in China and elsewhere, *over the present caricature of free enterprise*, those professorial economists whose economic philosophy has contributed to make our economic system such a caricature cannot be held free of all responsibility for the system's ultimate collapse. For "capitalism" is indeed under heavy attack in a large part of the world. And the college graduates our economics professors have taught are but poorly armed against the bombardments of communist and socialist ideology, when they can oppose the optimistically idealized programs of the "planners" with nothing better than this caricature of what capitalism could be at its possible best. *Why have they not been shown the intriguing blue-print of a free private enterprise system clearly worth fighting for?*

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# The Challenge of Australian Tax Policy

## *Can Professional Economists Continue to Ignore Experience with Land Value Taxation?*

*I will not insult my readers by discussing a project [land value taxation] so steeped in infamy.*

Francis A. Walker

I

A series of articles published in the last few years in the Australian magazine, *Progress*, by A. R. Hutchinson of Melbourne, focuses attention upon studies made by the Land Values Research Group, of which Mr. Hutchinson is Director of Research. The conclusions to which these studies seem to point are almost precisely those which the very few professional economists seriously interested in the taxation of land values would have expected. Nevertheless, to the majority of American economists, these conclusions and the supporting data may come as a surprise. It might be well if such economists would seek to familiarize themselves with the data. In large part, Mr. Hutchinson's articles have been republished in a thirty-two page booklet entitled "Public Charges upon Land Values"[1] and in two folders entitled, respectively, "Housing the Nation" and "Rating Land Values in Practice—Results in Greater Melbourne." These reports will be dealt with here as a unit.

Hutchinson classifies the Australian states into two groups based on the proportionate burden of taxes on land values. The first group of states consists of Queensland, New South Wales, and Western Australia. In all of these, local real estate taxes are, in general, levied on *land values only*. Land-value taxes in Queensland take for the public, he estimates, more than half (54.5 per cent) of the annual rental value of the land; in New South Wales nearly a third; in Western Australia about a sixth. (In Western Australia, though the rural areas tax mainly land values, the municipalities tax land and improvements equally. Besides local taxes there are, in most of the states, state land taxes; but these taxes Hutchinson considers relatively unimportant because in several of the states they are paid only by lands above a certain value and because they raise so much less revenue than do the local taxes.)

[1] Melbourne (Published for the Land Values Research Group by the Henry George Foundation of Australia), 1945.

The second group of states includes South Australia, Victoria and Tasmania. In these states, local taxes are levied, generally, without distinction between land and improvements, although "some of the districts in South Australia and Victoria rate upon the land value basis," *i.e.*, tax only the unimproved value of the land. *In Tasmania, none at all do so.* All districts in Tasmania and most in South Australia and Victoria "rate upon" (that is, levy taxation upon) what is called "the annual value basis" of land and improvements together.

Between 1929–30 and 1938–39 the area under all crops increased in the first group of states by 21.5 per cent and *decreased* in the second group by 7.6 per cent. The increase was greatest for Queensland (65.8 per cent), next for New South Wales (22 per cent) and last for Western Australia (3.4 per cent). The decrease in the states not taxing land values (locally) as such was least for South Australia (4.9 per cent), greatest for Victoria (10 per cent) and nearly as great for Tasmania (8.4 per cent). During the same period the "area under wheat for grain" increased in Queensland by 117 per cent, in New South Wales by 17 per cent, and decreased in Western Australia by 4.4 per cent, the average increase for the three land-value taxing states being reckoned as 9.9 per cent. For the other group of states the *decrease* averaged 19.2 per cent and ranged from a decrease of 15.5 for South Australia, through 22.8 for Victoria, to 41.5 per cent for Tasmania in which *no* local district or governing area taxes land values as such.

The author considers next, data in regard to the construction of dwellings between 1921 and 1933. He finds the number of new dwellings constructed per one hundred marriages to be 74 in the land-value taxing states and 59.3 in the other (the "annual value rating") states. Each state in the first group had more building than any state in the second group. Tasmania, with *no districts at all* "rating on unimproved land values," had only 29.7 dwellings per hundred marriages during this period, less than half as many as the next lowest state in the group. However, Western Australia, in which land values are taxed less than in either Queensland or New South Wales and which does have, as we have seen, a much poorer record than those states as regards increase of area under crops, appears to have a somewhat better record in dwellings constructed per hundred marriages.

Hutchinson does not state whether this better record in Western Australia is confined to *rural* districts, although the fact that the municipalities of this state do not have a land-value tax system might lead one to expect



such a result. But his figures on the degree of improvement of land do indicate that, as of 1939–1940, the "ratio of value of improvements as percentage of unimproved land value" in the case of country land was higher in Western Australia as compared to this ratio for city land, than in any other Australian state.

Attention is called to the fact that those districts in South Australia and Victoria which do tax land values as such "are the districts which contributed most to their states' better showing than Tasmania." Thus, in Victoria, "although at the 1921 census only 16 per cent of the state population was in the fourteen districts rating land values, these districts accounted for 46 per cent of the total increase in dwellings for the State between the two census years." And "evidence submitted to the Commonwealth Housing Commission in South Australia showed that dwelling construction in the districts rating land values in that state was markedly superior to that in the districts rating Annual Values," *i.e.*, taxing land and improvements at equal rates.

But Hutchinson is not satisfied with this rather general conclusion. He wants to compare cities or districts which are, as nearly as possible, similar in location advantages and type, except that some "rate on land values" and others do not. He suggests that "In many respects these comparisons may be more reliable than interstate comparisons of development since the comparisons are not complicated by different political policies which may exist in the states." Also, he notes that "It would be absurd . . . . . to compare development of the business centre of the city with a perimeter district." So he selects, first, mixed industrial and residential cities which do and which do not rate on land values, that are in the Greater Melbourne (Victoria) area and about equally distant by rail (five miles) from Flinders Street Station in Melbourne. These cities he classifies as in Zone 4. Next he selects cities further out from the Melbourne business center (seven miles), some rating on land values and some not, and all residential, which he classifies as in Zone 5. And, similarly, he classifies cities still further out (nine and a half miles) and entirely residential, as in Zone 6. Since in Zones 1, 2 and 3 there are no land-value taxing cities, Hutchinson's study is perforce confined to Zones 4, 5 and 6.

Comparing the cities in Zone 4 which tax land values and not improvements with those which tax both, he finds that the number of dwellings constructed per acre available, in 1928–1942, was more than 50 per cent greater in the former than in the latter cities. In Zone 5, he found the

number of dwellings in proportion to the acreage available to be more than two and a third times as great in the unimproved land value taxing cities as in the others. For Zone 6, he found it to be twice as great.

The *value* of *all* building per available acreage was, during the same period, in Zone 4, 40 per cent greater for the land value tax cities; in Zone 5 it was 140 per cent greater, almost two and a half times as great, and in Zone 6 it was 134 per cent greater.

Hutchinson remarks in regard to an alleged shortage of houses in Victoria of 40,000, that "if these ten cities in Melbourne which do not now rate on land values had been rating on that system and showing the same building figures per acre as the districts now rating on land values, instead of the 41,293 houses which were actually built there would have been 88,000 built. In other words there would be 46,700 more houses in these districts alone."

The change in holdings of vacant land in 1939 as compared to 1921 is noticeably different in the unimproved land value taxing cities and the others. In Zone 4, the decline in vacant holdings in the land value tax group was 57 per cent as against 30 per cent for the other group. In Zone 5 it was an 8 per cent decline as compared to a 50 per cent increase. In Zone 6 there was an increase for the only land value tax city on which data could be secured of 74 per cent, as compared to an increase for the only annual value rating city on which data could be obtained of 243 per cent. These increases the author attributes to speculative development of holdings previously agricultural. But the per cent increase was less than a third as great for the land value tax city as for the other. Perhaps it is a fair guess that the policy of taxing more heavily the value of land operated to prevent the waste involved in taking well situated land out of agricultural use years before it would be needed for urban uses. Perhaps one can fairly surmise that less adequate taxation of the value of land operates merely to have most of it held during these years in the form of vacant lots.

Coming back to a comparison of the states, we note that the ratio of the value of improvements to unimproved land values in 1939–40, was 151 per cent in the land value rating states and only 79 per cent in the others, and that it was decidedly highest (198 per cent) in Queensland, where the land value tax is highest. Furthermore, the average total value of improvements, for each land taxpayer in the states rating locally on land values, was fully twice as great as in the other states and was greatest of all in Queensland.



Land value taxation has been sufficient in Queensland so that the sale value of land per head of population actually declined 16.7 per cent between 1901 and 1937. In each of the other two locally land value rating states, it has risen by 11.5 per cent. In South Australia and Victoria, where, in general, districts do not rate on land values, the value of land per head of population has risen by 44 per cent and 77.5 per cent respectively. In Tasmania, however, the corresponding rise is given as only 4.8 per cent.

Another comparison Hutchinson makes is of the average income in the land value taxing states compared with the other states, received by non-property owners having incomes high enough to require them to submit a Commonwealth income tax return. The figures here were only slightly favorable to the land value taxing states, but the author shows that the proportion of persons receiving these higher incomes is considerably greater (40 per cent greater) in the land value taxing states.

Comparing money wages in factories paid in the first group of states with those paid in the second, he finds them larger in the first group, and larger in purchasing power.

Mr. Hutchinson's figures show, also, a considerably larger increase in value of plant and machinery in factories in the first group of states than in the second. In two of the second group there were actual decreases.

"One of the most delicate tests of whether conditions are favorable or not in any country," says Hutchinson, "is the flow of migration. If more people are coming to that country than are leaving it we may be sure that the new citizens regard the prospects in their new home as better that those in the land they are leaving. Conversely, when departures exceed new arrivals, it must be regarded as an ominous sign in the development of any state."

The data show a net migration into the land value rating states between 1929 and 1938, per 1,000 of the 1929 population, amounting to 8.8, and an outflow from the other states averaging 10. The inflow for Queensland, the state with the highest level of land value taxation, is the greatest, 16.5. *All of the other states* (the "annual value rating" states) *show an outflow.* For Victoria this is slight. For both South Australia and Tasmania it is considerable, 29.1 per 1,000 and 15.5 per 1,000 respectively.

No doubt it can be questioned whether conditions in the two groups of states are sufficiently similar to make the conclusions reached, purely from the data given, wholly reliable. Some critical readers may question

whether, despite the care taken by the author of the studies to select only cities similarly situated, even the conclusions drawn from the data on cities in the Greater Melbourne area should be taken seriously. But certainly the data presented, *pointing with almost complete,* if not complete, *consistency in the same direction,* make a sufficiently good *prima facie* case so that it would seem *inexcusable* for any professional economist *to refuse to examine carefully* and without antagonistic prejudice *the theoretical argument* for land value taxation. And in view of the seeming great advantage of the land value tax policy, there would appear to be little excuse for the failure of many economics teachers to present the relevant facts and theory clearly and with some completeness to their classes. Yet scarcely ever, in the economics courses at American universities and colleges—even in the course in Public Finance—is the theory of the subject—or any such relevant data—presented to students adequately, so that any considerable number of them get any appreciable understanding of what land value taxation can accomplish or why it can accomplish it. *Frequently neither the teacher nor the textbook mentions the subject at all,* —or they mention it only to make a few brief and unanalytical derogatory comments on it.

II

Land value taxation, if sufficiently high, makes it utterly unprofitable to hold good land out of use. It increases, therefore, the amount of land offered for rent or for sale. It lowers the rent of land and thus reduces for tenants the cost per month or per year of housing.

By making more good and well situated land available, land value taxation increases the productivity of labor or of labor and capital both. It thus tends to raise wages. And insofar as it makes possible the abolition or even the reduction of commodity taxes and other taxes resting largely on wage earners, workers are still further benefited.

Heavy land value taxation would make possible the abolition, among other taxes, of taxes on real estate improvements, on livestock, on machinery, etc. Thereby it would definitely increase the net per cent return on capital investment. This would almost certainly cause an increase of saving, and so of capital. But even if saving were not thus promoted, such a tax system would inevitably cause savings made in other communities to be invested more largely in the land value tax community or communities. And the greater amount of capital in any such community or communities would mean that labor could be and would be



better equipped with capital *as well as* better provided with good land. Thus there would be *two* reasons for a *greater productivity of labor* and *higher wages.*

For all these reasons it is easier for a tenant to become an owner of land. *The rent he has to pay while he is a tenant is lower. His wages are higher. From these wages less is taken in direct taxation of his income or in taxation of the goods he must buy. He can save more easily. If he does save and invest, his net per cent return from capital, thus untaxed, is greater and this further increases his ability to save. The price of land is lower.*

Some writers have contended—for example, Prof. Lewis H. Haney[2] and, apparently, Prof. Willford I. King[3]—that, though the price of land is lower, the tax which the owner must pay on it annually is higher and that this offsets for him the advantage of being able to purchase it at a lower price.

But such writers consistently and persistently overlook some very important points. They overlook the great reduction—and it might be even the abolition—of many or most other taxes. They overlook the lower rent of land, consequent on the forcing of good unused land into use. They overlook, therefore, the fact that, even if the land value tax takes *all* the rent, this tax will nevertheless be lower for the ex-tenant owner than the rent was previously when he was a tenant. They overlook the fact that the (marginal) productivity of labor is higher, so that more of what is produced from the land is wages ("imputable" to labor) and less is rent ("imputable" to land). They overlook the effect of the land value tax system in increasing the amount of capital in the community or communities adopting the system, thus further increasing the productivity of labor and the wages of labor. And they overlook the effect of a higher net interest rate on capital, along with the lower land rent from forcing speculatively held land into use, in reducing the sale price of land by *more* than the capitalization of the tax at the old (and lower) interest rate. In short, *there are serious gaps both in their appreciation of the relevant economic facts and in their comprehension of the relation of these facts to the appropriate mathematical calculations.*

Obviously, the most ideal system of taxation would hardly suffice to

[2] In his "Value and Distribution," New York, Appleton-Century, 1939, pp. 736–7.

[3] "The Single-Tax Complex Analyzed", *Journal of Political Economy,* Vol. XXXII, No. 5, October, 1924, p. 609. Dr. King mentions the point herein criticised, as something that "a captious critic might assert" and perhaps he does not mean himself to assert it; but he seems to be seeking to make sure that the reader will see it stated and he does not offer any refutation of it. One must perhaps judge his meaning and intent from the general tone of his article.

bring as much productive activity and agricultural and manufacturing development in the Sahara desert as might come to a region highly favored by nature, even though the latter has a very bad tax system. But do not the Australian data which have been summarized herein, re-enforce the argument from theory? And does not the theory—which has long since been well and rather thoroughly worked out, even though various economists of reputation write as if they did not at all understand it—make the figures presented by Hutchinson seem entirely credible?

Yet teachers of economics continue to stress "the ability theory" of taxation and, in lesser degree, what they are pleased to call "the benefit theory" and appear to have, usually, no appreciation of the overwhelming advantages to a community or a nation, of making the annual rental value of land the first source and, in so far as reasonably possible, the chief source of taxation. The truth is, despite the sniping of an antagonistic economics professoriate, that, certainly within the limits of what a tax taking substantially all of the annual rental value of land would yield, such a tax would be *more advantageous even to propertyless wage earners* of small income, *than the most drastically progressive tax on earned incomes or on all incomes together,* and this *even though such drastically progressive income tax were to take nothing at all from such wage earners.* Then *why* should any economics professors plume themselves on their "liberalism" when they are putting chief emphasis on the "ability theory"? And how can they think of themselves as sympathetic toward the ordinary worker, when they persistently refuse to present fully and fairly to students who would eagerly listen, the demonstrable advantages of and the convincing arguments for such land value taxation? Or *are ambition, hard work, efficiency, and the willingness to save and invest,* so *deserving of punishment* that we should tax them *in preference to* taxing land values, *although the latter tax policy is better even for average and below-average propertyless wage earners!*

Is it, perchance, regarded as academically more "safe," or less "radical," for economics professors to emphasize a tax system that goes a considerable distance toward the Marxian ideal—"from each according to his capacity, to each according to his need"—than to emphasize land value taxation, *which is of the very essence of a truly self-consistent philosophy of free private enterprise?*

But perhaps most living economists, just because they have been trained by a generation or generations that rejected Henry George, have no real understanding of the land value taxation policy and feel under no



necessity to acquire such understanding. Perhaps they mislead their own students, and readers, because they are so smugly confident, though they have never thought it necessary to examine it objectively and thoroughly, that the land value taxation case is utterly mistaken.

Meanwhile, not a few business leaders are constantly seeking to get taxes on property-in-general and on the larger incomes, reduced by substituting taxes that burden more heavily the smaller incomes and the purchases of the relatively poor. Instead of urging a really significant reform based on fundamental principle, their interest appears to be merely the getting of taxes off of their own large incomes and thereby increasing the burden on the recipients of smaller incomes. *What wonder if the propaganda of such business leaders is greeted by common folks with lifted eyebrows or even with jeers! Such propaganda is hardly the way to make the system of "capitalism"—the private enterprise system—more attractive to the masses. Nor is it an effective way to inoculate them against the virus of communism!*

The basis of the case for the public appropriation of most or nearly all of the annual rental value of land by taxation, is the fact that geological forces, not men, made the earth, and the further fact that the location advantages of land, in so far as they result from human activity, are a by-product of the activities and choice of habitat of many millions of human beings. They are not produced by one man or a few men.[4] But capital—buildings, machinery, locomotives, livestock, planted fruit trees, ships—can be brought into existence only through work and saving.

