

# **Topics in the Measure of Economic Freedom**



# Politicized Prices

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## Introduction

**W**HEN A PRICE GOES UP, economists would normally expect that the quantity demanded would decline. But when some prices go up, people riot in the streets and overturn buses and governments. What determines the difference in responses?

Some prices are believed to have been politicized, and influenceable not only by supply and demand forces, but by activity in the political arena as well. If a part of the public believes that a price has become, or could readily be, politicized, then there is less reason to view the price as a parameter and to be a passive price-taker. Using the notion of politicized prices, we gain important insights into the political economy of the modern state in both developed countries and in the Third World.

Bates has investigated the developing economies of Western Africa, and found extensive politicization of prices in key markets. Most of these economies had developed at least one cash crop during the colonial period,

and continued exporting this product after independence. However, the monopsony trading companies which had organized export in the colonial period were not just continued. In addition, they were used much more extensively as revenue sources by paying the cash crop producers less than the world price. The resulting politicization of the export price generated substantial urban-rural tensions and lackluster export performance.

De Soto has produced a remarkable book, *The Other Path*, which details the restrictions on the private sector which Peruvian governments have created. The result of the restrictions is the creation of a dual economy which is quite different from the dual economy discussed by some labor or development economists. The relatively modern formal sector of the economy exists in urban areas. It employs a small fraction of the labor force, usually unionized, at relatively high wages. Most of the formal sector consists either of State Enterprises (SEs) or of firms which are subsidized or protected by the state from foreign competition.

Large numbers of rural migrants have come to the cities, particularly to the capital of Lima, during the twentieth century. Most of these migrants are indigenous Indians, while most of the urban residents had been at least partially of European origin. To halt the in-migration, various governments passed laws and regulations restricting the economic opportunities of the migrants, making them ineligible for jobs in the formal sector and unable to own urban land. The result is a nation in which associates of de Soto have estimated that 63% of the labor force works in illegal informal economy employment. At any time, the police or other bureaucrats can harass or put the squeeze on these workers and, in fact, do so from time to time. The entire formal sector is required to adhere to detailed labor laws and other regulations to the extent that de Soto estimates (p.150) that, on average, a formal sector firm incurs costs of satisfying these regulations that are three to four times the taxes paid by the firm.

The formal firms have access to three key resources controlled by the state. Such firms can borrow from the formal sector banks, which may charge 15% to 20% interest on a loan in the face of an inflation rate that often exceeds 100% p.a. Access to such a loan means a subsidy of at least 80% of the principal loaned, and access is limited. The banks can lend money at this negative real rate since they are allowed by the government to borrow from the central bank discount window at 6% to 9%. Again, access to this source of funds is rationed, presumably by political means.

The second key resource to which formal sector firms can compete for access is foreign exchange. The Peruvian governments have maintained a heavily overvalued currency, making foreign exchange quite cheap, typically 10% to 20% of the black market price. Gaining access to foreign exchange then consists of an 80% to 90% subsidy, and access is rationed by the political authorities.

In both the foreign exchange and bank loan markets, the prices are completely politicized, bearing no serious relation to market equilibrium, other than being far away from an unpoliticized equilibrium. This politicization of price provides considerable resources for the political authorities to allocate at will. The negative real interest paid on savings and deposit accounts causes almost complete disintermediation in the financial sector except for those firms and organizations required by their ties to the state to keep such deposits. The major source of funds for banks to lend is the discount window, and this means that the inflation rate is a residual variable that results from the satisfying of political demands for subsidies. The foreign exchange markets are more problematic for the regime in power, as it cannot print dollars. In this case, all formal sector firms are required to sell their foreign exchange to the central bank, and holding bank accounts denominated in foreign currencies is either totally illegal or tightly regulated. In addition, all transactions by the state with foreign governments, such as aid payments, and international bodies such as the I.M.F. are used as sources of foreign exchange to give away. Through these two sources, a substantial fraction of GNP may be allocated by the state without the use of taxation, being given away to build and maintain political support by helping some friends, and buying off enemies.