There is a related distinction between the two kinds of income stemming from these two kinds of property. In the case of capital which one's own work and saving have made possible, and *without which the capital would not be in existence,* the income the owner receives comes to him from the added product of industry which this capital makes possible and which, therefore, is in no sense abstracted from others. In the case of natural resources and valuable city sites, the facts are far otherwise. When, for example, geological studies and investigation and (perhaps) actual drilling show clearly that there is oil under a particular tract of land, oil which the landowner did not put there, which the landowner did not find, and which the landowner does not help to get, the royalty (rent)

[4] This point I have discussed more thoroughly, and with due reference to minor qualifications, in some of my books. See "The Economics of Taxation," New York (Holt), 1924 (reprinted by Lucas Brothers, Columbia, Mo., 1938), Chapter VIII, § 2. See, also, "The Economic Basis of Tax Reform," Columbia, Mo. (Lucas Brothers), 1932, Chapter IV, § 6, and "Basic Principles of Economics," Second Edition, Columbia, Mo. (Lucas Brothers), 1947, pp. 264–5 and 351–3.

which he receives comes to him merely for *permitting* others to withdraw the oil. Similarly, when, as has happened, the growth of the tributary territory makes it important that millions of people live on and near New York Harbor in order that the world commerce on which all of us depend may be most effectively carried on, this means that the owners of New York City land are in a position to secure hundreds of millions of dollars a year merely for *permitting* men and women to work and live where the rest of us need to have them work and live in order that our wants may be adequately served. The difference between receiving income from capital which, without work and saving, would not even be in existence, and receiving income because one is in a strategic position to forbid others the use of a part of the earth which has been made desirable because of geological forces or community growth and development—*this difference is fundamental and profound.* What shall we say of learned professors of economics in whose economic philosophy—and in whose teaching and textbooks—it has *no place at all?*

Francis A. Walker, a teacher and writer of economics who was a contemporary of Henry George, referred to George's "practical proposals" as "this precious piece of villainy"[5] and concluded his discussion of them with the statement: "I will not insult my readers by discussing a project so steeped in infamy." Can it possibly be that contemporary teachers of economics who can find no classroom time for the consideration of any tax reform which goes even the tiniest bit and by the tiniest steps in the direction of relatively increased taxation of land values, are reacting similarly?

In the United States there have been not a few changes in tax rates and tax policies. But *no other change or proposal for change,* so far as I am aware, *has ever stirred any college or university teacher of economics to language so denunciatory.* In those cities, districts and states of Australia that now "rate on unimproved land values," *the dominant sentiment has obviously not been that the one change in taxation which is most superlatively sinful is a change in the direction of taxing land values more while abolishing or reducing other taxes.* Possibly these Australians *do not feel* that "society" has made a *perpetually binding* "pledge" to all owners and to-be owners of land, *never* to levy *any heavier taxes* on them *than have been previously levied!* Therefore, the proposal to change taxation in this particular direction, *could be discussed reasonably* and

[5] "Political Economy," New York (Holt), 1887, p. 418. (The text reads ". . . *price* of villainy," obviously a typographical error.)



*with due consideration for its probable consequences* on community progress and welfare.

Few—if any at all—of the economics teachers and writers who follow Francis A. Walker in this matter, have read Henry George's book, "A Perplexed Philosopher,"[6] Chapter XI of which is devoted specifically and most effectively to answering this sort of objection. I have myself discussed the matter in a number of publications[7], directing attention especially to such questions as

(1) What is the *nature* of "society's" supposed "pledge"?

(2) Just *what* members of "society" are thus under "pledge"?

(3) Are the *victims* of a bad economic or social institution to be considered as under a binding "pledge" *never to seek* to change the institution from which they are suffering, except as they, the victims, reimburse the beneficiaries of the system for the latter's loss of their favorable position?

(4) Are the victims of such an institution under such an ethically binding "pledge," as being a part of "society," even if they never consented to the institution understandingly but only through the influence of the propaganda of its beneficiaries,—and even if they never consented to it at all but opposed and protested against it?

(5) Are the victims of such an institution likewise under a "pledge" not to change it without paying to reimburse its beneficiaries, even if the institution was established before they were born but was ignorantly—and perhaps only tacitly—consented to by some of their ancestors, *i.e.*, are the present victims "responsible" for it when their "consent" to it, if ever given at all, was given only vicariously?

(6) If the institution under criticism happens to be slavery and such victims are slaves, would it then be a sinful act for them to run away without reimbursing their owners for the loss (since some of these owners may have *bought* their slaves) of their invested savings,—or, if strong enough, to *abolish* slavery and their own servitude without contributing to the reimbursement of these owners?

To the best of my knowledge and belief—and I have checked on a good many of them—none of the economists who follow the lead of

[6] This book is currently available from the Robert Schalkenbach Foundation, New York.

[7] "The Economic Basis of Tax Reform," especially, Chapter IV, §§ 7 and 9; "Fiscal Policy, Taxation and Free Enterprise," also printed as Part I of "A Postscript and Questions," Columbia, Mo. (Lucas Brothers), 1946, Chapter VII; and "The Teaching of Economics," New York (Schalkenbach Foundation), 1948, Chapter IV.

Francis A. Walker in this matter has shown any sign of having *really* faced, *ever*, these questions.

Economics teachers who are not so completely convinced of the rightness of F. A. Walker's point of view as to know in advance that further study of the matter is useless, might take the trouble to consult one or more of the publications referred to above!

In view of the frequent and numerous changes that have been made in taxation policies and tax rates, as well as in other economic policies, why should it be assumed that those who may have purchased *land* have made *their* purchases on an implied—and morally binding—"pledge" that the tax rate on land, as compared with other taxes, shall *never* be increased!

When, in 1913, the Pennsylvania legislature established the Pittsburgh (and Scranton) graded tax system, it provided that the city tax rate on buildings should become, in 1914, only 90 per cent of the rate on land; that in 1916 it should be 80 per cent; in 1919, 70 per cent; in 1922, 60 per cent, and in 1925, 50 per cent. This meant that to get the same revenue for the city, the tax on land values had to be gradually raised. If this gradual change had been continued by corresponding stages until 1940 and applied also to the taxes levied by other taxing authorities, such as the county and the school district, all taxes on buildings in Pittsburgh (and Scranton) would have been then done away with. Had a comparable policy been followed throughout the entire United States, or even any large number of the states, the land value tax rate would presumably be high enough by now in the territory so affected, to absorb for public use the greater part of the situation rent of land.

Did the Pennsylvania legislators, then, in passing this law in 1913, commit a *sinful act?* Was the passing of this law, *unlike* or *beyond* any *other* of the *many* taxation changes that have been made by our various legislative bodies, a "precious piece of villainy" and was its mere proposal "a project . . . steeped in infamy"! If not, how shall we account for the psychology of those professors of economics who seem able to accept with apparent equanimity all sorts of policy changes—some of them certainly unwise and wrong—but who greet any proposal looking to the eventual establishment of a land value tax policy with denunciation?

In any case, is not the expressed opinion of various economics professors that "society," which makes frequent changes of policy in other matters and frequent changes in tax policy and in rates of taxation, is nevertheless under a binding implied "pledge" *never* to move, *even by the most imperceptible steps,* in the particular direction urged by Henry



George and already followed for some distance by Queensland,—is not this opinion *utterly silly?*

Some of the pronouncements of distinguished economists from our best known universities suggest that their failure to explain the land value tax program and the effects it would produce—which it apparently does produce in (for example) Queensland, Australia—to their students, could, possibly, be due to their not understanding it themselves. This, in turn, could be because the economics teachers *they* had in *their* student days had no interest in explaining it and so these contemporary teachers never had occasion to study it or to learn anything about it.

In an article in the November, 1939 issue of *The Atlantic Monthly,* "Business Looks Ahead," Prof. Sumner H. Slichter of Harvard University writes of high real estate taxes as an "important obstacle to cheap housing." He refers to the Detroit Bureau of Governmental Research as estimating the rate of real estate taxation in 274 cities as "about 25 per cent of rent or rental value." This, he says, means that "the present real estate taxes are equivalent to a 25 per cent sales tax on shelter," and he urges that sources of local revenue should be "broadened" so as to "make it possible to cut real estate taxes in half."

Professor Slichter ought to know—but I suppose it is highly doubtful whether any of his teachers in his student days ever explained the matter to him, and apparently he is not conscious of any vacuum in his understanding of it—that taxation of land values does not have the same effect as taxation of buildings and other real estate improvements. He ought to know that to cut in half the part of the real estate tax which rests on land values would make land rents and land values higher rather than lower. The theory of the subject is clear and convincing. The data from Australia cited at an earlier point in this paper certainly do not tend to support Dr. Slichter's views—unless his views are wholly different from what his words make them appear clearly to be. And if it be said that the particular data herein cited were not available to Professor Slichter when he was writing his article, it is still to be noted that the theoretical argument against him is unanswerable. It is unfortunate for the people of the United States that they can get no help from Dr. Slichter and others like him towards understanding what consequences land value taxation definitely tends to bring about and appears to have already brought about, to a considerable degree, in parts of Australia.

III

THE CASE OF DR. SLICHTER is not an isolated one. In my books I have subjected to analysis the confused pronouncements, antagonistic to the

land value tax reform, of more than a dozen of the economics professoriate. Economists who have discussed land value taxation in print may be interested in checking *to see if their names are on the list!* Other economics teachers, who may have feared to express sympathy for the land value tax policy because of a seeming weight of professorial authority against it, *may have their courage restored* after contemplating the warped and twisted economic "arguments" against this policy used by these "authorities." Let us hope that not forever, when land value taxation is mentioned, will there be the present tendency for economics teachers (by hasty disavowal) to *"scurry for cover" lest someone accuse them of being "single taxers" or "followers of Henry George."*

But at present, prejudice against the land value tax program is widespread among teachers of economics, *the very persons who,* more than any others, *should have a clear appreciation of its advantages.* A few do realize the desirability of moving in this direction. One of these, who had collaborated in writing a book in which an increasing land value tax was favored, told me in personal conversation that he had taken considerable "razzing" from colleagues because of it. Another sympathizer with the land value taxation program informed me that when, as a graduate student, he had indicated his viewpoint in the presence of one of his teachers, this teacher suggested to him that, as a young economist, he should be careful about committing himself to a view not generally approved in the profession. A third, after some experience in teaching and collaborative writing, confided to me that "economists seem to have closed minds on the subject." A fourth economics teacher told me that, when taking a graduate course at one of our distinguished universities, he made some reference to Henry George as an economist, to which his professor replied: "Well, if we call Henry George an economist."

It is true that Henry George was guilty of some errors of analysis. I shall refer later, in this connection, to his discussion of interest on capital. But in view of the logical errors I have pointed out in various articles and books, committed by economists rated among their fellows as the most distinguished, it would seem that those economists and all others who accept their alleged reasoning, cannot with propriety or common sense, from the glass houses of their own systems, "throw stones" at Henry George.

A student coming from another institution and enrolled in my course in Public Revenues, confided to me that one of his former teachers of economics, on learning that he was taking this course with me, inquired: "What do you want to take that for?" Then, referring to the land value



tax idea as "mediaeval", he said to the student, in relation to my course: "Well, don't pay too much attention to it."

A distinguished and respected economist who has done a great deal of valuable work in another field of economics, has more than once indicated privately to me real sympathy with this important reform. He explains that he does not express this sympathy publicly because, *in view of the widespread antagonistic prejudice on the matter among economists,* he fears that his own studies in the other field would become thereby discredited and of relatively little influence.

I shall make no attempt here to repeat analyses I have made elsewhere pointing to the fallacies and irrelevancies in the principal arguments used against the high taxation of land values. Not a few economists are still naïvely presenting their objections to this policy *without ever having investigated*—pretty generally, it would appear, *without ever having heard or seen*—the convincing *objections to their objections!* Hardly any of them are familiar with Prof. George Raymond Geiger's really brilliant study, "The Theory of the Land Question."[8] Probably very few of the new generation of economists have read more than a few pages of Henry George and, when they have, it is seldom indeed that they have gone beyond "Progress and Poverty" to read such incisive criticism of opposing contentions as is to be found in his book entitled "A Perplexed Philosopher." Yet as Dr. Geiger says with regard to the stereotyped objections constantly appearing in economics texts, "it is only fair to add that every one of these objections has been met by writers who, from Henry George on, have tried to break the wall of indifference and misrepresentation that so effectively surrounds this reform."

The arguments and pronouncements antagonistic to Henry George and the land value tax reform, to which I have called attention here and in previous publications and to which so many of the "big names" in American economics have been committed, *are certainly not indicative of intellectual discernment or of logical keenness and consistency!* Rather are they, in general, such arguments and pronouncements as would make one who had somehow slipped into committing them; who had, later, really made a clear, objective and logical appraisal of them, and who was at all sensitive to any judgement of an informed posterity, *devoutly wish he could expunge them completely and forever from his record, so that no one could see them ever again.*

If there has been no progress in the United States towards relatively increased taxation of land values, may not this be largely because teachers

[8] New York, (Macmillan), 1936.

of economics in most colleges and universities either "refute" the arguments for it—usually in a few sentences or, at most, three or four paragraphs—or ignore it? And few students, in these days of heavy reading assignments, go far afield to read anything their professors do not assign. How, indeed, would most of them have occasion to realize or to suspect that here is a subject very much worth studying? And so, among the numerous graduates of our institutions of higher learning, from whom our leaders in business, government and journalism are largely drawn, there are hardly any to whom the idea ever occurs to urge this reform.

At the University of Missouri we have many students who have done their first two years of college work elsewhere. *Almost without exception they have been taught nothing*—or next to nothing—*about this really fundamental and important reform* which, if either theory or the data we have from Australia mean anything, promises much in prosperity, and in hope for common folks, to any country that will adopt it. Are university and college students of economics *never* to have a reasonable chance to *learn anything about it in their college economics courses?* And then, if, *as a result* of such a condition, no movement for the public appropriation of the rental value of land or most of it, develops, will the economics professoriate adopt the added excuse that the reform is "politically impossible" here—notwithstanding what has been done in Queensland!—and therefore not worth while explaining to students? Will there continue to be *practically no chance to learn about it in college*—where, of all places, its study is most appropriate—so that college boys and girls will usually not learn anything about it unless they just happen to drop into one of the classes (taught as a labor of love by volunteer teachers who have other jobs to make a living) of the Henry George School of Social Science?

In an article of just a few years ago, "Capitalism in the Postwar World,"[9] Prof. Joseph A. Schumpeter of Harvard University undertook to give an analysis of the way certain forces, political and economic, threaten or may threaten the continuance of "capitalism." Among the influences he mentioned was heavy taxation which largely absorbs the gains of enterprise and investment. In this connection he referred to "burdens which eliminate capitalist motivation and make it impossible to accumulate venture capital, with risks of borrowing greatly increased." And in an appended footnote he went on to say: "High or highly progressive taxation of profits increases the risks of borrowing for purposes

[9] Chapter VI of "Postwar Economic Problems," edited by Seymour E. Harris, New York (McGraw-Hill), 1943.



of long-run investment, because it absorbs profits the accumulation of which might be counted on to take care of subsequent losses."

But why did not Professor Schumpeter call attention to the fact that a tax taking all or most of the annual geologically-produced and community-produced *rental value of land* definitely does *not* remove or at all weaken the motive to accumulate? Why did he fail to remind us that the more we take of this income which is *not* the product of individual work and efficiency, or of saving and investment, the more can other taxes be reduced and the less will be the "burdens which eliminate capitalist motivation"? Is it because he—and, perhaps, a considerable number of other economics teachers—really thinks it *desirable* to *"eliminate capitalist motivation"*? Or it is because, *after careful and unprejudiced study* of such evidence as is presented herein and such analysis as appears here and in the various publications herein referred to, he was thoroughly convinced that there is no case for land value taxation and no argument for it sufficiently plausible, even, to be worth mention? Or did he never have the theory of the question really explained to *him* by any of *his* teachers, so that it has never occurred to him to mention it?

In this connection it is appropriate to quote from a letter written to me just a few years ago by a university teacher of economics. "The thing that is both curious and amazing to me," said this teacher, "is that I could have attained a Ph.D., having gone, among others, to two state universities, without having been subjected to more than a few pages of literature, mostly derogatory, and without having spent more than five minutes of class time on Henry George's philosophy."

*Many textbooks* in the "principles" of economics—and some, even in public finance—*make no mention at all of the subject.* Indeed, the recent text on "The Elements of Economics" by Prof. Lorie Tarshis of Stanford University, does not have the word "land" or the word "rent" or the name of Henry George in the index. The publishers claim it is in use at Columbia, Harvard, Yale and other universities. The same statement can be made regarding "*The Economics of Public Finance*" by Prof. Philip E. Taylor of the University of Connecticut. Such cases remind one of the limerick which relates that

> A college economist planned
> To live without access to land
> And would have succeeded
> But found that he needed
> Food, clothing and somewhere to stand.

If there is occasionally a teacher who is eager to present the subject fully and fairly, he is quite likely to be limited in his opportunities of

doing so by the prejudices of colleagues. Texts are selected and assignments arranged which all must use and follow. Dull and, from the point of view of the general welfare, *relatively inconsequential* topics are dwelt on for weeks. Almost no time—if any at all—remains for a consideration of the question whether some men should have to pay other men for *permission* to work on and live on the earth in those locations where work is relatively productive and life reasonable tolerable. I know personally of one teacher—probably in some such strait-jacket—who stated that he was trying to work out a method of presenting the subject in a single class meeting. That amount of time is, of course, *utterly inadequate for real understanding,* all the more so because of the prevailing lack of comprehension of what is proposed and *the confused and confusing antagonistic arguments* that the students will have to meet. *The situation is much as it would be in a college of medicine if the lecturers on cancer and on rabies were forced to devote their time chiefly to the subject of poultices and dressings and were allowed hardly any time for the explanation of surgical techniques, radium and X-ray treatment, and vaccination.* Thus, in economics, because important truth is denied or ignored, the students—and the public—are cheated.

It may be—*and has been*—a matter for unfavorable comment in a book review, if an author devotes "too much" space (*i.e.,* barely enough to enable an average student to understand the cause and effect relations involved!) to land value taxation. But *never* have I seen *any* review of *any* textbook in the field of economics or public finance criticize the author for devoting *too little* space to the subject or *even* for devoting *no space at all* to it. I doubt if there has been, *ever,* any such review in *any* of the regular professional journals of economics. Is this because "that sort of thing just isn't done in the best circles"?

What *should* determine the amount of space, and of time, to be devoted to the theory of land rent and its taxation? As we have already noted, other taxes and tax systems cannot, so long as any considerable part of the annual rental value of land is left to private owners, be so favorable to productive efficiency and so advantageous to the well-being of the majority of the citizenry of a country as can taxation of land values. The proponents of other tax systems, however inadequate and incomplete they may consider the inductive data herein summarized on the effects of land value taxation, have never, so far as I am aware, presented any similar inductive evidence regarding the prosperity inducing tendencies of the taxes or tax systems they urge. The study of land value taxation and its relative merits makes necessary a thorough study of the theory of the production



and distribution of wealth and applies this theory to tax policy. Most certainly such a study can be used to train the student in logical analysis. And if it be argued that chief emphasis should be put, rather, on the study of the taxes and tax systems now actually in force in the United States and Western Europe, the answer is that *such a view completely misconceives the proper aim of university and college education for citizenship.* What our graduates should get, if they are to be intelligent and helpful leaders of public opinion, is such an understanding of cause and effect relations *that they can point the way to better policies than those of the past and the present* and can present cogently and effectively the reasons why such policies *are* better.

Or is it instead the proper function of the professors in our universities and colleges, *first* to find out what views are currently in favor, and *then make sure to indoctrinate their students with these accepted views!* Can it possibly be that this philosophy of the teaching of economics is the excuse for the current attitude of the economics professoriate toward the land question?

## IV

NOT LONG AGO, after I had sent to a well-known teacher of economics a reprint of an article discussing some techniques for the teaching of rent and taxation theory, I received an acknowledgement that concluded with a mild reproof. The mildly-chiding professor suggested that if my development of the subject were "part of a broader attack on other major difficulties in our economy perhaps a more sympathetic hearing would have been attained."

I have written books and articles dealing with international trade, tariffs and bounties, with transportation rates, with the problem of the regulation of the rates of and of the valuation of public utilities, with business fluctuations and price level stabilization, etc. My teaching has for many years put emphasis not just on one but on *various* reforms needed to make "capitalism" work more effectively and fairly to the common advantage. I had been under the impression that the fact of my having shown interest in, and participated in the discussion of, these other aspects of economic theory and economic reform might indeed help at least a little in drawing sympathetic attention to my presentation of the land value tax proposal. And then comes this letter!

If I have devoted relatively more attention to the land rent problem than to some others, this is partly because it is so fundamental—after all, *why* should we *not* raise questions about *who should have to pay whom* for *permission* to *work on* and *live on* and to use *the earth?*—and partly be-

cause the land value tax proposal *has been so shamefully misrepresented and ignored* by various members of the economics professoriate and *needs friends so desperately.*

The teacher to whom this subject makes a significant appeal as a teaching problem will not be wholly without reward. A recent letter from one such teacher includes the following:

> In my own college days I studied economics at — University, and like most students of the subject, found nothing of particular interest—certainly nothing stimulating—about the subject, as taught. Then I went to the — Law School, and went to Chicago to do law office clerical work. . . . During the three years I spent there before my entry into the military service, I stumbled across Henry George classes, and for the first time in my life I was able to see that there was some direction that could be taken by a person with a strong sense of the values of individualism and a strong sense of mission in life, even in a world like the one we were living in. More than four years in the army and now two years of post war adjustment have only postponed the performance of what I think is the most important thing in the world—helping people to do some straight sound economic thinking.

Let no reader conclude that, as Dr. Willford I. King contends, men like this "are not merely advocates of an economic policy but that they are a religious cult and that their intense devotion to their creed has little connection with logic or reasoning."[10] That is a *cliché* for which there is no sufficient justification. It is the *argumentum ad hominem* of writers who *cannot really answer* the arguments of those on whom they seek to cast discredit. I have myself had considerable contact with leaders and teachers in the Henry George schools in New York City, Chicago and St. Louis. I have found some of them to be persons of considerable learning and all of them mentally alert and eager to understand the cause and effect relations involved in this subject. Only last year I lectured to teachers of the parent Henry George School in New York City, on the theory of interest from capital, criticizing sharply the views of Henry George on this subject. My talk was received with, apparently, considerable approval. Later I wrote an article for *The Henry George News*, organ of the New York branch of the School, elaborating this criticism. Special pains were taken by the editor to see that this article was printed not only in the *News* but separately—some thousands of copies—so that it might be available for the use of teachers of the School in different cities. Professors of economics who echo after each other this and other *clichés* about those who have found sense in Henry George's teaching regarding land rent and good tax policy, simply do not know what is going on elsewhere

[10] "The Single-Tax Complex Analyzed," p. 612.



than in their own little group. When will they "snap out of" their coma?

It is my experience that students in the "principles" of economics (and in public finance, too) *are more interested in this part of the course than in any other part.* Individual students have informed me that they have heard about this topic as a part of the course and that they wanted to take the course especially for that reason. Any adequate presentation of this topic *reaches for fundamentals. It stirs discussion. It is dramatic. The students talk about it outside the class.* Only recently one of my best students told me that "the question of the land tax is *the most discussed question on this campus.*" *They endeavor to explain the theory of it to others* not taking the course. They *talk about it at home during vacation. Teachers who omit or "soft-pedal" this part of economics can scarcely hope,* if other things are at all equal, *to make their classes as interesting to their student customers.* No amount of money spent from the income of large endowments, to hire instructors or "tutors" to stimulate discussion in dormitories or other small groups, can compensate for leaving out of the work in economics *the most exciting and vital topics on which it can shed light.*

Recently a college teacher of economics told me that the economics students where he is teaching tend to accept "a mixture of Keynesian economics and traditional socialism." Other economics teachers, including one of considerable years and experience with whom I have discussed the matter, agree that this is probably a general condition in American colleges and universities. Certainly there appears to be reason to believe that in most of our institutions of college rank, students of economics who are inclined to social idealism—as many are—*tend toward one or another form of socialistic philosophy.* This, I believe, is *because they do not get,* from their courses in economics, *the vision they might get* of what a system of free private enterprise would mean to common folks, if it were so reformed as to make it *consistent with the principles appealed to by those who essay to defend it.* Such reform would, indeed, include much more than reform in our land and taxation system *but this it must certainly include.* There is tragedy in the fact that among those who have been lured into communistic activities, and even into betraying the interests of their own government to those of an alien power, are some *who followed communism because of their own social idealism* and who *might have been saved from this personal tragedy had the influence of our economics professoriate not been in the direction of discrediting and hushing up all serious advocacy of the public appropriation of the annual rental value of land.*

A land value tax policy would reward industry, efficiency and thrift. It would stop the waste of vacant land speculation. It would further ownership of land as against tenancy by those who use it. It would be better for workers as such, whatever their prejudices in the matter, than any other tax policy. *It would, along with effective anti-monopoly policy, the ending of special government privileges to various groups, stabilization of the dollar as the yard, quart and pound are stable, etc.,*[11] *conduce powerfully to strengthen the system of free private enterprise* ("capitalism") and *increase its attractiveness as compared with the regimentation of socialism to which we seem to be tending.* If our teachers of economics, *instead of rejecting,* as so many of them have done, the teaching of Henry George, had striven to make the important and relevant parts of that teaching understood, we might by now, through their influence and that of thousands of their students, be well on our way to the realization of this basic reform in full measure. Thus we would be *more prosperous, stronger should war threaten,* and with *the peoples of other countries looking too admiringly at us and our system to be greatly tempted by communism.* If our military leaders had ever had it adequately explained to *them* in their college days, *it might have been applied to occupied countries,* hastening their recovery from the ravages of war, making more distinct the advantages of free enterprise over socialism and communism and increasing our influence as against that of the communist states.

But this our professors of economics have not done. Instead, they have mostly sought, even when they have been willing to discuss the land question at all—*say for five minutes!*—to indoctrinate their students with an entirely different economic philosophy, inconsistent with and antagonistic to that of Henry George. And their influence has spread widely. Students have come from far countries to study at American universities and especially at the larger institutions, such as Columbia University. In these institutions students from the Chinese Republic, whose founder, Dr. Sun-Yat-Sen, was greatly impressed by Henry George's contribution to economics and wished to make some application of George's principles to Chinese taxation policy, have been indoctrinated with a contrary philosophy and have returned to China to teach this contrary philosophy in Chinese colleges and universities.

[11] If and when our economic set-up is reformed in all these respects, there will remain, still, the undeserved inequality that stems from the injustices of the past. Elsewhere I have discussed the possibility of mitigating this inequality by means of wisely graduated inheritance taxation; while yet not denying the natural and reasonable desire of men and women to bequeath from their savings to those near and dear to them who may survive them, and, therefore, not appreciably weakening the motive to save. See my "Basic Principles of Economics," pp. 453–7 or "The Economic Basis of Tax Reform, pp. 61–7.



*If communism—or socialism*—and the incident regimentation *should win,* in the United States, in Western Europe, in China and elsewhere, *over the present caricature of free enterprise,* those professorial economists whose economic philosophy has contributed to make our economic system such a caricature cannot be held free of all responsibility for the system's ultimate collapse. For "capitalism" is indeed under heavy attack in a large part of the world. And the college graduates our economics professors have taught are but poorly armed against the bombardments of communist and socialist ideology, when they can oppose the optimistically idealized programs of the "planners" with nothing better than this caricature of what capitalism could be at its possible best. *Why have they not been shown the intriguing blue-print of a free private enterprise system clearly worth fighting for?*

Were the great majority of the teachers of economics in the universities and colleges of the United States *convinced communists* desirous of *following "the party line,"* were the leaders of the party *in Moscow* seeking *to corrupt* capitalism into as poor a system as it could be made, in order that it might operate so badly as to *provoke revolution,* and had the communist leaders, for that very reason, given to all of these communist teachers of economics definite instructions either to *keep students from ever thinking about the land value taxation program at all* or to *cast discredit on it,* the situation as regards education of university and college students on land rent and its taxation could hardly be worse than it actually is. For with current trends and political pressures what they are and the current teaching of economics what it is, the people of the United States are unlikely to go along the path that Queensland has followed more than half the way, and, still less, to go further than Queensland has gone, thus reaping the advantages—and more—that Queensland has gained in considerable degree. Rather are we likely to follow the example of Tasmania and eventually, perhaps, do even worse. And how can anyone say that the teachings of our economists have and will have nothing to do with the result, unless he believes that this teaching has no effect whatever on the minds that are subjected to it?

It is of course difficult to assess individual responsibility when the mental pattern of most of the economics professoriate is so largely conditioned by the teaching of their predecessors, the economists of an earlier generation, and by the ideas and *clichés* current among their contemporaries. *But there is nevertheless a collective responsibility.* And so in a very real

sense, the failure of the economists in our colleges and universities, to make clear to their students the cause and effect relations involved in the land value taxation policy, is *a betrayal of the interests of common folks, who had a right to expect from these teachers a guidance they have not received.*

"Political economy," wrote Henry George[12] nearly three-quarters of a century ago, "has been called the dismal science and, as currently taught, *is* hopeless and despairing. But this, as we have seen, is solely because she has been degraded and shackled; her truths dislocated; her harmonies ignored; the word she would utter gagged in her mouth, and her protest against wrong turned into an indorsement of injustice."

What are the chances that, among the present (seemingly) "lost generation" of professorial economists, any considerable number will reject *the illogical teaching of so many of the prestige names* in economics? What are the chances that any of this lost generation will re-educate themselves to an understanding of the land question? What are the chances that any appreciable number of them will earnestly strive to give their students a fundamental comprehension of "capitalism" *and* of the nature and significance of the reforms—*including reform of the tax system in the direction pointed out by Henry George*—essential to its beneficent operation? Some of them *can* do effective teaching along this line *if they want to. Who* among them—*and how many*—*will really want to*?

And what are the chances that there will be, here and there, a department chairman, or a president of a small college, who seriously believes that students at his institution *ought to have the opportunity* to gain *real understanding of the case for this important reform*—as well as, in general, of the advantages of a system of free private enterprise so reformed as to be consistent with the principles commonly appealed to in its defense? What are the chances that some chairman—or president—will want to have, in his department of economics, *at least one* teacher *really capable* of giving and *interested* in giving such understanding? What are the chances that such a chairman—or president—will not only *strive earnestly to get such a teacher* but will see to it that the teacher has *full freedom and opportunity* for adequate oral presentation, reading assignments and class discussion of the problem—to the end that against *that* university or college, at any rate, the indictment levelled in this paper shall not apply?

[12] In "Progress and Poverty," New York, 1879, "Conclusion." The passage quoted is on page 559 of the Fiftieth Anniversary edition, New York (Robert Schalkenbach Foundation), latest printing, 1948.

- 2 -

# Taxation According to "Ability to Pay"

## *What It Means and What Is Wrong With It*

WHEN IT IS PROPOSED that the annual rental value of land, geologically produced and community produced, be made the first source of public revenue, those who are implacably opposed to this reform present a variety of objections. Among these is the contention that such taxation would operate to the relief of the owners of capital, such as buildings, and to the relief of the recipients of large salaries, and that both classes "ought" to be required to pay appreciable—even large—sums in taxes.

Before discussing at length the major principles involved, it may properly be pointed out that to appropriate most of the rent of land to community needs does *not* necessarily mean the abolition of all other taxes. We can, therefore, combine with such heavy land-value taxation, *if we want to,* especially heavy taxes on the largest salaries, even though these are fairly earned by skill and hard work, and similar heavy taxes on the capital (or the income from it) of those who have a great deal of capital, regardless of how hard they may have worked to acquire it. We can use the revenue from an increased land-value tax, *if we want to,* for the purpose of lightening the tax burden only on the incomes of those who earn *low* wages (or "salaries"), on the capital of those who have but *little* capital and on commodities (*e.g.,* cigarettes and goods subject to a general retail sales tax) which are bought in considerable degree by the comparatively poor.

Nevertheless, it is highly important to emphasize the fact that the economic philosophy of these objectors is altogether

different from that of advocates of the public appropriation, by increased taxes, of land and site rent. These objectors to the land-value tax program are little interested—indeed, one is inclined to believe that most of them are not at all interested—in the *source* from which the taxpayer's income is derived. They are much more concerned with taxing heavily *large* incomes, however fully and fairly earned by service given to those from whom the incomes, in the last analysis, are received than they are concerned with taxing incomes which are not earned at all by any service rendered in return. That some should be able to derive incomes by charging others for *permission* to work on and live on the earth, in those locations where work is relatively effective and life relatively pleasant, does not especially disturb them. What disturbs them is, rather, that some persons have appreciably *larger* incomes than other persons. And this appears to disturb them just as much when such larger incomes are received in return for equivalent service rendered as when they are purely exploitative.

I

PERHAPS IT WILL HELP to bring home to the reader the principle involved in this controversy if we suppose a country where there is private ownership of seas, rivers, lakes and air and where, therefore, a large part of the people have to pay rent to the owners of such "property" for the *permission* of the latter to *transport* goods on—and to row, fish or swim in—the seas, rivers and lakes and to *breathe* the air. Suppose, then, an effort to bring it about that the rents paid to use seas, rivers, lakes and air—which the "owners" never themselves brought into existence—should be the first source of public revenue and, therefore, used for the benefit of all. Immediately it is objected that this arrangement might relieve of taxation some persons whose incomes, though fully earned by the rendering of equivalent service in return, may nevertheless be larger than the incomes received by some of the poorer owners of sections of seas, lakes or rivers or some of the owners of small amounts of the country's air or some not very prosperous owners of very small lakes!



Such concern over the inequality of income resulting from inequality of contribution, together with comparative indifference to the problem of exploitation, is nearly identical with the attitude of those who urge charity to aid the poor but have no interest in *justice*. If, having understanding minds as well as sympathetic hearts, we were willing really to establish substantial justice—in the sense that incomes were received henceforth for services rendered and not through chicanery, monopoly, slavery *or* charging men for *permission* to use the earth—there would certainly be much less need for charity.

Those who express such great concern lest sizable *earned* incomes be somewhat relieved of taxation by making the rent of land a first source of public revenue are probably, in general, adherents of the "ability theory" of taxation. They believe that taxes "ought" to be levied on a basis of "ability to pay."

The idea of basing taxes on ability to pay grows out of the fact that a dollar has less significance to a person who has many dollars than to one who has few. To a person whose income is already large an additional dollar means only the ability to buy some inconsequential luxury. In the case of a person whose income is very small, on the other hand, the lack of a single dollar of it may mean deprivation of sufficient food, clothing or other necessity. The contention is made, therefore, that taxes on the larger incomes involve less "sacrifice" from the taxpayer than taxes of similar amounts on the smaller incomes and that taxes on the larger incomes should be greater.

But how much greater? So far, the notion that taxes should be based on "ability to pay" is vague. How much more "ability to pay" goes with a $50,000 income than with a $2,000 income?

Here we need to consider two somewhat divergent branches of the "ability" idea. One is that taxes "ought" to be so levied as to impose "equal sacrifice" on the different taxpayers. The other is that taxes should be so levied as to impose the *least aggregate* or *total* sacrifice.

Individuals differ in needs, tastes and desires, and so we cannot be certain that two persons of equal incomes will be undergoing equal sacrifice if they are equally taxed. However, it is evidently assumed by those who hold the "equal sacrifice" philosophy that for practical purposes we are not to bother with individual tastes and habits but only with differences of income and of relatively necessary expense (such as the expense imposed by dependents). Then, presumably, a rough guess would be made regarding "equality" of sacrifice. Such a guess might be, for example, that an annual tax contribution of $15,000 from a person with a $50,000 income involves a sacrifice "equal to" that imposed on the recipient of a $2,000 income by an annual tax of $10!

But the question inevitably obtrudes itself whether anyone, anywhere, at any time, has worked out or could possibly work out cogent evidence to show what *would* be "equality" of sacrifice. Might it *possibly* be the case that the phrase "equality of sacrifice" is just a slogan used to persuade an unanalytical public to accept the policy of those who use the expression?

But why should we want taxes levied so as to make the "sacrifice" of different taxpayers precisely *equal?* Is the word "equal," in this connection, anything more than a euphemism? Why not claim that the *amount* contributed



by different taxpayers should be "equal"? Or that each should contribute an "equal" per cent? Is there any reason from the point of view of logic, ethics or the welfare of the social group why the thing to be made "equal" in the case of different taxpayers should be their "sacrifice"? Indeed, why not make the "sacrifice" very *unequal* in order that the magic word "equal" may be applied to the net income remaining to taxpayers after tax contributions are subtracted? Is there, in short, any really *convincing* argument for having the word "equal" apply to sacrifice rather than to *amount of tax contribution* or *per cent* of income taken or *amount of income left* for individual spending, *except* that some economists *intuitively feel* that way about it? Are not some of our mentors, in fact, giving us a mumbo-jumbo economics?