The third key resource to which only the formal firms have access is the facilitation services of the state: its legal system. The informal businesses have little if any recourse to the formal legal system in Peru, as this system operates such that recourse would have negative value in almost all cases for the informals. As Douglass North has written, there is a fundamental tension between the predatory and the facilitative roles of the state, and Peru has a state that is largely predatory. The only external third party systems of enforcement available to the informal businesses involve the usual social norms of kinship systems and neighborhood control, and the informal systems that they have developed to substitute for the biased formal system. Without access to these three resources provided by the

state, the informal sector of the economy is able to progress only so far, and the lackluster performance of the Peruvian economy, like that of most of Latin America, derives in large part from this cause.

In order to measure important aspects of economic freedoms, I believe that macro methods, while attractive for advertising purposes, are not now suitable as science. The ultimate aim of measuring transaction costs and the politicization of prices is to determine which factors are most clearly related to the economic failure of the typical less developed economy. This means that measures which can be compared across nations are needed, just as in the macro approach. However, I do not believe that any single number can capture the myriad of ways in which the state can be used to distort an economy, since we do not know how to make the various distortions commensurable operationally.

Rather, my approach to measurement is to find ways of measuring the politicization of the set of markets in which a firm operates. With such measures, one can go in two directions. The effects of each type of the politicization on the behavior and performance of an industry can be researched. Does the inability to obtain import licenses to buy spare parts for a modern machine mean that the technology used must be obsolete? Does the illegality of an informal sector business mean that it must avoid the use of fixed capital, since such capital represents quasi-rents that the local gendarmerie and bureaucracy can extract? I believe that these questions are best dealt with at the micro level, especially if we are to obtain theoretical and empirical results that can convince the skeptical or currently indifferent political scientist, economist or public official. Given useful measures of politicization of prices at the level of an industry, performed across a set of industries, one can begin to discuss how to measure economic freedom in a more aggregative way that would enable the measures to be compared across polities. With these measures, we can also determine what factors are related to politicization and of the different forms of politicization. But that is further down the road than what can now be accomplished, and much research is needed to get there.

This paper examines the notion of the politicized price in a single market, attempting to provide means of measuring the politicization. It begins with an examination of several different types of price controls which have been used. The actual effects of these controls vary greatly with the resources available for enforcement, and the belief of the citizenry in

the validity of the price control system. The typical less-developed country has limited fiscal resources available for any sort of use, and its administrative competence is often very meager. Means of evasions and corruption are discussed in this context.

A further limitation on the ability of the state to politicize prices is economic, resulting from the endogenous behaviors of the actors in the economy. The ability of political authorities to affect prices is particularly limited for commodities in international trade and is investigated in Section B. Means of measuring factors which would hinder or allow successful politicization are provided. The ability to enter and exit the industry at will also limits the discretion of the state in politicizing prices, and is considered in the remainder of Section B.

The final substantive section, C, presents some recent examples from U.S. history of the politicization of prices. The California auto insurance regulatory system, described as relying on market forces by MacAvoy (p. 23), was changed in two key ways during the 1980s, resulting in a market that is intensely politicized. The Iraqi invasion of Kuwait on August 2, 1990, caused a substantial increase in crude oil prices and retail gasoline prices. This led inexorably to their politicization, but only to a very slight degree so far. Finally, the industrial policy debate of the early 1980s identified the semiconductor and computer industries as sunrise industries in which the United States had commanding leads. By 1986, the Japanese dominance of the computer memory chip market, called Dynamic Random Access Memories (DRAMs), was clear to all. The response of our politicians was to politicize the price of DRAMs and help make them almost inaccessible for our computer system houses in 1988. These examples suggest that while the U.S. economy may be one of the least politicized economies in the world, one can easily measure significant amounts of politicization in some sectors. While this politicization has not usually lead to riots or the toppling of governments when prices change, it does show that politicized prices are a universal phenomenon, differing largely in the degree of politicization in each market, and the pervasiveness of politicization in almost all markets.

## A. A Private Firm and Controls

Consider the typical firm in the private sector. To avoid problems peculiar to specific sectors, let's assume that the firm is in a business that is not especially likely to be affected by intervention in the usual course of its business. In other words, the firm is not in a regulated industry and is not publicly owned.

How does this firm set its price? The neo-classical model of perfect competition lacks any convincing discussion of how prices are set by competitive firms. Price-setting in real markets, as opposed to perfectly competitive markets in the textbooks, occurs through a process that Popper, in a related context, describes as *conjecture and refutation*. The firm, by setting a price, has made a conjecture that this price is sustainable as an equilibrium. An equilibrium would mean that there are no net forces for change away from the situation that results. Setting a price above the competitive level would make entry profitable, representing forces for change. Entry would occur with the new firms pricing below the first firm in order to get market share, with each making a new conjecture about the equilibrium price. Each conjecture that is incorrect generates a refutation. If the price is still too high, then further entry would still be profitable with the new firms cutting price further. If the price conjecture is too low, then that firm would have many customers, sell most or all of its inventory, and be unable to replace that inventory for sale with the revenues generated. This process would result in the usual equilibrium with all firms producing somewhere near the minimum of their Long-Run Average Cost (LRAC) curves and pricing at that minimum average cost level. Such a conjecture is not refuted by market response, there are no net forces for further change, and it would be an equilibrium. This can result even if the original firm really does not know its cost curves at all, but simply can evaluate its profits and inventories.

What are the ways in which the prices of this firm might be politicized? We shall ignore the specific structure of the state, such as whether it is unitary, federalist, or so forth, and simply view all organs and levels of the state as part of an amorphous whole. That whole is motivated to avoid political problems with the citizenry, and may wish to further the interests of certain groups of people, whether its supporters or dangerous oppo-



nents, at the expense of the rest of the citizenry. We expect that it may wish to intervene in the private sector to further these goals.

The most direct form of intervention that politicizes prices is to set up a system of specific, or general, price controls. The price of each product of a firm may be controlled, with new controls generated for each product added by each firm. Any changes in a product require new limit prices and the sheer magnitude of the attempt to utilize a centralized mechanism of price-setting for all the products produced by each firm soon overwhelms any attempt to operate a control system at this level. The informational flows involved in such a system are beyond belief. As a result, actual systems usually do not attempt to operate at that level, although the Price Control Phases of the Nixon Administration attempted a self-enforced system which tried to set prices firm by firm for each and every product.

Price controls are costly to administer and can require substantial skill and administrative competence. Many states do not seem to possess these characteristics. This limits their choices to three types of price controls. Some types of price controls can be relatively self-enforcing, with one side of the transaction or the other, as well as third parties, quite willing to report attempted violations to the authorities. Alternatively, the controls can be selectively enforced, with whatever enforcement resources that exist being devoted to some small subset of the possible violations, but with no real expectation that the controls are being complied with in general. Finally, the system of controls may simply be something for the supporters of the state to point at as an exemplar that those in the know realize is simply a statement of hope.

### **Self-Enforcing Controls**

Typical price controls on goods sold at retail or wholesale are not self-enforcing. Both parties to the transaction are desirous to make the transaction at the agreed price. The party on the short side of the market, typically the buyer, might have to engage in costly search or incur substantial costs if the transaction does not occur, and may well wish to make sure that the supplier is available for future dealings. The seller would rather receive a price above the controlled one, ignoring differences in risk involved. Neither would usually have an incentive to notify the authorities about the illicit transaction, at least based on the illegal contract alone.

Self-enforcing controls are generally of two types. When wages are controlled, and the controls are generally enforced, the employer has a financial incentive to stay within the law, particularly if the employer believes that other employers are going to comply. This is not a prisoner's dilemma game, but an assurance game. The general experience during World War II was that this seemed to be the result in most labor markets (Rockoff, p.123). A second type of control that lends itself to self-enforcement is one that makes the limit price(s) easily known or seen, and requires each seller to post its own prices, making them highly visible even to third parties. In examining a system of politicized prices, one must find out if there are posting requirements that might make the system more self-enforcing than otherwise.

### **Uniform Price Controls**

A price system that appears simplest to administer, is one which sets uniform prices for a specific commodity for all sellers. Such uniform systems seem quite attractive until one considers the range of commodities and the enormous diversity of the types and forms in which even a "single" commodity can be produced and sold. This type of system may be adequate for those commodities for which standardized contracts such as those traded on public exchanges can be used. But there are contracts on only a few dozen such commodities in the United States, and others which have been attempted have failed, often because of the inability to define and standardize the product sufficiently so that the paper contract could be a nearly perfect substitute for the product itself.

Technology has not been kind to this simplest form of price control. The introduction of flexible manufacturing systems of the type that allowed Coleco to individualize each Cabbage Patch doll are reducing the size of production runs and allowing manufacturers to greatly widen their product lines. This proliferation of product lines makes all price control systems operate poorly, but go to the heart of a uniform price control system: how does a bureaucracy set new limit prices in an economy that produces thousands of new products each month? Obviously, such a system would slow or at least greatly stifle innovation if it attempts to control each commodity. The reality of such control systems, with their human bureaucracies, is that the introduction of new products is the easiest way to evade the controls entirely.