If there is nevertheless some sort of case for taxing the larger incomes more heavily so that sacrifice between different taxpayers is "equal," may there not be a still more plausible case for so levying taxes as to produce the *least possible aggregate* sacrifice? In this view, if $15,000 has been taken in taxation from a $50,000 income and still more revenue is needed, whether $10 more or $100 more or even $32,000 more, this additional amount should still be taken from the $50,000 income *before anything at all* is taken from the $2,000 income. Indeed, even if $47,000 ($15,000 plus $32,000) has been taken in taxation from the $50,000 income, there still remains $3,000, and so a dollar still has less utility (or importance) to such a taxpayer than to the recipient of an annual income of $2,000. Therefore, if (say) another $900 is needed by government, there will be *less sacrifice* imposed *in the aggregate* if this, too, is taken from the $50,000 income, bringing the recipient's net income down to $2,100, than if it is taken from the $2,000 income. And likewise if still another $99 or even $100 is needed by gov-

ernment, less aggregate sacrifice will be imposed by taking it also from the larger income, reducing this to a net of $2,001 or $2,000, than by taking it from the smaller income of $2,000 and so reducing the smaller income to a net of only $1,901 or $1,900.

But what if the expenses of government do not require so much revenue and such high taxes as we have just been assuming? And what if, therefore, the recipients of the initially larger incomes still have more left, *even though they pay all of the taxes*, than have the recipients of smaller incomes?

The logical answer, from the point of view of one who favors taxation to impose least aggregate sacrifice, would be that, since additional wealth has greater utility to the recipients of the smaller incomes than to those whose incomes are large, *i.e.*, since their *need* is greater, therefore government should increase its levy on the larger incomes and spend the resulting additional funds mostly in providing services gratis for the needy. In other words, the only logical stopping place for the advocate of taxation according to least aggregate sacrifice is the communistic terminus of equal incomes for all,—or, perhaps, "from each according to his capacity, to each according to his need."

But any such scheme of taxation and public expenditure, it will be said, would largely weaken the motive to efficiency. If the more competent and efficient worker, who earns more by virtue of his superior efficiency, is to have all—or even the major part—of such additional earnings taken from him, is it equally likely that he will work thus efficiently? And is it equally likely that he will spend the time and effort to become thus competent? If the benefit of his extra effort is to flow, not to those of his own family, for whom his affection is presumably the strongest, but to the entire community



in larger tax revenues, is it humanly likely that he will feel the same incentive to effort? If to undergo an extended period of training for a difficult profession is to add little or nothing to the trainee's income, can we be confident that men will be as eager as now to undergo such training? Under the direction of Nicolai Lenin, even the communistically-minded Russian Bolsheviks abandoned their earlier communistic ideal of equality of incomes and began to pay more to the skilled and efficient than to the inefficient, the unskilled and the untrained.

But to say all this is to admit that "ability" or "sacrifice" should, at most, not be our only basis for the apportionment of taxes. And we may find, as we go on with our inquiry, that not only the matter of incentive to efficiency but also other important considerations have been and constantly are being overlooked or ignored by the tax theorists who prate so earnestly of comparative "sacrifice" and of "ability to pay."

## II

One consideration which certainly ought not to be overlooked is the possible effect of taxation on saving and, therefore, on the available total of capital. Inadequate capital means less and poorer equipment for a country's working force. It means lower productiveness of labor. And so, other things equal, it means lower wages.

If capital is very heavily taxed or if the income which it yields is very heavily taxed, there is at least some basis for doubting whether the amount of saving and, therefore, the amount of capital equipment will not be less. Certainly this possibility should not be completely ignored in planning a system of public revenue. If those who save are allowed to gain but a tiny share of the extra wealth the capital they have saved makes possible, they may have less motive for saving. And certainly the ability to continue to save and to save

increasing amounts, on the part of those who have acquired the habit of saving, is lessened by such a tax.

But even though some refuse to admit that taxation of capital may tend to reduce saving and investment and thus involve a decreased total amount of capital, there is still the question of the effect such taxation may have in reducing the available amount of capital in a particular state or nation. For if in one jurisdiction or state, capital is very heavily taxed, whereas in another jurisdiction it is taxed less or not at all, investors will certainly prefer, with other conditions anything like equally favorable, to send their savings for investment into the jurisdiction where capital is not taxed or is taxed but lightly. (If necessary to avoid future taxation on the income from such investment, they may themselves move.) For investors, like other men, *prefer more to less!* Thus the people in the state or jurisdiction where capital is heavily taxed may come to be less well provided with the capital needed for effective production.

What sort of economic "science" is it which bases its tax theory on intuitive slogans such as "equal sacrifice," which ignores the possible effect of taxation on thrift and the aggregate amount of capital, which ignores the effect of taxation in any given community in causing those whose saving makes capital possible to invest in *other* communities, and which ignores entirely any bearing taxation may have on the incentive to efficiency?

III

BUT THIS IS NOT ALL. Everyone who is acquainted with the facts knows that very considerable quantities of land are held wastefully vacant for years in the hope of a rise in the price at which they can be sold or, sometimes, in the determination not to sell for less than the potential seller has paid. This tends to crowding and slums in the cities, to lower productiveness of labor (*e.g.*, because much land near cities and, therefore, well located for truck farming and dairying, remains vacant and unused awaiting a hoped-for suburban residential use which may be delayed for decades or never materialize at all), and to various other wastes. Taxation according to "ability to pay" or according to any system of equal or least sacrifice means that these considerations also are altogether ignored. In fact, there is a tendency to commiserate with the speculative holder of vacant land and assess his property for taxation at a relatively lower per cent of its actual value than other property, despite his being a cause of waste and of loss to the community. "Poor chap!" it is said. "He certainly shouldn't be taxed much on his vacant land since he isn't making anything on it. He hasn't really much 'ability' to pay taxes on it."



But taxes ought to be levied with a view to *promoting the common welfare.* And a heavy land-value tax, as a result of which men *could not afford* to keep others—by high prices for land—from using land they themselves do not use, would definitely promote the common welfare.

Not rightly to be ignored, either, is the question of tenancy. High land-value taxation would make the price of land low. It would make possible great reduction in the burden of other taxes as well as increased productivity of labor and higher wages. The would-be owner of his home or farm could earn more, save faster and buy land far more cheaply. His rise from tenancy to independent ownership would be far easier. *And the social consequences of this might well be profound.*

Yet all this is entirely ignored by those who, when questions are raised regarding taxation and the tax burden, are able merely to mouth such phrases as "ability to pay" and "equal sacrifice."

"The educated classes," said a distinguished sociologist of

an earlier generation,[1] "are victims of the phrase. Phrases are rhetorical flourishes. They are artifices of suggestion. They are the same old tricks of the medicine man adapted to an age of literature and common schools."

The one tax which can be urged most consistently with a defense of "capitalism" (the system of free enterprise) is a tax which appropriates practically all of the annual rental value of land. Such a tax does *not* discourage efficiency. It does *not* penalize thrift and the construction of capital. It does *not* impose a burden on so-called "venture capital." It penalizes only the *interference* with production which comes from holding good land out of use.

The "system of free private enterprise," *if so reformed as to make it consistent with the principles on the basis of which it is commonly defended,* would be definitely preferable, I believe, to any system of regimented socialism. But the adoption of a socialistic economy seems *less unlikely* than it did only a few decades ago. And I am inclined to think that this is, in part at least, because most protagonists of our so-called free enterprise system do not really understand it and do not see—even when they are not unwilling to see—how it must be reformed if it is to operate really as in their defenses of it they say it does. Land-value taxation is, indeed, not the only reform needed. All forms of monopoly and monopolistic conspiracy must be adequately dealt with. Our monetary and banking system must be such as to make for stability in the general price level, to the end that inflation shall not enrich borrowers at the expense of lenders nor deflation bring ruin to borrowers and widespread unemployment to wage earners. But unless our reforms encompass land-value taxation, and, therefore, a practical recognition of the right of all to use the earth, they will not be enough.

[1] William Graham Sumner, "Folkways," Boston, Ginn, 1907, p. 179.

# - 3 -

# Two Decades of Decadence in Economic Theorizing

## I

THE CONSTANTLY PROLIFERATING TREE of economic theory has various branches. In this paper, attention will be devoted not to all the branches but only to that which is concerned with monetary theory, and especially with monetary theory as it relates to the fluctuations of business, to the alternation of "prosperity" and "depression."

An understanding of the way in which restriction of the circulating medium conduces to business depression can probably best be reached if we begin with the simplest possible case. Let us assume, therefore, an economy in which there are no banks and in which all transactions are carried on by the use of money. There is, as in the world we know, buying and selling of commodities, borrowing and lending of money, leasing of land and buildings and the hiring of labor. Let us assume that the amount of money in circulation in 1928 and until (say) June 30th of 1929 was 21 billions of dollars, that trade has been and is active and that employment is steady and high.

But immediately thereafter the quantity of money decreases, and rather quickly, to 14 billion dollars. In order that our illustration may more closely simulate the conditions often occurring in the contemporary world, we shall assume the decrease in money to occur in such a way that almost no one has any realization of what has occurred to others than himself and that, in any case, few would understand its significance or anticipate its consequences. Through one or another circumstance, each person has lost (on the average)

one-third of his money by fire, by dropping it into the water, losing it in the fields and woods or otherwise. Each person has available for spending, on the average, two-thirds as much as previously. But, as said above, no one or almost no one is aware that all others have suffered an equivalent money loss.

Under such circumstances, dull business and unemployment would be almost inevitable. For the amount of money available to spend has been reduced by $7,000,000,000, and with only two-thirds as many dollars available to spend, as previously, how *can* as many goods be purchased or as many workers be hired?

There is, of course, no mathematical reason why depression and unemployment should ensue just because the total volume of spending is reduced by a third. These results would not manifest themselves *if* prices, wages and rentals would all decline in as great proportion—*and as quickly*—as the volume of spending. For even though only two-thirds as much money is spent for commodities, just as many commodities can be and will be purchased with this decreased money provided the commodities sell for only two-thirds the previous prices. And even though only two-thirds as much money is spent in the hiring of labor, as many workers can be and will be hired and for as many hours, provided wages are only two-thirds as high. And likewise with the leasing of houses and of business property and other business transactions.

But who will assert that such a decrease of money and resulting decrease of demand for goods and for labor would be immediately succeeded by acceptance of equally reduced prices, wages and rentals? Who will assert that the necessary proportionate reduction in prices (including retail prices as well as wholesale and raw material prices) and of wages and rentals would come within a month or two? Who, indeed,



will declare with confidence that such a reduction of prices *and* of rentals and wages would come within a year—or even two years?

But then it may be argued by some that even with a great reduction in the number of dollars *available* to spend, there need be no proportionate reduction in the number of dollars spent—or no reduction at all! Men will make up for the decrease, it may be said, by spending money that they had been holding for emergencies. That is, the *velocity of circulation* of money will be greater.

Yet to suppose that there is no reduction at all in the amount of money spent is to suppose that a man *will spend as many dollars when he has few as when he has many!* The truth is, whatever may be the mathematical possibilities in the case, that human beings spend less money when they have less money, and that to reduce the amount of money in a country (the number of dollars, francs or marks) causes less to be spent than if the amount of money had not been reduced. Hence the demand for goods declines and the tendency of prices is downward.

Indeed, there is a reasonable probability that a decrease in the number of dollars, before very long and at least for some time, will reduce the number of dollars spent in even greater proportion. For the decrease of demand for goods and the incipient fall of prices may give rise to anticipation of further fall of prices. Thereby it may induce business men to delay spending their money lest the goods they purchase with it prove unsalable except at a loss; or may induce consumers to delay spending in the hope of finding better bargains later. That is to say *velocity of circulation* of money may not only fail to become greater but may actually become less.

Under such circumstances, business can remain as active as before only if prices fall even more rapidly than the decline in the number of available dollars.

If, however, commodity prices do fall in a sufficient ratio, this will still not insure business activity if at the same time such business expenses as rentals and wages remain comparatively rigid. Thus, if commodity prices fall because of a decrease of money and yet wages do not fall in anything like the same proportion, then the goods produced by labor will not sell for enough to pay these rigidly held wages. Demand for labor must and will decline, unemployment must result and production be cut down.

If charges made by owners for the use of land and capital are rigid despite falling commodity prices, there will be more land and capital left unused.[1] In consequence, labor will be less well equipped with the means of production, will produce less, and must accept even lower wages than otherwise if it is to be employed.

But is not all this unrealistic? We do not carry on business solely with money. In fact, much more business is transacted by the use of bank checks than by means of money in the narrow sense. Does not this fact make the above analysis irrelevant?

The answer is definitely in the negative. Although most of our business is indeed done through the transference, by checks (and bank drafts), of bank demand deposits from one person to another, this means merely that bank deposits are part of the circulating medium and act on the demand for goods and on prices precisely as does money. And if, with only money used, a decrease of (say) one-third in the number of dollars would bring business depression, then, with bank demand deposits used, a decrease of one-third in the volume of bank deposits as well as in the volume of money, would likewise result in business depression.

[1] In the case of land, the holding of a considerable amount of it out of use seems to be a *chronic* evil. I have discussed this in my book on "The Economic Basis of Tax Reform," (Columbia, Mo., Lucas Bros., 1932) and would refer especially to chapter IV, §3.



The truth probably is that central banking policy has more to do than anything else with the alternation of prosperity and depression, and that central banking policy affects business activity through affecting the volume of circulating medium of which bank deposits subject to check are, at any rate in the English-speaking countries, the major part. Unwise bank policy can quickly turn prosperity into depression. And the explanation of how it does so is almost identical with our explanation above of how a disappearance of a third of all money would do so. In fact, the causal influence leading to depression may be every bit as unperceived by the generality of men as if each individual had accidentally lost a third of his money while yet no one knew that any others than he had suffered such loss.

The decrease of circulating medium which thus tends to depression, always or almost always results from restriction of bank credit, and such restriction, when there is a controlling central bank or central banking system, is usually a matter of central bank policy. This of course does not mean that those who control central banking policy deliberately seek—or have ever sought—to bring about depression. It means rather that bank credit policy may be, and sometimes is, inept, so that evil consequences ensue which the determiners of policy did not intend or expect.

If the interest (and discount) rates charged by banks are unduly low, there is encouragement to borrowing from banks, to the increase of demand deposits, therefore, on which checks can be written and, in extreme cases, to serious inflation. On the other hand, if the interest (and discount) rates charged by the banks are unduly high, there is discouragement to borrowing from banks, and the volume of demand deposits on which checks can be written declines. This decline in the volume of circulating medium, if sufficiently great and prolonged, will bring depression.

Students of banking understand that the central bank or banking system—in the United States, the Federal Reserve System—has ways of controlling the lending policy of the other banks. Thus, by lowering their own interest and discount (rediscount) rates, by purchasing eligible securities in the open market and in other ways, the Federal Reserve banks can promote increase of the circulating medium. On the other hand, by raising their own interest and discount (rediscount) rates, *selling* securities in the open market and otherwise, they can force other banks to restrict their lending and can thus bring about a *decrease* of the circulating medium. And such a decrease may be sufficient to induce business depression.[2]

That such action by the central banking system could bring—and even that it did bring—business depression was a view that had considerable support prior to the rise, in the Nineteen Thirties, of the "new economics" and its "prophets." Here was a cause which very obviously *could* bring about depression. Here was a cause which was definitely in operation prior to and into the depression of 1921–1922. Here was a cause which was definitely again in operation prior to and into the depression of the Nineteen Thirties. The late Irving Fisher stated that according to the best estimates he knew, "check book money," *i.e.*, bank demand deposits, "shrank between 1929 and 1933 from 22 billion to 14 billion dollars" and that it was "this shrinkage of 8 billions that constituted the essence of the depression."[3] Why, then, should the "prophets of the new economics" apparently reject—or, at any rate, soft-pedal—central bank policy as the most significant cause of depression, and spend their time in speculations as to whether relatively inconsequential conditions, and conditions perhaps largely generated by depression itself, are the significant causes; or whether the causes are to be found in conditions that cannot convincingly be shown to operate in that direction at all?

[2] In my "Basic Principles of Economics," (2nd edition, Columbia, Mo., Lucas Brothers, 1947). I have presented the elements of this subject more fully than I am doing here and would refer readers who need such a discussion of the elements to Chapters V and VI of that book.

[3] In "100% Reserves," *Commercial and Financial Digest*, Los Angeles, Cal., June 1937.



About a year and a half before the stock market crash of 1929 a distinguished Swedish economist, the late Gustav Cassel, who was at that time in the United States, appeared before the Banking and Currency Committee of the House of Representatives. In the light of the events of 1929 and following, his statements before this Committee may seem to be almost prophetic. Here is his testimony:[4]

> The Chairman. In connection with the practical situation that confronts us here now, we are in the midst of what has been termed a speculative situation. Yesterday the Federal Reserve Bank of New York raised its rates. Brokers' loans were reported to have increased $150,000,000 in the report that was issued yesterday. Much attention is being directed to the volume of brokers' loans and its effect on the whole monetary situation.
>
> We would be very glad to have your opinion on that present situation, if you care to express it.
>
> Doctor Cassel. Well, Mr. Chairman, I am very glad that you ask me this question, because it gives me an opportunity to show how the aim of checking this speculation, from the point of view of stabilizing the money of this country, is an outside interest, involving the monetary policy in great difficulties. If you had not that speculative tendency in the New York Exchange, the Federal Reserve banks here in this country, I understand, would be able to keep a 3½ or 4 per cent rate of discount. Now, there is this stock speculation, and to meet that the Federal Reserve bank in New York feels it is obliged to raise the rate of discount to 4½ per cent. That is, I assume, not at all done for monetary purposes; that is a measure entirely outside of the normal province of the Federal Reserve system, which is to regulate the currency of the country; but there seems to be a popular demand that the Federal Reserve system should mend all difficulties arising in the country and particularly fulfill the function of keeping the speculators in New York within reasonable limits. I think that is unsound.

[4] Given May 16th, 1928. See *Stabilization Hearings before the Banking and Currency Committee of the House of Representatives,* on H.R. 11806, p. 381.

It would be a great benefit to the country if some means could be devised by which it would be possible to limit speculation on the New York Stock Exchange without increasing the Federal Reserve bank's rate, because such increases may be very unwelcome. They may disturb the whole monetary policy, and it may have an effect on the general level of prices that will result in a depression in production in this country, followed by a decrease of employment, all only for the purpose of combating some speculators in New York.