All U.S. price controls systems that attempt to control prices charged by manufacturers have bogged down and failed to work for products such as clothing. Once an industrial economy gets past the initial stages of mass-produced fabric manufacturing, the increasing incomes of the populace gets spent on greater diversity in styles, colors and the fabrics used in apparel making. Each year and each season sees the introduction of new products, with great rewards for those who can discern the desires of the buying public the earliest. Adding price controls and delays to the system is not only not desired generally by the public, but means substantial resources would have to be used to set prices for each of the new products that are continually being introduced. Even though a workforce 1/20 the size of the Post Office was used during World War I for the price control bureaucracy, and a force half the size of the Post Office costing 0.2% of GNP during World War II, these bureaucracies failed to be able to deal with this problem at all (Rockoff, p. 74, 125, 150-4). The apparel companies were easily able to evade any price control at will by introducing a replacement garment. The company itself was expected to determine the control price on the garment, and could expect relatively little oversight in most cases. Enforcement resources were devoted to the larger companies, and clothing with substantial numbers of smaller firms, was very hard to control.

There were attempts to introduce uniform price controls in apparel. These attempts were embodied in the formation of committees to design a standardized garment which all firms in an industry would be expected to produce. Robert Brookings pushed the Liberty Shoe project (Rockoff, p. 50) during World War I for a single design of shoe to be produced by all manufacturers. This effort was unsuccessful, but Bernard Baruch was able to get the firms to produce a more limited range of styles. During World War II, a similar effort was made with women's dresses. Stanley Marcus of Neiman-Marcus was asked to develop a standardization order which covered dresses and bathing suits (Rockoff, p. 117). Before this effort could proceed further, however, the Office of Price Administration (OPA) leadership was removed as having too many professors, and few businessmen (Rockoff, p. 94). This episode illustrates the enormous problems that any uniform price control system would have in a truly modern economy with flexible manufacturing.

The continued use of this system in less-developed economies, such as those of Latin America, illustrates its attraction, just as it may suggest its

power to stifle further economic development. When a state with a weak administrative apparatus and relatively limited resources attempts to operate a price control system, it must use a system that is easy to administer, or accept the result that the price controls will be widely violated. A typical national state in Latin America can acquire about 10% of GNP in the form of tax revenues, and this greatly limits what the state can do administratively. Given such limited real resources to help build political support, the politicians try to use regulatory and other devices to give themselves more with which to acquire and maintain political power. Hence the ubiquity of controls on currency transactions, overvalued exchange rates and high rates of money growth and inflation.

### **Margin Controls**

The earliest form of price controls in the United States were margin controls, which stated the maximum margin allowed on resale of goods purchased domestically or imported. Such controls are simpler to administer than any form of control that requires use of historical records about the prices charged by a firm in the past, or which attempt to control profit margins. In the earliest system of price controls in colonial America, each importer in Virginia was supposed to charge no more than 100% more than their delivered cost for imported goods (Rockoff, p. 16). These early systems were faced with severe administrative problems, and tended to rely on the fear of mob action rather than the direct coercive power of the state. A typical form of enforcement during the Revolution was to publish the names of violators in the local newspaper, with the expectation that the local Sons of Liberty would make the violators see the error of their ways. These schemes might have an effect on prices for a month or two, but usually broke down completely at that point as means of evasion were discovered or shortages developed.

In addition to the administrative problems in enforcement, margin controls are also relatively easy to avoid. Retailers always bundle some services with the goods that they sell. These bundled services also are the first to be adjusted when price controls are used. The physical good may even stay the same as before the controls, but fewer, and less costly, services are afterwards bundled with the commodity. Traditional discounts and courtesies are removed. The customer may have to pick up the product or arrange transportation itself. The systems in the United States during the

twentieth century have allowed higher margins for firms which provide more services to their customers. This created loopholes through which firms could readily go in order to raise prices. But these firms provide the minimum services that could allow the new designation and the higher margin. In general, all bundled services become of reduced quality, and for each class of supplier, the level of services bundled is reduced.