There is, to be sure, a bit of careless statement at the end of Cassel's testimony. One should not say, it seems to me, that a decrease of production would be *followed* by a decrease of employment. When there is such a decrease of production from restriction of bank credit, there is, obviously, a *simultaneous* decrease of employment. Also, I think it may be better from the point of view of the logical possibilities in the case—and without prejudice to whatever statistical studies may show to be the most common line of sequence—not to say categorically that credit restriction by the banks decreases production *because* it reduces prices. Credit restriction must certainly bring reduced production and unemployment if prices are generally rigid or "sticky" and do *not* fall. And also, of course, reduced production and concomitant unemployment must ensue if prices of commodities do fall while wages do not.[5]

But whatever criticism one may make of particular sentences in Cassel's statement, it remains true that he did emphasize the possibility that the policy being followed, would lead to business depression and unemployment. It is also true that the policy in question was even accentuated in the succeeding year, that some of the Federal Reserve banks charged even higher discount rates than they were already charging when Cassel made his comment and that, in addition, securities were sold by the Federal Reserve banks in the open market, thus further tending to reduce the circulating medium and the demand for goods. And we did have depression, both long and severe.

[5] This result need not follow, of course, if the reduced prices are consequent on greater productive efficiency and larger output instead of being due to decrease of circulating medium.



Under these conditions does it not seem that economists might reasonably have been expected to emphasize and re-emphasize the very great importance of central banking policy and, especially, to stress the serious dangers of sharp and persistent bank credit restriction? Average wholesale commodity prices were already lower in the earlier months of 1929 prior to the stock market crash than they had been in 1928[6]; and the prices of 1928, though a little above those of 1927, were definitely lower than those of 1926. It can hardly be argued, therefore, that this persistence in restrictive action was necessary or desirable *to prevent price level inflation!*

II

YET SCARCELY HAD THE BREAK OCCURRED than, despite the warning of Cassel, the view began to gain support among economists that the stock market crash and the downward movement of business came upon us *not* because of this restrictive action of the Federal Reserve banks but because they did not apply such restriction sooner! The thought seems to have been that failure to restrict credit earlier encouraged stock market speculation and a rise in the prices of corporation stocks well above their "normal" values, that such (assumedly) speculative rise of prices of stocks would probably be succeeded by a fall, that this fall of stock prices would destroy business confidence and that thus business depression would ensue.

To this opinion there are a number of cogent objections.

[6] See the *Federal Reserve Bulletin*, January, 1930, p. 30. The figures of the Bureau of Labor Statistics for price levels over many years can be found in the successive issues of the *Federal Reserve Bulletin*.

First, whatever height stocks attained at this time cannot be regarded as unreasonably high *merely* because stock prices fell so low in the succeeding depression. If the depression had been avoided, business activity *and* prices *and* corporation incomes would have remained high and relatively high prices for corporation stocks would have been justified. One may well ask with *what* standard of reasonable values were these allegedly speculative prices of stocks compared? Has any economist who holds the view herein criticized, taken the pains to work out what would have been "normal" prices for these stocks in case the depression had *not* come and to compare *such* prices with the prices ruling before the stock market break?

Second, it is not at all demonstrably the case that a slump in the stock market will, of itself, induce such lack of business "confidence" as to bring significant depression. There was such a stock market slump in 1903, called "the rich man's panic of 1903," which was not accompanied, or followed in any short enough interval so that the sequence could be fairly regarded as causal, by serious business depression. This is not to deny that business activity may have been a shade less in 1904 than in 1903. But 1904 was a year of fairly active business nevertheless and so were 1905 and 1906. And the considerable stock market reaction in the summer of 1946 has not, to date, been followed by business depression.

Third, even if it were sufficiently demonstrated that a stock market slump would of itself be likely so to affect the minds of business executives as to reduce greatly their borrowing from banks and their demand for commodities and labor, there seems good reason to believe that any such tendency could be completely or, certainly, mostly offset by an easy credit policy of the Federal Reserve banks. Federal Reserve rediscount rates could be lowered. The Federal Reserve



banks could purchase eligible securities in the open market, thereby giving increased buying power to those from whom the securities were purchased and giving, also, increased reserves and lending power to the various member and non-member banks and thereby indirectly (through the lending of these banks) increasing demand deposits and buying power.[7]

[7] The same answer could logically be made to those persons who contend that stock speculation (*e.g.*, in 1928–1929) "takes money away from legitimate business,"–if there were any convincing evidence that such speculation does actually require the use of any appreciable proportion of the circulating medium.

In this connection it may be appropriate to comment on a passage from a recent article by Lloyd A. Metzler, entitled "Business Cycles and the Modern Theory of Employment" (*American Economic Review*, Vol. XXXVI, June, 1946, paragraph at the top of page 286). Mr. Metzler says:

"It is hardly necessary to point out that Say's Law of Markets is no longer a widely accepted economic doctrine. One of the principal achievements of the modern theory of income and employment was to emphasize that savings do not constitute a demand for capital goods; in large part, they constitute simply a demand for legal evidences of wealth, such as stocks, bonds, and savings accounts. A substantial portion of the demand for investment goods comes from business men, and is not directly related to the level of income. It is therefore entirely possible, indeed at most times probable, that an increase in total output will increase the total supply of goods more than it increases total demand; some of the increased income will be used in the purchase of previously existing assets, and will not represent a demand for currently-produced goods. Hence, general overproduction is a possibility which must be taken into account."

*If* we assume that demand for such "legal evidences of wealth" undergoes a vast relative increase in a relatively short period; *if* we suppose that those who sell these "previously-existing assets" to the new purchasers of them do *not* use the proceeds of such sale to purchase "currently-produced goods" but in turn themselves buy other "legal evidences of wealth" from other sellers who in their turn buy still other "legal evidences of wealth," and so on and on, then it must be admitted that some part of the circulating medium is both *withdrawn* from the "currently-produced goods" market and, for a period, *kept away from* that market. *If*, further, the proportion of circulating medium so withdrawn is *considerable*, and *if* prices in the currently-produced goods" market are "sticky" and *if* there is no easing of bank credit nor any other policy directed to increasing the total of circulating medium, there will obviously be less *demand* for "currently-produced goods." *In that sense*, it can then be said that "general overproduction is a possibility which must be taken into account"!

But before the reader consents to the view that there is anything of appreciable importance in what Mr. Metzler calls "one of the principal achievements of the *modern* theory of income and employment" (italics mine), there are several points of which he should take careful note. First, Metzler's statement gives no basis for concluding that there is "overproduction" except as there is price rigidity. Second, it does not show that there would be such "overproduction" *even with* such price rigidity *except* because of *a decrease of circulating medium in the "currently-produced goods" market* consequent on the use of more of it in the "legal evidences of wealth" market; and this difficulty could be obviated by an easy credit policy which would fully replace any such circulating medium thus withdrawn, by an equal addition of circulating medium. Third, so far as stock market speculation is concerned, it appears that vast exchanges are effectuated with the use of relatively little currency. The late James Harvey Rogers showed, in his brilliant but rarely cited article entitled "The Effect of Stock Speculation on the New York Money Market" (*Quarterly Journal of Economics*, Vol. XL, May, 1926, pp. 435–462) that, having due regard to "the mysterious economies introduced by the operation of the Stock Clearing Corporation, . . . for the three-year period May 1, 1922

Certainly the *assumption,* without any convincing proof, that some inferential tendency of a stock market slump to bring business depression, absolutely *could not* be offset by a properly adjusted Federal Reserve policy, is wholly gratuitous, however numerous or distinguished the economists who make that assumption.

During the Nineteen Thirties the view even gained currency among economists—and I have heard it argued vociferously—that banking policy had demonstrated its ineffectiveness to stabilize business and the price level. Yet in fact we did not have, during the period from 1928 into the depression years, a banking policy both wisely adjusted to the purpose and determinedly persisted in. A careful study of banking policy and of business during the period in question does not demonstrate that banking policy *could not* maintain reasonable stability. Rather does it lead to the conclusion that banking policy affects business activity powerfully and that, in this instance, an inept policy worked powerfully to reduce both business activity and employment as well as the price level.

But then it has been argued, by various economists, that, in any case, it is impossible for banking policy—or any purely monetary policy devoted to increasing the circulating medium—to bring business back near to normal in any reasonable period, once depression has become acute. For, it is contended, the increased money (or bank deposits subject to check) will in any case merely be hoarded. Depression psychology will prevent borrowing from banks for business

to April 30, 1925, the purchase prices of securities bought on the New York Stock Exchange were paid for with a deposit currency having a velocity of turnover of approximately 1,100 times a year. Or . . . the efficiency of a dollar of bank deposits in transferring stock exchange securities is approximately equivalent to that of $37 in ordinary personal and commercial use." (See pp. 444–445.) And Dr. Rogers went on to say (p. 445): "In fact, when it is borne in mind that, on account of those high velocities, the existing volume of such speculations for the past three years was financed with an average of approximately $15,000,000 of deposits, is there any wonder that no observable influence on New York money-market rates can be traced?"



expansion, however large member and non-member bank reserves become through favorable Federal Reserve policy. Depression psychology will prevent any person or persons from whom the Federal Reserve banks purchase securities, from either investing or spending the money so received! And if the federal government directly supplements Federal Reserve policy, printing billions of dollars of new money which it then pays out to buy back or redeem federal government bonds, this new money will also be hoarded, every dollar of it, and so will have no effect toward increasing the demand for goods and restoring employment! In this view it would appear that if each person in the country, during a period of depression, were put into possession of more money than before—whether twice as many dollars or 100 times as many or 10,000 times as many—there would nevertheless be no appreciable increase in spending, no increased demand for goods and no stimulus to business and employment! Instead, production would remain low or even sink lower, spending would remain low or even become less, prices of goods would remain low or fall even lower! All this, of course, is preposterous nonsense but it is to such a conclusion that those economists must inevitably be driven who do not admit that monetary policy can possibly promote recovery from depression.[8]

It may be interesting, in this connection, to examine the statements of a member of the Federal Reserve Board, Adolph C. Miller, who had previously taught economics at Harvard, Cornell, Chicago and the University of California. This statement was made to the same committee, the Banking and Currency Committee of the House of Representatives, by

[8] Even then, when and if government is driven to the direct employment of labor, this would be a use of monetary policy in a very real sense if the labor so hired is paid with new and additional circulating medium. If the labor is not so paid, then the withdrawal of money (by taxation or by borrowing) from those who might otherwise spend it themselves, may decrease employment in other industries as greatly as it promotes employment in the industries encouraged by the government spending.

whom Gustav Cassel was questioned just two days later. Following are the questions of the committee chairman and Mr. Miller's reply:[9]

The Chairman. I notice this, Doctor Miller, that following the activities of the board in the spring of 1923, the wholesale price level went down until, say, September of 1923, to about 97 or 98, which was followed by some irregularity later on in the year and in the early part of 1924, but in midsummer of 1924 the wholesale price level reached the low point of about 95. Was that lowering to that point of 95 the direct result of the activities that were taken by the Federal Reserve Board in the early part of 1923?

Doctor Miller. I would say emphatically no; emphatically no. I would say that prices were down at that time primarily because they went up so high in the previous period and that the whole movement of prices in this period was one toward the ascertainment of a new level. The prices themselves were, so to speak, finding their new level.

Must it now be pointed out that *prices* are *not alive* and that they cannot "find" their level as the woodchuck finds its hole! Certainly if several of Mr. Miller's colleagues on the Federal Reserve Board entertained the same ideas or other ideas equally wide of the truth, one should hardly be surprised to find a Federal Reserve policy adopted which would lead to calamitous deflation and depression or to great inflation or to alternations of inflation and deflation. And one should find it quite possible to admit that such a policy or policies would then be entirely consistent with the best possible *intentions* and the most conscientious—however misguided—effort to serve the public well!

It should indeed be noted that not all of Mr. Miller's testimony before this committee ignores so cavalierly or denies so categorically any possibility of significant Federal Reserve influence on the general level of prices. Nevertheless, it is hard to believe, in view of his statement quoted above, that he

[9] *Stabilization Hearings before the Banking and Currency Committee of the House of Representatives*, pp. 295–6 (May 14, 1928).



could have had a very keen realization of how controlling Federal Reserve policy can be.

## III

AMONG ECONOMISTS, AS ELSEWHERE, there are various trends and fads which have, each, their little day and then give place to others. At one time the talk and controversy among members of the craft is about "neo-classicism," at another time about "institutionalism," at still another time it is about the theory of imperfect competition, or the Keynesian theory and the idea of "liquidity preference." In the early years of the twentieth century there was great emphasis on detailed facts and on statistical verification, even in problems where statistical studies yielded little if any light. More recently we have had the writings of Keynes, Hansen and others of the Keynesian "school," with little or no attempt at the statistical checking of conclusions on monetary theory but rather just an attempt to build new theoretical systems.

Already in the second and third decades of the century there had been considerable reference to the velocity of circulation of money and bank deposits and to the conditions that induce men to spend quickly or slowly, or even to hoard. Certainly there was some recognition of the possibility that under certain conditions men may tend not to spend their money quickly but to hold it temporarily unspent, awaiting business recovery if various investments are in contemplation, or awaiting a fall—or further fall—in prices so that their money may buy more. This really meant, though the expression "liquidity preference" was not then commonly employed by economists, an inclination on the part of some of the community to keep their resources in "liquid" form—as money or bank deposits.

There was also, I think it may be claimed, considerable understanding among economists—certainly some economists

had such understanding—in the early decades of the century, of the general concept of velocity of circulation. And so there was understanding of the fact that an additional number of dollars introduced into circulation, like the dollars already in circulation, would ordinarily be spent again by those who received them, and still again by the second recipients and so on; and that thus the introduction of this money would be likely to have a more stimulating effect than if it could be spent only once! The new money, like the old, would have "velocity of circulation" although, as has just been noted (paragraph above), velocity is not necessarily constant and precisely predictable under changing conditions. Certainly it is not in the least necessary to use the term "multiplier" in order to understand or to convey understanding that an increase of circulating medium may promote revival from depression. It may be questioned whether anything is gained by introducing this new term to express the fact that money introduced into circulation will be spent more times than once or twice—unless it be regarded as a gain so to fill economic literature with technical terms and make it seem so occult a science as to frighten away the non-specialist citizen from consulting economists' writings at all! For this is only one among a variety of new terms.

Of course, economists can still write and speak for each other's delectation. They can still devote time to criticizing each other's views. They can still seek the plaudits of other—younger and less noted—economists who may become their admiring disciples, participate in defending their views against dissenting economists, and gain reputations by applying the theories and definitions of their masters to particular cases, or by suggesting minor modifications of these theories. Indeed, the very fact of using many technical terms may help give some of these writers reputation among that part of the



journalistic reviewers and general public who impute learning where there is incomprehensibility!

It might seem to the ordinary intelligent and public-spirited person that economics can be useful in proportion as its principles are presented as simply and clearly as is reasonably possible, and with a minimum of technical terminology. For, in a democracy, public policy depends upon the approval, active or tacit, of many minds and it is important that the truly significant reasons for or against particular economic policies be widely understood. Yet so soon as it begins to be fairly evident that a particular force or set of forces is the most significant cause of an economic evil and the related theory is sufficiently clarified to make possible wide public understanding, it appears that not a few professional economists are seized with a desire to direct discussion into the introduction of new terms, into quibbling over trifles, into holding up inconsequential facts as significant causes, and into suggesting as causes facts which may have no causal influence at all.

But now let us return to "liquidity preference" in its relation, if any, to the causation of business depression. There is a considerable group or "school" of economists whose view it is that very low returns on capital conduce to business depression through causing men to hold idle, waiting for a more favorable conjuncture, funds they would otherwise lend or invest.[10] Because of such hoarding, demand for labor and for commodities is reduced, workers are subjected to unemployment and business activity is decreased.

"The concept of *Hoarding*," said the late Lord Keynes,[11] who is generally considered to have been the leader of this group or school of economists, "may be regarded as a first approximation to the concept of *Liquidity-preference*. In-

[10] See J. M. Keynes, "The General Theory of Employment, Interest and Money," New York, Harcourt, Brace and Co., 1936, especially Chapters XIII and XVI.
[11] *Ibid.*, p. 174.

deed, if we were to substitute 'propensity to hoard' for 'hoarding,' it would come to substantially the same thing."

It is of course true that few persons are willing to *borrow* at (say) 4 per cent interest when they are confident that the capital thus secured will yield only 1½ per cent or 2 per cent. Nor will they borrow even at 1 per cent if they firmly believe the capital will yield only ½ per cent or nothing at all. And there is no doubt that some persons under some conditions will refuse to lend at rates low enough so that borrowers can pay them from the annual returns of the capital.

But before concluding that the genesis of business depression is to be thus explained, we must raise several important questions.

First, if and when returns are so low on capital as to discourage borrowing, must there not be some *reason* for these low returns? And should we not inquire what such reason may be? What if the low returns which are alleged to be causative of business depression are in fact *caused by* restriction of bank credit? Restriction of bank credit does tend—if prices are somewhat rigid, and also if wages and rentals are rigid even though commodity prices are not—to bring about business depression; and business depression means *low returns on capital.* Also, continued restriction of bank credit does bring, despite a degree of rigidity or "stickiness" in many prices, a general fall in the price level. With such a fall the returns on capital, *measured in money terms,* are reduced even though business does not become less active. The capital may be as effective as before in producing wheat or cotton, automobiles or shoes, electric refrigerators or nylon stockings. But if the prices of these products have fallen since the investment was made, the *dollar* returns as compared to what capital *was* worth in dollars when it was constructed, will be low. Of course in a period of falling prices the capital itself, even if not at all depreciated physically, will be of progressively less monetary value. And thus the return on capital each year may be a reasonably high per cent of the value of the capital *in that year.* But this return will obviously be a smaller per cent of the earlier or initial monetary value of the capital. And hence unless the interest rate which the lender charges the borrower is sufficiently reduced, the borrower must suffer loss. It follows that, when prices are falling or are expected to fall, the potential borrower (if at all understanding) will not be an actual borrower—*unless* at an interest rate which is lower in terms of the per cent on the number of dollars borrowed.



But why should not lenders readily accept such a reduced interest rate in order to be able to lend? Why should not competition at once bring the interest rate down so that borrowing would not be discouraged? Just what is the *raison d'etre* of this "liquidity preference" on the part of lenders? May not it, too, at least in considerable part, stem from an inept central banking policy?

If central banking policy—or, equally, the general monetary policy of government—is so directed as to result in a fluctuating price level and in alternating periods of business activity and business depression there will certainly tend to be fluctuations in the interest rate (as measured in money terms) that borrowers are inclined to pay. Yet at the time when demand of borrowers is the lowest and when it is therefore difficult to lend except at a low rate of interest, many lenders will more or less confidently expect—and, on the basis of the fact of such fluctuations in the past, have some reason for expecting—a turn for the better. Such an expectation will make them unwilling—or less willing—to commit themselves irrevocably, for periods of any considerable length, to loans at low interest rates and make them prefer to hold their resources in the form of cash or checking accounts, *i.e.,* in "liquid" form easily transferable, in case of a favorable conjuncture, into some

other form. In case circulating medium *is actually* thus held out of use, the effect may indeed be to deepen any existing depression. But through all our analysis we must hold fast to the fact of some degree of rigidity of prices, including wages, rentals, etc. For if all prices would immediately and adequately fall, then *any* amount of reduction of circulating medium *or* of its velocity of circulation would militate not at all against active business. All goods, including buildings, machinery and other capital, would fall enough in price to be purchasable *without* the use of the withheld funds of the hoarders.[12] And of course, potential lenders unwilling to lend can themselves purchase capital or hire men to construct capital.

In any event, to say that "liquidity preference" (and, therefore, reduced velocity of circulation) may deepen depression is very different from saying that it ever did *initiate* or is likely ever to initiate depression. In the analysis followed herein above, bank credit restriction decreases the circulating medium; with the resulting decrease of demand for goods there is a tendency for the price level to fall but not to fall quickly and adequately; and this decrease of circulating medium and so of demand, *along with* the rigidity of prices, wages, etc., brings declining production, employment and trade.[13] Then, *because* of falling prices and *because* of dull business, it is quite conceivable that there will be a greater tendency to hold money uninvested and unspent, *i.e.*, a tendency towards reduced velocity of circulation of money and checking accounts (in other words, "liquidity preference"). There is likely to be, also, less inclination to borrow from

[12] If the interest rate (or rates) charged by lenders is somewhat rigid, we can say that it is just one more of the "sticky" prices. Even so, if other prices fall ***enough***, there will not be depression.

[13] For a fuller discussion of some aspects of the theory of business depression, see my *Basic Principles of Economics*, 2nd edition, Chapter VI, and my article on "Policies for Full Post-War Employment," in AM. JOUR. ECON. SOCIOL., January, 1944 (Vol. 3, No. 2).



banks, and thus a further decrease of the *volume* of circulating medium. And if business failures bring about bank failures, there is a still further tendency to decrease of circulating medium, since purchases cannot be made by writing checks on failed banks.

For all these and perhaps other reasons, there is the possibility that a depression, once started, and if no adequate remedy is applied, will continue for some time and even grow worse. And in this process, as we have seen, reduced velocity of circulation ("liquidity preference") may quite possibly play a part. But is there any evidence—have any of the economists of this "new" school ever presented convincing evidence—that business depression ever has been or is at all likely to be *initiated* by a "liquidity preference" which manifests itself *independently of any adverse banking or general monetary policy?*

Conceivably, a long period of active business with the price level stable or slowly rising would generate such an *expectation* among lenders of receiving their *customary* favorable returns that, when credit restriction by the banks reversed this trend, some of these lenders would for some time refuse to accept low enough interest rates to continue lending. And this might be not because they were anticipating an improvement for which they desired to be "liquid", but just because they would have become *habituated* to the higher returns. It might be because they would have come to think of these returns as part of the fundamental nature of things and so would be unable, for some time, to reconcile themselves to accepting any less. Such an attitude is hardly to be termed "liquidity preference" but is rather mere obstinacy based on habituation. Here again, however, the initiatory influence does not come from a declining velocity—if, indeed, velocity does so decline—but from a restriction on the volume of cir-

culating medium from which restriction the other phenomena flow.

Of course it may be contended that, in the absence of any business or price level fluctuations from unwise monetary (including banking) policy, the returns on capital might conceivably become so low—conceivably less than enough to cover depreciation—that many recipients of money would hold it indefinitely rather than invest in productive capital. If no gain at all could be realized from investment in buildings, machinery, steamships, etc., and especially if there were an average loss, one who wished to provide for his old age or for the education of his children would do as well or better just to lay his savings aside in the form of money (at any rate if he could count on its being stable in value or purchasing power) until such time as he might need these savings to live on. Could this be called "liquidity preference"?

But such a condition, *with* wise control of the volume of circulating medium, would not tend to bring business depression. If so much money were hoarded as to threaten reduction in the demand for goods and in the general level of prices, a wise monetary policy would provide for the issue of enough additional money (and/or bank credit) to maintain the price level. This would mean that the demand for goods in general at this price level would *not* decline, for such decline would bring the price level down. A sufficiency of money to maintain the price level would, by that very fact, be a sufficiency of money to maintain the demand for goods in general. Hoarders laying aside money for future use could be permitted to do so freely, yet there need be no disrupting decrease in the demand for goods and labor. Obviously—though the uncomprehending may deny this—there will be some limit to the amount of money wanted for hoarding, since each hoarder would naturally *apportion* his available



money (or money and bank deposits) between his current needs and his anticipated future needs and neither would nor could hoard all of it.

Capital is productive but its marginal productivity decreases as the amount of capital in relation to labor and land increases. And thus it could *conceivably* happen, as just assumed, that a widespread and continuing spirit of thrift would so increase the amount of capital as to bring its marginal net productivity rate and, therefore, the rate of interest, close to the zero point or even below zero. However, as the marginal productivity of capital approached zero, an increasing number of persons would begin to show a preference for keeping their savings in the form of money,—or of gold, platinum, silver, diamonds or other valuable and easily stored commodity not subject to appreciable physical depreciation. And so there is some reason to doubt that the average net marginal productivity of capital would ever go below zero or, even, go quite to zero, no matter how widespread the spirit and habit of thrift might become.

There is, however, another aspect of the matter of gain from saving and capital construction, *viz.*, taxation. The average net marginal productivity of capital may be (say) 8 per cent. But if a general property tax takes nearly half of this and if a high progressive income tax plus, perhaps, an excess profits tax takes much or most of the remainder in those years when yield is high, while leaving the owner to suffer loss in bad years, then the average per cent on capital *to the owner of it* can be very low indeed. In such circumstances the considerations as to hoarding presented in the paragraph above would be entirely applicable. But, as indicated in the paragraph second above, this fact need not bring business depression, provided there is a monetary policy calculated to maintain a stable price level.

If, however, some of the "liquidity preference" theorists are convinced that hoarding brought about by a low rate of return consequent on such taxation would tend to depression, they have open to them a very simple remedy. Let them *depart from the conspiracy of silence against the taxation of land values.* Let *them* become the *leaders* in attacking the prejudice that stands in the way of this reform. Let them *point out* to their considerable clientèle of readers that a tax appropriating more or, even, practically *all* of the annual rental value of land would not reduce by one iota the net per cent return on capital to those who save and make capital construction possible. Let *them* emphasize, *even though others do not,* that the extra revenue thus gained would make possible a large reduction in the taxation of capital, thus leaving to the investors in capital those larger per cent returns for the lack of which these "liquidity preference" theorists believe potential investors refrain from investing and thereby help to precipitate business depression.

## IV

AMONG THE "EXPLANATIONS" for the depression of the Nineteen Thirties is the statement that the rate of increase in the population of the United Sates had slowed down and *therefore* the demand for new housing had slackened. Another and fundamentally identical alleged cause is that there was no *new* industry established in the Nineteen Thirties, such as the automobile industry, to provide employment.[14]

[14] See, for a discussion favoring both of these hypotheses on the cause of business depression, Alvin H. Hansen, "Fiscal Policy and Business Cycles," New York, Norton, 1941, Chapter I. With regard to the first of those mentioned above, that having to do with population growth, Hansen says in a footnote (p. 45):

"It has been argued that cessation of population growth should be favorable to employment, since the supply of new workers in the labor market would be reduced. But it is easy to show that population growth, if it occurs in a period of territorial expansion, raises the demand for labor more than it raises supply. Thus, the volume of extensive investment associated with the net addition of one worker involves capital outlays on a house, amounting to, say, $4,000, and outlays on plant and equipment amounting to an additional $4,000. Eight thousand dollars of investment represents a



There is a wealth of evidence to show that most human beings have enough unsatisfied wants so that, if for any reason they do not need or want goods of a particular kind, such as houses, they will buy other goods—more and better clothing, motor boats, electric refrigerators, musical instruments, books and newspapers, additional and better tables, chairs, rugs, etc., or even enlarge and beautify the houses they have. Or they will spend more in educating their children or invest more in the purchase of productive capital. Those who do *not* have any desire to spend money will, presumably, not work to earn money, and the quantity of goods produced to sell will therefore be lessened. If the population becomes smaller the volume of goods produced will presumably be smaller. In any case, the assumption that if and because men do not want more or larger houses, therefore they will probably spend less in any appreciable degree—*i.e.,* that they will have an appreciably greater tendency to *hoard* their money—and thereby bring a substantial decrease of demand for goods in general is *utterly gratuitous.* And in the absence of such an *assumption,* the entire argument has no significant relevancy.

It is the same with the argument in regard to the "new"

far greater effect on the demand for labor than the effect on supply of one additional man-year of labor."

Economists have many times insisted that demand is not merely desire but depends on purchasing power. Why does not Hansen tell us precisely how "one additional man-year of labor" provides the purchasing power for a demand amounting to $8,000?

There is, too, no sign of understanding, in the quoted passage, of how capital comes into existence through saving. Those who wish to invest in the construction of capital must save, *i.e.,* deny themselves present goods. What they might have spent for such present goods can then be spent for capital or for the construction of capital. There is here no increase in demand for goods in general but merely an increase in demand for capital balanced by a decrease in demand for consumable goods. Of course, an increase in the volume of circulating medium may increase the demand—at current prices—for goods in general and may thus bring about a rise in the price level.

It may, indeed, be easy to *say,* but certainly is *not* easy to *show,* "that population growth . . . . raises the demand for labor more than it raises the supply."

Perhaps it may be appropriate to add that demand for labor is commonly supposed, by economists, to have some relation to the productivity of the labor. Hansen seems to write, here, as if demand for labor depended on the housing and machinery "needs" of the laborers!

industry. Presumably such a "new" industry increases employment because people want to buy its product or products. But if the particular new products (*e.g.*, automobiles) had never been invented, are we to suppose that those who have bought these goods would not have spent the money for anything else? Would the money so spent have been merely laid away in safes or otherwise and thus have had no more effect on demand than if it did not exist?

Even if it be assumed that some previously unenjoyed product is so enticing as to make people much more eager to buy it than they would be to buy anything else, are we to suppose that they will not, for the most part, find the means to purchase it by economizing on, *i.e.*, manifesting a *decrease* of demand for, *other* goods? And if in their eagerness to buy they borrow from others, must not the lenders then decrease *their* purchases of goods which otherwise *they* might buy?[15]

Or it is intended to argue that when a "new industry" is introduced, a larger volume of bank credit is extended in proportion to bank reserves than there otherwise would be? Or that velocity of circulation is thereby increased? Just *how* and *why* is it supposed that the development of new industries saves us from depressions and on what basis is it concluded that not to have the new industries subjects us to greater risk of having depressions? If those who so argue do not mean to say that the lack of new industries tends to de-

[15] On pages 39 and 40 of his "Fiscal Policy and Business Cycles," Hansen compares the decade of the Nineteen Thirties with the fourth quarter of the nineteenth century "with its deep depressions of the Seventies and the Nineties." In a footnote (p. 39) he goes on to say:

"It was in this period, when the railroadization of the country was increasingly reaching a saturation point, that Colonel Carroll D. Wright, Commissioner of Labor, made his famous declaration with respect to the exhaustion of real investment opportunities. . . . The declining rôle of the railroad was, indeed, the most significant single fact for this period and offers the most convincing explanation for the chronic hard times, particularly of the decade of the nineties. . . . While others were stressing superficial aspects, Colonel Wright placed his finger upon the really significant cause of the world-wide stagnation."

Must one not assume from the above, that, in Professor Hansen's opinion, those who emphasize the influence of a substantially increasing and of a substantially decreasing volume of circulating medium in relation to production and trade, are "stressing superficial aspects"?



pression *by virtue* of somehow keeping down or reducing either the circulating medium or its velocity of circulation,[16] then what do or can they mean? And if they do mean this, why do they spend so much time attempting to trace depressions to so problematical an influence, while they stress so little as a cause the sharp and persistent credit restriction of the Federal Reserve system in 1928–1931, which tended so directly and clearly, as did similar credit restriction in 1919–1921, in the direction of reducing circulating medium and the demand for goods? *Why* must some economists *try so desperately* to trace depressions to causes which are so problematical, so relatively inconsequential and, sometimes, so fantastic, instead of emphasizing particularly a powerful cause, demonstrably capable, in conjunction with price, wage, rental and interest rigidities, of producing severe depression and clearly in operation prior to and even well after the onset of both of these business depressions?

It is as if, following a violent earthquake, the brick walls of

[16] Hansen says ("Fiscal Policy and Business Cycles," pp. 37–8):

"Thus, if technological developments and innovations tend to favor a rapid expansion in real investment, money incomes may be expected to rise, and the money supply and its utilization (MV) may be expected to adjust itself to these conditions. If, on the other hand, the underlying technological developments are unfavorable to a rapid expansion of real investment, money income will fail to keep pace with output and the secular trend of prices will be downward. Here again the money supply (M) and its utilization (V) adjust themselves to the demands of the underlying real factors."

Does this mean that with "technological developments and innovations," new gold mines will automatically be discovered, so that a country on the gold standard will have increased coinage? Or does it mean that the governments of countries on inconvertible paper standards will not only increase their issue of paper money but will time these increases to these "technological developments and innovations"? Or does it mean that there will automatically be additional extension of bank credit regardless of the sufficiency of bank reserves? Is not any of these suppositions rather gratuitous?

And how about the velocity of circulation of money (V)? Is it assumed that a bookkeeper, salesman or mechanic who receives (say) $50 a week and who has previously been spending his weekly wage or salary gradually so as to make it last until the next week's pay is due, will, because of "technological developments and innovations", begin spending each week's wage the first day or two after receiving it and will cease to worry about how his family will live for the remainder of the week? Or will corporations and other business units thus spend their funds more quickly rather than merely spend for new kinds of capital *instead of* increasing or replacing older kinds?

Without insisting that new ideas of ways to spend or invest money could never, under any circumstances, influence velocity of circulation at all, we can at least fairly ask for something more than the blythe assumption that "the money supply and its utilization (MV) may be expected to adjust itself to these conditions."

a tall building come crashing to the ground. There is lengthy discussion among men of learning as to the cause or causes of the building's fall. At first a few mention especially the earthquake. But more and more the learned articles and books are devoted to speculation as to whether great emphasis should not be placed on a fact noted by a few surviving bystanders. These bystanders had seen, just before the crash, a sparrow poised on the roof and had noted that the bird leaped into flight only about a second before the building began to collapse. After considering the testimony of these observers, some of the most noted of the professors conclude that the major cause—or one of the major causes—of the building's crash, was probably the backward pressure of the sparrow's legs as he leaped forward and upward from the roof!

But surely such writing by professional economists—if it be not ignored by the non-specialist reading public—must be a source of confusion and must work against rather than for the adoption of wise policy. Perhaps it would be better if more economists would pause, on occasion, from their interest in this or that latest formula or will-o-the-wisp of theory and ask themselves what, after all, economics is chiefly for.[17]

[17] It is important to point out, however, that not all economists have meekly followed the lead of the "prophets of a new economics." The late Henry C. Simons of the University of Chicago was one of their most able and persistent critics. See his articles in the *Journal of Political Economy*, "Hansen on Fiscal Policy," L (1942), pp. 161–96, and "The Beveridge Program: An Unsympathetic Interpretation," LIII (1945), pp. 212–33. Reference should be made, too, in this connection, especially to the recent book by George Terborgh, "The Bogey of Economic Maturity," published by the Machinery & Allied Products Institute (Chicago) in 1945.

In addition to the above references, I want to take the opportunity offered by this reprinting of my article, to refer particularly to the recent inductive studies of Dr. Clark A. Warburton of the Federal Deposit Insurance Corporation. The facts marshalled by Dr. Warburton appear to be consistent with the view presented in the present essay and to be inconsistent with the views herein criticized. See, especially, "Hansen and Fellner on Full Employment Policies" in *The American Economic Review*, Vol. XXXVIII, No. 1 (March, 1948); "Monetary Velocity and Monetary Policy" in *The Review of Economics and Statistics*, Vol. XXX, No. 4 (November, 1948); "Bank Reserves and Business Fluctuations" in the *Journal of the American Statistical Association*, Vol. III (December, 1948).

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# An Off-Line Switch in the Theory of Value and Distribution

THE THEORIES of value and distribution of the distinguished Austrian economist, Eugen von Böhm-Bawerk, are still frequently cited and commented on, although more than half a century has passed since he published them. Perhaps in any case these theories—or some of them—would have been stated by other writers. But it is difficult to avoid the conclusion that Böhm-Bawerk's analyses, both directly and through the modified forms given them by other writers, have been continuously influential from the eighteen eighties to the nineteen forties. And because I believe that he—as Jevons once said of David Ricardo[1]—"shunted the car of economic science on to a wrong line," it seems to me important that certain of his concepts and views be challenged on every appropriate occasion, in the hope that thereby "the car of economic science" may be placed definitely on the *right* line leading to a significant terminal.

To examine Böhm-Bawerk's concepts and theories critically now, so many years after their first publication, might well seem anachronistic, a case of digging into matters of historical—even antiquarian—interest solely.[2] But in view of the living influence of these concepts and theories and, as I believe, their *harmful* influence, such a critical examination may be one of the most important tasks we can undertake.

[1] "The Theory of Political Economy," fourth edition, London, Macmillan, 1911, p. li.
[2] The late Franz Oppenheimer did not think so, however. Only shortly before his death he finished translating his critique of marginalist theory into English for publication in this JOURNAL. As this work is now being prepared for publication by the editor, I have not had an opportunity to consult it in preparing this paper.

I

In "The Positive Theory of Capital,"[3] Böhm-Bawerk describes "roundabout" production, illustrates the gain from it and contrasts "roundabout" with "direct" production. It is Böhm-Bawerk's concepts on these matters, his theory of interest on capital developed (in part) from them and his view regarding the value of capital, to which I want to call especial attention.

It is important to note at the start, I think, that there are two conflicting concepts of "roundabout" production and, therefore, two conflicting concepts of "direct" production. And I think it can be shown that the concept which was held by Böhm-Bawerk, of each of these, is the less useful for economic analysis and for the solution of our economic problems. When it is a question of choice of concepts, it is desirable to choose the most helpful for the purpose at hand. In this case the concepts we want are such as will most simplify the analysis of the interest problem and fit in best with analyses of other economic questions, such as, for example, the determination of the price of a commodity, the alternatives of wage earners and the value of capital.

Böhm-Bawerk's concept of roundabout production is one that includes practically *all* production. In his picture of the productive process there is *almost no* "direct" production in any modern economic society; if, indeed, in such a society, there is ever, anywhere, *any at all*. For, to Böhm-Bawerk, "direct" production is production *"mit der nackten Faust"*[4]—with the naked fist or the bare (unaided) hand. It is production without the aid of any tools or equipment, either already made or to be made. It is production which proceeds to the making of consumable goods or services without using any

[3] References are to the English translation by William Smart, published in 1891. See Book I, Ch. II; Book II, Ch. II and Book VII, Ch. II.
[4] *Ib.*, p. 22.



capital available in advance and without turning aside at any point in the process to construct capital which then can be used. In short, capital enters into the process *nowhere*. And such production is, of course, hopelessly ineffective.

Thus there is, in Böhm-Bawerk's view and, presumably, in the view of all the economists who follow his analysis, rarely or never a case where, in (say) a worker's alternative between roundabout and direct production, the scales are balanced equally. There is rarely or never a choice such that the chooser can be said to be "marginal."

But in the alternative concept of "direct" production, which, I have long believed, should supersede that of Böhm-Bawerk, the test is the immediacy of the end product and *not* whether production takes place without any tools or equipment. In this alternative concept, the housewife who is cooking a meal for her family, is engaged in *direct* production notwithstanding she is using cooking utensils and a stove in the process,—notwithstanding, that is to say, that she is definitely *not* working "with the naked fist." Similarly, the farmer who is picking apples is engaged in direct or nearly[5] direct production, notwithstanding he uses a ladder *and* gets the apples from trees which had to be produced by the industry of the past and which are clearly capital. But the farmer who is *planting* apple trees from which apples can be got in (say) ten years, is definitely engaged in *roundabout* production. Using the terms thus, we can say that both direct *and* roundabout production involve labor *and* land *and* capital. A building (capital) is being devoted to roundabout production when it is used to produce building materials or machinery for further production and is devoted to (relatively) direct production when it is used to produce shoes

[5] If not *quite* "direct," this is because the apples are not immediately consumed and, even, may go through several hands before being consumed. They may go, for instance, to a commission merchant, and thence to a retail grocer or, possibly, be kept for a time in cold storage.

or clothing or (e.g., a bakery) bread. Similarly, a piece of *land* may be devoted to direct or to roundabout production according to what goods are being produced from the land or, even, according to the use to be made of these goods. For example, a coal mine is being used for roundabout production if the coal produced is to be used for smelting steel, and to relatively direct production if the coal is to be used to heat homes.

This line of distinction between roundabout and direct production brings more clearly into view an alternative of the wage earners which seems never to have impressed Böhm-Bawerk at all. Böhm-Bawerk appears to think of the wage earner as having a choice, as a rule, only between working in a *roundabout* process for a capitalist or working—for himself—in a direct or relatively direct process. For he says:[6]

> Let us assume that, in the methods of production current in economical society at the moment, the making of a product ready for consumption requires a period of time extending in all over two years. The technical productiveness of this method, we shall assume, is such that it takes a week's labour to turn out a product which will have the value of 20s. The same product may be turned out by shorter methods, but the result will be disproportionately unfavorable. If a three months' process is adopted, the technical result falls to one-half; if the worker has no capital, and his process is, accordingly, one that yields its return immediately, the productiveness falls to one-quarter;—that is, respectively, to 10s. and 5s. . . .
>
> In the circumstances of modern industry, the wage workers scarcely ever possess sufficient means to utilise their own labour in methods of production extending over years. They have, therefore, to face the alternative of selling their labour, or of employing it on their own account in such short and unproductive processes as the scanty means at their disposal permit. Naturally they will make that choice which is most advantageous to them. Those workers who are well enough off to embark, on their own account, on a production process lasting at least three months, and yielding a return of 10s. per week, will be willing to sell their labour at any price over 10s.; at any price under 10s. they will rather work on their own account. On the other hand, those workers who are entirely without means, and who, working on their own account in a hand-to-mouth process, could only have a return of 5s., will be willing to sell their labour at any price above 5s. As, unfortunately, the labourers who are entirely without capital, form to-day the great majority, we may assume for our illustration that the "Supply" of labour will be represented by a long row of workers who are ready, in the worst case, to sell the week's labour for 5s., and a shorter row who will do the same for 10s. present money.

[6] *Ib.*, pp. 313–4.



But in fact the wage earner has the significant alternative, even though he works for hire, of either working to produce capital *or* engaging in *direct* production in the sense of direct production which has been indicated in the present article as the sense most helpful for the analysis of the problem of distribution. Thus, the worker can plant new fruit trees (roundabout production) *or* pick fruit (direct production) from trees already bearing. He can build new fishing boats and make new fishing nets *or* he can work, with what capital is already available, to catch fish. He can, on the one hand, build barns or manufacture reapers, cultivators or harrows (using, in so doing, capital already in existence); *or* he can, on the other hand, gather vegetables or harvest grain.

Furthermore, the worker who chooses to follow *direct* production (in the sense here indicated) does not have to be supported by the saving of "capitalists," even though he may be hired by capitalists, or of anyone, since he is himself producing present, i.e., immediately consumable, goods. In other words, he *and* the workers engaged in producing the various other kinds of immediately consumable goods are together producing as much in such goods as they are consuming. They not only produce the amount of their wages but it is possible, even, that, collectively, they produce the exact kinds and proportions of goods they consume.[7].

The worker who is engaged in roundabout production,

[7] Not certain, since capitalists and landowners and laborers all exercise choice as to what special kinds of goods to consume.

But cost of production, in this view, is not to be measured merely in the alternative which *labor* has of producing present goods. Capital is produced by labor *and* land *and* preexisting capital. In producing a particular piece of capital, other capital was used. A building, for example, is not the product of labor alone. The lumber, or the structural steel and brick, used in its construction, were produced with the aid of capital—buildings and machinery. Such buildings and machinery might have been used for the production of present goods or, at least, of more nearly present goods.

It is true that some capital is highly specialized and cannot be used effectively in other lines. So, indeed, is some labor highly specialized. And some land—e.g., a mine of iron ore—may be adaptable only to roundabout production. Nevertheless, much labor, much capital and much land can be turned *either* to producing goods for relatively immediate enjoyment *or* to the production of more capital (viz., to roundabout production).

And so, if capital were to be less valuable, in relation to present goods, the labor and the land and the capital which are engaged in producing capital and which are marginal (in doubt—"on the fence") between such production and the production of present goods, would cease producing capital (i.e., would no longer engage in roundabout production) and would turn to the production of present or immediately (or nearly immediately) consumable goods.

And if, on the other hand, capital were to become appreciably *more* valuable, in relation to present goods, then labor and land and capital which are engaged in producing present goods and which are marginal between such production and the production of capital, would turn to the production of capital.

In short, capital in general cannot be expected to remain worth less—and it cannot be expected to remain worth



more—than its marginal cost of production measured in the present goods or immediately consumable (or the *relatively* immediately consumable) goods that the factors producing capital might produce instead.

It is to be noted that this cost of production operates on the demand side as well as on the supply side of the market. A would-be purchaser of a piece of capital, who could himself produce it in the time required to earn (say) $500 by producing present goods, would refuse to purchase this capital at a price of $550 but would instead make it himself. In other words, he would *not* appear on the *demand* side of the market, i.e., as a buyer of capital, at a price for this capital higher than its cost of production *to him*.

No doubt, in our specialized economic world, the would-be purchaser of a piece of capital does not *generally* have the practicable alternative of himself producing it. But sometimes he does have this alternative or, at least, the alternative of partly producing it (but buying some materials for it). Furthermore, if it is selling at an unduly high price, there will be persons or corporations able and willing to produce it at a lower price because they are able to produce it at a lower cost, and their competition will normally bring down its price.

It seems to me that nobody who *really* understood the direct influence on the value of capital, of cost of production operating through both the supply and the demand sides of the market, could possibly write as did Böhm-Bawerk in his criticism of the Ricardian law of rent. This is what Böhm-Bawerk said about it:[8]

> The theoretical explanation of rent from land, then, coincides ultimately with the explanation of interest obtained from durable concrete capital, and land rent is nothing but a special case of interest obtained from durable goods. That the two explanations do not entirely coincide, and that, on

[8] "The Positive Theory of Capital," English tr., pp. 355–6.

the contrary, the current rent theories are substantially so very different from the interest theories, is only traceable to the fact that, in the course of the explanation of rent, an intercalation had to be made which did not require to be made in the case of interest on durable capital; and that, at the same time, from a faulty conception of the rent problem, economists exhausted the whole content of the rent theories in making this special intercalation. In the case of all products of labour, and, consequently, in all goods that constitute capital, it needs no explanation that they and their material have economic value: were it not so they would not be produced. In the case of the services of land, on the other hand, this is not self-evident. And, therefore, the economist must first exert himself to show why and under what circumstances the use of land receives a value and a price. With a correct value theory, a few strokes of a pen will supply this proof;—by means of the doctrines of marginal utility and of complementary goods. Wanting the guidance of such a theory, and entangled in the fetters of the labour value theory, economists gave it a shape which was unnecessarily circumstantial and clumsy, and was, at the same time, not very satisfactory in principle. Of Ricardo's rent theory, which in essence has remained the ruling one up till the present day . . . it must be said that it contains an abundance of truth put in a formula essentially false. It is a brilliant piece of casuistry, which is out of connection with the central fire of correct principles; it lights up a bit of the road, but leaves the rest in obscurity and error. . . .

But how far does the Ricardian, or any other rent theory, take us, even if it were correct in every point where it is disputable? It takes us no further than we get in the question of interest, when it has been shown that a threshing machine, after deducting all other costs, yields an annual *gross* interest, and why it does so. Where Ricardo ends his rent theory, there in truth ends the intercalation, which, because of its obviousness, did not require to be made in the case of movable capital. But it is just then that the chief question of the problem suggests itself: why there is a net interest within that gross interest which is yielded by the year's use or service of the threshing-machine or the field, after deduction of all other costs. And to this question—which the rent theory up till now has entirely omitted to put—no answer can be given, either as regards the field or the machine, but to point to the under-valuation of future goods and future services.

Here Böhm-Bawerk is saying, is he not, that *both* the capital which men make *and* land are valued by a process of



capitalizing or discounting the anticipated future yield into a present value? Here he is definitely overlooking the fact—or so it seems—that the *cost of production* of capital has a *direct* influence on both the demand for it and the supply of it and, therefore, on its price.

But it is along this line that Böhm-Bawerk analyzes the value of "production goods" throughout "The Positive Theory of Capital." Thus, in an earlier chapter in which he treats especially of "The Value of Production Goods,"[9] as in the passage quoted above, he explains the value of capital as arrived at through the discounting process from the future income yielded by it.[10] Nowhere does he appear to evidence a clear comprehension of the fact that capital cannot, in general and in the long run, be worth more than or less than its marginal cost of production and that this cost, for capital-in-general, is properly expressed in terms of the present (immediately consumable) goods which might be or might have been produced instead. Nowhere does he evidence a clear comprehension of the *direct* influence on the value of capital, stemming from the fact that the factors (labor, land and capital) which produce capital can be devoted, instead, to the production of present goods.

But might not his entire point of view on this matter have been different if he had followed the line of distinction between direct and roundabout production which has been set forth in this article and which brings into view the alternatives of the worker (and also of capital owners and landowners), *instead of* considering all production other than that

[9] Chapter X of Book III.

[10] It is true that he shows (pp. 186–9) how a consumable product may appear to get its value from the "productive good" used in producing it and, therefore, as he puts it, from "cost." But he is careful to point out that, in this case, the value of the "productive good" is arrived at (through discounting) from the value of one of its alternative products and that in "the *last* resort" the value of the consumable product really "adapts itself only to the value of another product." Nowhere, certainly, does he show an appreciation of the direct influence of the cost of production of *capital* on the value of the capital.

"with the naked fist" as roundabout? Would he not then have been much more likely to have recognized the *direct* influence on the value of capital of the cost of producing it? And would he not have been much more likely to have recognized a clear and sharp distinction between land and capital and, along with that, between the rent of land and the interest yielded by capital?

The extent to which this practice of relying exclusively on a capitalization or discount process for arriving at the value of capital has permeated Böhm-Bawerk's thinking is indicated further in some of his statements regarding the gain or "profit" on capital. Note, for example, the following paragraph:[11]

Knowing that the undertaker buys the future commodity, "Means of Production," for a smaller number of pieces of present goods than the number of pieces which will compose their future product, we ask, How does he come by his profit? The answer is very simple. From his "cheap" purchase, indeed, he does not get any result; for, estimated by its present value, the commodity is dear. The profit comes first into existence in his hand. It is during the progress of production that the future commodity ripens gradually into the present commodity, and grows at the same time to the full value of the present commodity. Time elapses; what was next year becomes this year; and on the great changing stage of life everything—man himself, his wants and wishes, and with them the standard by which he measures his goods—shifts one scene forward. The wants which, last year, were future wants, and little thought of as such, attain their full strength and their full right as present wants; and a similar advance attends the goods which supply these wants. A year ago they were goods of the future, and had to be content with the lower value that attached to them as such; to-day they are present goods, ripe for consumption, and enjoy the full value of such goods. A year ago it was to their prejudice that they were measured in the, then, "present" goods. To-day that standard has sunk into the past, and if the men of to-day measure them again in "present" goods, they stand equal with them in the first and chiefest rank, and suffer nothing by the comparison. In short, as time passes it cancels the causes by reason of which the then future commodity suffered a shrinkage

[11] *Ib.*, pp. 301–2.



of value, and brings it up to the full value of the present good. The increment of value is the profit of capital.

A simple, clear and logical view of the causation of an interest return on capital is that capital ordinarily *adds* to the output of industry by more than its cost, i.e., by more than enough to meet repairs and depreciation; that this gain naturally goes to the person who owns capital and to anyone who, through saving, brings new capital into existence; that a borrower will gladly pay interest to a lender for the use of capital which is thus productive and that a lender, who can himself use profitably the capital he has saved, will seldom wish to lease or lend it to another without charging interest.

But this is not Böhm-Bawerk's approach. On the contrary, his view is that the value of capital is arrived at not by its cost of production but *solely* through *discounting* its prospective future yield; and that the gain or "profit" or interest yielded results from the fact that, as time passes, *the future discounted value becomes a present realized* (and larger) *value.*

It is true that Böhm-Bawerk had much to say about roundabout production and the gain yielded by it. And there is no question that he thought of this gain as having something to do with the receipt of interest. But he thought of the relationship as quite different from the simple one set forth above. His view was that there were a number of reasons why future goods are less valuable than present goods,—why men prefer present goods to future; and that one of these reasons was the possibility of gaining by means of roundabout production. Hence this gain from roundabout production tended to influence the rate of discount and, thereby, the rate at which future discounted value increased to present realized value.[12] In short, the rate of gain from roundabout production helped to determine the rate of subjective preference for present as

[12] *Ib.*, Book V.

against future goods and this preference caused a rate of discount or interest in the capital market.

To a somewhat similar view (perhaps not precisely the same) as presented by other and later economists, I have elsewhere[13] presented the following reply:

If the same amount of labor which would produce 100 units in present goods would, when invested in a roundabout process, bring 110 units a year later, and if this is true as regards all the labor which can be spared for roundabout production, then it requires, in the market, approximately 110 units of next year's goods to buy 100 of this year's.

To make clear the way in which our assumed gain of 10 per cent from roundabout production would influence a borrower, let us suppose the case of a man who needs 100 units of this year's goods to support life during the year and who must, therefore, spend his time in direct production, in order to secure these goods, unless some one else will provide him with the desired 100 units of this year's goods (or the money to buy them), as a loan or in some other manner. If he can secure the 100 units as a loan, that is, if he can borrow, then he will not have to spend his time producing this year's goods, but can engage in roundabout production. In our illustration, this means that his work invested in roundabout production will secure 110 units of goods available next year, instead of the 100 units of present goods which it would otherwise bring. Thus, if he can borrow, his production will be larger by 10 per cent. As long as he can borrow at any lower rate than 10 per cent, whether the rate be 7 or 9 or 9.9 per cent a year, it is to his advantage to borrow and to secure the larger output which roundabout production makes possible.

Unlike a spendthrift borrower, the borrower of our illustration does not borrow in order that he may more largely increase his present income at the expense of a more than equal reduction of his future income. He does not borrow in order to save himself present work, but in order that his present work may be devoted to a more productive roundabout process rather than to a less productive direct process. In borrowing, he really is not comparing this year's 100 with next year's repayment of 109 or 109.9, for he could get this year's 100 without borrowing, by devoting his labor to direct production. Instead, he is comparing the 110 of next year's goods which roundabout production will yield, with the 109 or 109.9 (or anything less than 110) which he must pay for the loan. *He is comparing two futures rather than a present and a future. . . .*

[13] "Basic Principles of Economics," Columbia, Mo., Lucas Brothers, 1942, pp. 330–3.



Thus, during a twenty-year period, while direct production would, as here assumed, bring but 100 units a year or a total of 2,000 units, a roundabout process could produce for each year's efforts, up to and including the nineteenth year, 110 units available the year after, or 2,090 units not counting at all the further product of the twentieth year's efforts. Even if, in order to bring the entire reward of the twenty years of effort within the twenty years, the work of the twentieth year must be devoted wholly to direct, as contrasted with roundabout production, so yielding only 100 units, still the total reward of the twenty years of activity is 2,190 units. And it would be only 2,000 units if productive effort were wholly direct throughout the twenty years. If a producer borrowed to make such roundabout production possible, his borrowing would be, surely, in no sense due to a preference for present goods as such or because he wished to enjoy an earlier instead of a later output. Rather would it be due to a preference for a production, during the twenty years, of 2,190 units of goods instead of only 2,000 units.

Whatever may be said as to the possibility and justification of formulating the problem as Böhm-Bawerk does, it can hardly be denied that his formulation keeps pretty effectively out of sight the fact that the significant choice may be between two futures. Böhm-Bawerk's formulation reduces the problem entirely to one of choice between future and present. And thus here again, as in the question of the value of capital, it looks as if he had "shunted the car of economic science on to a wrong line." In fact, this is not a different question but, rather, part of the same question. Indeed, a principal reason for discussing here the quoted passages from Böhm-Bawerk dealing specifically with the theory of interest, is that these passages throw light on his view regarding the determination of the value of capital. It is all part and parcel of the same economic philosophy.

Some contemporary economists who have failed to realize the *direct* influence on the value of capital, of its cost of production—a direct influence operating through both supply and demand—have argued for an indirect influence. Like

Böhm-Bawerk they hold the view that the value of a piece of capital is derived from the value of its expected future yield by capitalizing or discounting this anticipated yield into a present value. But they contend that a lower cost of production of a given kind of capital equipment tends to encourage the construction of more such equipment, that this means a larger total future yield from this kind of capital and, hence, a smaller value per unit of such yield. As a result, they say, the capitalization of such future yield into a present value is less and thus the reduced cost of construction of the capital has brought—through all of these steps in the order stated—a reduction of its value.

To illustrate this point of view, let us suppose the case of a fisherman who owns an old fishing boat that will soon be too depreciated for further effective use. He wishes a new one. He is able to catch $150 worth of fish per month. But he is also a good boat carpenter and can build himself a satisfactory boat in a month's time.[14] A professional boat builder offers him a boat practically identical with the one he can build, at a price of $250, and he refuses to buy it. He considers that he can build himself such a boat at a cost of $150 (in the value of the alternative goods—fish—he might have produced during the month). He will not buy at a price greatly above the *cost of production to him*. Nor will other fishermen who know anything about boat building. (Those who do not know how to build boats will still presumably have the advantage of the competition of boat builders who, also, will find less demand at prices that tempt some fishermen to build their own boats.)

Now let us imagine one of these economists—a Professor Richard Roe—saying to the fisherman:

[14] In our specialized society, no one would be likely personally to do *all* the work, including the making of the screws, cutting the trees for lumber, etc. But to make due allowance for these complications would render the argument harder to follow while nevertheless not at all modifying the general principle involved.



> I suppose that when you refused to buy the boat for $250 you made your adverse decision solely because, knowing such boats to be producible for much less than $250, you foresaw that fish would henceforth be correspondingly plentiful. You, therefore, believed the fish would be relatively cheap. You then capitalized into a present reasonable value for such a boat the future low-priced fish which could be imputed to (the marginal product from) the use of the boat. And this capitalization came out at considerably less than $250.

The student of economics who is thoroughly indoctrinated with the theory of capitalization may, indeed, go through this reasoning. And even the fisherman may realize, if the argument is carefully explained to him, that such a train of thought would not be entirely illogical but, in fact, includes a substantial part of the truth. Nevertheless, he is much more likely, in our story above, to think of the *direct* effect of cost of production of capital on its value, and, if the student of economics does not think of this, at any rate he ought to. The fisherman might well say:

> Why no, Professor Roe, I didn't think at all of the matters you speak of. I just thought it was foolish for me to work almost two months to earn $250 in order to buy such a boat when, by working only a month, I could build one exactly like it.

Is there or is there not, because of the alternatives of different persons, such an influence of cost on value? If there is, then the "capitalization" or "discount" theory of the school of economists described above, notwithstanding that it does contain an element of truth, is certainly a *most inadequate* description and explanation of the facts.

I believe I can claim to speak without undue prejudice. For, although I have been emphasizing for some thirty years, whenever I have had the opportunity, the direct influence of the cost of producing capital on its value, nevertheless I was myself, at an earlier date, an adherent of the other view!

III

The blurring of the distinction between land and capital and between rent and interest which we have been noting in Böhm-Bawerk, is found in the works of a good many later economists, some of them of high distinction. To what extent they have been influenced directly by Böhm-Bawerk, I am not in a position to determine. Probably many of them have been led to their slant on the matter through the comments of John Bates Clark in his well-known study of "The Distribution of Wealth."[15] Clark was a highly original thinker whose analyses of the relation of the productivity of labor and capital to wages and interest placed all economists in his debt. But in view of Böhm-Bawerk's wide influence and the fact that Clark was familiar with his work and cited him several times in "The Distribution of Wealth," it seems reasonably probable that the point of view here referred to (which, I believe, will clearly appear to be a wrong one) really stems from Böhm-Bawerk. Clark's statement of the point of view is as follows:[16]

> What, then, is interest? Is it not a fraction of itself that a permanent fund of wealth annually earns? . . . Does a building, or an engine, or a ship literally earn in a year a fraction of itself? . . . The *capital* that is embodied in the buildings, the engines and the ships of the world does enlarge itself in this way. *It earns interest; but what the concrete instruments themselves earn is not interest, but rent.*
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> A popular and accurate use of the term rent makes it describe the amount that any concrete instrument earns. . . . In a use of terms which harmonizes with practical thought and which, as we undertake to prove, is entirely scientific, rent and interest describe the same income in two different ways. *Rent is the aggregate of the lump sums earned by capital-goods; while interest is the fraction of itself that is earned by the permanent fund of capital.* . . . . .
>
> Science has proposed a different distinction between rent and interest. It has tried to confine the former term to the product of land,—and that, too, without taking account of changes in the value of land,—defining it as what a tenant pays to his landlord for the use of the "original and indestructible" properties of the soil. This usage probably would never have grown up if the science of political economy had originated in America, where land has always been a commercial article, and where the man who buys a piece of it reckons whether he can get as good interest on his investment in that form as he can in any other.

[15] New York, Macmillan, 1899.
[16] *Op. cit.*, pp. 123–4 and 137.



It is true that the return on land and the return from capital can be stated, either of them, as a percent *or* as a lump sum. *Superficially* then, the return from land and that from capital may seem much alike. But this is *only superficially.* For the return from capital is naturally reckoned as a percent and ought to be so reckoned,—a percent on the *cost* of the capital. What we are interested in knowing in the case of the return from capital, is how much more we gain by following a roundabout process than a direct process of production, and how much the extra product amounts to *in comparison with* what the product would be had immediately consumable goods (present goods) been produced instead. In other words, we are concerned with knowing the *percent* of the excess gain from roundabout production to what would be or would have been secured by direct production. In still other words, we are concerned with the fact that capital normally yields, during its lifetime, *more* than its cost of production (measured, as we have herein noted several times, in the present goods that might be or might have been produced instead), and we are naturally and properly interested in knowing how large this gain is *in relation to* the cost of the capital which makes it possible.

But the value of land is *not* measured by any "cost" of "producing" the land. Hence it is essentially meaningless to inquire as to the percent yield *on* cost.

It may be said, however, that Clark and the other economists who follow him and Böhm-Bawerk do not refer to a

percent of cost of production but to a percent of *value*. And, it may be asked, why is not the percent of the value of land a matter of significance just as is the percent gain on the value—and so the cost—of capital?

The answer is that this *value* of land depends on the expected future yield *and* on the *percent* at which this expected yield is capitalized into a present value. The market rate of interest used in such a process of capitalization, itself depends largely on and tends to be equal to the rate of net marginal yield of capital on the cost of production of capital. Knowing the *cost* of capital in terms of present goods *and* the rate of net marginal yield on this cost, we know the percent interest rate which should be used in capitalizing the anticipated future rent of land into a present value. Thus, the sale value of land has *no independent significance* but is merely a derivation from the anticipated rent of the land and from an interest rate which is a function of the productivity of capital. To talk about the rent of land as a percent on its value is, therefore, to emphasize as if it were important, a percent of a value which itself can be arrived at *only by knowing that percent in advance*.

The rent of land, then, is logically and properly expressed as a lump sum,—in dollars; while the interest on capital is logically and properly expressed as a percent on cost.

One wonders how many of the numerous neo-classical and other contemporary economists who have followed Böhm-Bawerk and Clark in this analysis have plumed themselves, like these two, on having seen more deeply into the problem of land rent than did Ricardo and other economists of the earlier (i.e., not "neo") classical school; whereas, actually, they have seen *less* deeply into it.

One wonders, too, whether there have not been a number of neo-classicals of conservative bent who, confronted with the contention of Henry George that the rent of land is the ideal source of public revenue, and reacting antagonistically to this contention but in doubt as to just how to meet it, have been relieved at the thought that land rent is really a percent *just like interest on capital;* and have felt that now, indeed, they could confound the land-value-taxers and discredit their philosophy!



But possibly the day has finally passed of easy victories over the land-value-taxation philosophy, for conservative economists who have too easily accepted, and used in their propaganda, various superficialities and half truths and outright fallacies.[17] Perhaps the time is coming when those who see great advantages to society from the public appropriation of practically all of the annual rental value of natural resources and sites, can no longer be put on the defensive among their professional confreres by such propaganda. Perhaps it will not be they who, in the decades to come, will be looked upon as fair game for satirical comment or, otherwise, as reformers whose case can be safely ignored. Mayhap, instead, it will then be the few remaining intellectual heirs of the satirizers and ignorers who will have to sit in the outer cold and darkness while those of the land-value-tax philosophy are warming themselves at the fire of general professional approval!

[17] See, for an analysis of many of these, my book on "The Economic Basis of Tax Reform," Columbia, Mo., Lucas Brothers, 1932.

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# Economic Fallacies and Economic Teaching

IT IS HIGHLY IMPORTANT in the teaching of economics that students be taught to analyze various widely held fallacies and that they learn how to refute them convincingly. Any teaching which leaves them the easy victims of such (often) plausible fallacies is to that extent inadequate and superficial. Any such teaching is not less—but, rather, all the more—important when some of the fallacies have had the support not only of many of the politically "great" but of well-known professional economists!

Among the fallacies which, in my own teaching, I seek to guard my students against, through explanation, analysis of quotations, general discussion, and written examinations, are the following:

(1) That if workers in a particular line are able, through union control of the number of wage earners in it, to get an increase of wages, the prices of goods will rise not only in this line but also in other lines. In fact, in the absence of increased circulating medium, prices and wages in other lines will tend downward.[1]

(2) That the initiatory force in bringing about business depression is a "state of mind" manifesting itself in "liquidity preference" or a tendency to hold money idle (*i.e.*, a reduced velocity of circulation), rather than a decrease of circulating medium as by sharp and persistent bank credit restriction.[2]

(3) That spending by government for public works can be relied on as an effective way to mitigate unemployment, entirely regardless whether it is new and additional circulating medium which is thus spent, or funds secured through borrowing from or taxing persons who are thus made to spend less in order that government may spend more.[3]

(4) That if other countries depreciate their currency in relation to gold

[1] This is discussed at length in my "Basic Principles of Economics," 2nd edition, Columbia, Mo. (Lucas Brothers), 1947, Chapter V, §5. *Cf.* also, "A Postscript and Questions," Columbia, Mo. (Lucas Brothers), 1946, Part II, Chapter V, §5.

[2] See "Basic Principles of Economics," Chapter VI, p. 129, and "A Postscript and Questions," Part I, pp. 40 and 41. Compare, also, my recent paper in AM. JOUR. ECON. SOCIOL., Vol. VII, No. 2 (April, 1947), entitled "Two Decades of Decadence, in Economic Theorizing," especially pp. 164–5. In this connection, too, I would refer the reader to a communication by Dr. Clark Warburton in *The American Economic Review,* Vol. XXXVIII, No. 1 (March, 1948), entitled "Hansen and Fellner on Full Employment Policies." This, though brief, is an effectively presented challenge and discussion.

[3] "Basic Principles of Economics," pp. 121–2, and "A Postscript and Questions," Part I, pp. 30–32.





(as by raising an official government price of gold), we must do likewise or have depression and unemployment. In other words, they will "export their unemployment" to us.[4]

(5) That an increase by the United States in the official price of gold, sufficient to prevent the outflow of gold, is the same in its effect on foreign trade as the levy of a protective tariff, *i.e.*, that it similarly reduces international division of labor.[5]

(6) That there is no loss or economic disadvantage in having a huge national debt provided it is domestically held, so that "we owe it to ourselves."[6]

(7) That government borrowing (as by selling its bonds) cannot, according to the condition of bank reserves and whether government does or does not spend the proceeds, either increase *or* decrease the volume of circulating medium and the general level of prices.[7]

(8) That "exploitation" of the workers by "capitalists," by making it "impossible for the workers to buy back what they produce," is the cause of business depression and unemployment.[8]

(9) That the existence of low wages and a "low standard of living" in a country gives it a better chance to produce goods cheaply and thus "undersell" countries with higher standards of living.[9]

(10) That to give certain groups subsidies or tariff favors increases the demand for goods because the favored groups have more to spend, and that thus there is no loss but rather a gain to the groups that are taxed to make the favoritism possible.[10]

(11) That the best system of valuation of public utilities for the purpose of rate regulation is on the basis of "prudent investment," *i.e.*, the amount in dollars "actually, honestly and prudently invested" in the plant at some date in the past and with no allowance for any change either in particular cost prices or in the general price level.[11]

(12) That if inequality is unjustifiably great and thus some have large

[4] "Basic Principles of Economics" p. 116, and especially, "A Postscript and Questions," Part I, pp. 113–4.

[5] "Basic Principles of Economics," pp. 165–6, and "A Postscript and Questions," Part I, pp. 111–2.

[6] "A Postscript and Questions," Part I, pp. 25–6.

[7] "Basic Principles of Economics," pp. 114 and 121–2, and "A Postscript and Questions," Part I, pp. 30–6.

[8] "Basic Principles of Economics," Chapter VI, §7. *Cf.* "A Postscript and Questions," quotations and questions in Chapter VI, §7.

[9] "Basic Principles of Economics," pp. 149–51 and Appendix, §1, and, especially, "A Postscript and Questions," Part II, Chapter VII, §3, numbers 7 and 8.

[10] "Basic Principles of Economics," pp. 167–71.

[11] *Ibid.*, Chapter VIII, §§5 to 10 inclusive.

incomes to which they are not properly entitled while others are poor, a good way to obviate the evil is through a government policy of restricting the production of the things the well-to-do desire and of encouraging relatively the production of the necessities and comforts of the poor.[12]

(13) That the invention and use of labor-saving machinery decreases the opportunities for employment and tends to bring about widespread unemployment.[13]

(14) That the most expensive part of the supply of a commodity can be identified—at least theoretically—as that part produced by the "high-cost firm" or firms; and that the so called "marginal cost curve" of such an individual "high-cost" firm necessarily indicates the price which must be paid to get *that part* of the supply produced. Whereas the truth is that marginal *opportunity cost* is fundamental in the explanation of supply in a way that the so-called marginal cost of the individual firm (really marginal outlay) is not.[14]

(15) That the value of capital is determined only *indirectly* by cost, *i.e.*, that cost of production of any kind of capital determines the amount of it produced, that the amount of it produced determines its yield, and that its yield determines (through the process of capitalizing or discounting) its sale value, and that it is only *through* this indirect process that the cost of production of capital has any causal relation to its value.[15]

(16) That the productiveness of capital affects the rate of interest *only indirectly, i.e,* only *through* its effect on the "time shape of the income stream" or (otherwise expressed) through "over-endowing the future" as compared with the present.[16]

(17) That interest on capital is not earned in the same sense as wages, *viz.*, through contribution by the saver (if he truly earns what he saves) to production, over and above what would be produced in the absence of the capital his saving made possible.[17]

(18) That when tangible capital is taxed, mortgage holders, bond-holders

12 *Ibid.*, Chapter VIII, pp. 216–7.
13 *Ibid.*, pp. 258–9, and "A Postscript and Questions," Part II, Chapter XI, §1.
14 "Basic Principles of Economics," Chapter XI, §§3, 4 and 5 and Appendix, 3; also, "A Postscript and Questions," Part I, pp. 19–20.
15 "Basic Principles of Economics," Chapter XIII, §§3, 5 and 9 and especially pp. 338–9.
16 *Ibid.*, Chapter XIII, §§2 to 6 inclusive and 9.
17 *Ibid.*, Chapter XII, §5, and Chapter XIII, pp. 336–7 and §10.



and other lenders "escape" taxation unless intangibles are also directly taxed.[18]

(19) That the willingness of some wage earners to work for less than labor is worth in a free market, compels other workers to accept equally low wages and so "brings down the whole level of wages."[19]

(20) That there is no distinction significant for economic theory or policy, between capital and land or between the interest yielded by capital and the rent of land.[20]

(21) That the effect of taxing land values is to increase the rent paid by tenants, whereas it definitely tends to reduce rent and to increase wages.[21]

(22) That (within the limit of the amount of revenue either one could yield) a graduated income tax is more favorable to the welfare of wage earners than a tax which would appropriate nearly all of the annual rental value of land.[22]

(23) That although changes in economic policy, including tax policy, which redound to the general advantage are to be desired in other cases, nevertheless an increase in taxes on land values relative to other taxes is ethically indefensible regardless of its beneficence.[23]

(24) That in teaching economics it is just as well to leave out—or to barely mention—the question of who should have to pay whom for *permission* to work and to live on the earth, in those locations where work is relatively effective and where life is not too unpleasant.[24]

Could it possibly be that the younger generation of economists have given their time so completely to the study of bizarre theoretical systems which, though temporarily of the "new look" variety, may soon be—and perhaps already are—"on the way out", while giving inadequate attention to some of the most fundamental principles and most significant problems of economics, that they must be regarded as in considerable degree a "lost generation?"

And might it be, too, that by leaving out, especially, or soft-pedaling, *what is perhaps the most exciting and vital question economists can face,* they necessarily *rob their teaching* of its *greatest and most dramatic appeal* to students?

18 *Ibid.*, p. 378 and Appendix, §4.
19 *Ibid.*, pp. 409–10.
20 *Ibid.*, pp. 264–5, 276, 310, 351–3, 378 and Chapters XV and XVI.
21 *Ibid.*, pp. 426 and 474.
22 *Ibid.*, pp. 426, and 474–84.
23 *Ibid.*, Chapter XV, §11, and "A Postscript and Questions," Part I, Chapter VII.
24 See my booklet on "The Teaching of Economics," New York, Robert Schalkenbach Foundation, 1948, especially Chapter V.