When a manufacturer adds new goods to its output, or a retailer new lines of goods, the margin control system runs into problems. In both cases, no established margin exists on the product, and discretionary decisions must be made. Given the usual flexibility of cost accounting systems, there is some ability to shift costs across products. A supplier with several goods usually finds that some are selling quite poorly, possibly within the price controls. By shifting costs away from these goods and toward the new goods, a higher cost basis can be established for the new good and a higher price charged. Retailers can add the new lines and claim new services that must be bundled with them, and get a higher margin on the new products than on the existing products. Such flexibility gives most price control systems trouble, and the margin control systems are easily evaded by such devices.

Along with the price controls themselves, additional regulations are often imposed to improve compliance with the goals of the system. Advertising of prices is often restricted in various ways, being required or prohibited variously. Requirements of visibly posting transaction prices or legal limit prices are also used to make self-enforcement easier. These features of price politicization also need to be measured.

## Avoidance and Politicization

Attempts to politicize prices are often resisted by the private sector agents on whom they are foisted. This is not always the case, as these agents may expect countervailing benefits accruing from the state as a *quid pro quo*. However, such bargains are not normally enforceable in any court of law if the political authorities change their mind and renege on the agreement. In general, we expect the private agents to use their skills to attempt to avoid or evade the politicizing actions.

One standard result we should always expect from an attempt at politicization of any sort is organizational change. The type of change varies with the opportunities and costs presented by the new environment, but

some sort of change is usually forthcoming. Sometimes the politicization favors small firms, as did the Nixon price controls on oil, which focused on the largest firms. This allowed smaller firms to creatively redesignate old oil as new oil through various ruses and charge the much higher price allowed on the new oil. The converse can also occur, with larger firms being favored, as in the World War II price controls involving wage negotiations. And always, politicization means that one must reallocate efforts toward an office in the capital.

An American example can make these ideas concrete. In 1965, in the case of *Williams v. Walker-Thomas Furniture Co.*, Judge Skelly Wright of the D.C. Circuit Court of Appeals wrote an opinion affecting credit instalment contracts. As the court he then sat on was the highest common law court of the District, this was new judge-created law of the usual sort, but does not appear to have the efficiency characteristics discussed by Posner. The furniture store defendant was selling furniture to slum-dwellers on credit, maintaining title through an instalment contract to allow it to more easily use the self-help remedy of repossession. In addition to these clauses, the contract dealt in a special way with repeat customers. A customer with an open account who bought additional furniture on credit would agree to pro-rate all payments as between all the open contracts. All open contracts would now be paid off at the same time. This provision, though cryptic, meant that all furniture not already completely paid off would be available for repossession if payment on any were in default. This obviously provided more security to the furniture store, but had a second result: in order to use the provision effectively, the furniture would normally have to carry all its own contracts. It might well borrow against them from others, but it would not sell them as auto dealers and savings banks do with their loans, as this would complicate the consolidation of all debts and rearrangement of payments whenever further purchases occurred.

The D.C. Court ruled that such a provision in an instalment contract could well be unconscionable, and thus unenforceable. Let's suppose that the provision actually became illegal and was not used any more in the District. This politicizing of credit contracts would likely generate an organizational innovation. Without the provision, there is far less reason for a furniture store to hold its own contracts. It would be more likely to sell these contracts after the court decision and help develop a secondary market in them. One would expect that this would have a standardizing

effect on the contracts and on the information concerning the creditworthiness of the borrower. It is conceivable that, once organized, the cost of credit could decline with a new source of funding made available to the retail furniture stores, especially those located in slums. In any case, organizational innovation through vertical disintegration in the financing and servicing of contracts is a likely result. In the actual instance, later decisions by the same court undercut the original decision and allowed the continued use of the offending contract clause and business practice.

### ***Politicized Hiring and Suppliers***

Large formal firms in Latin America and defense firms in the United States often find it in their interest to hire former politicians and bureaucrats. These people have specialized knowledge of the procedures and machinations of the part of the state from which they came. In addition, they may have important personal and political ties to those with some power to help the firm. This is especially important in Latin America, in which court proceedings can be influenced substantially through the appearance of a military official or politician friendly to one of the parties. The formal sector in Latin America may be operating as a golden parachute retirement system for bureaucrats and military officers who have not disgraced themselves during their time in office. Such a device would be of considerable value to the polity as it would allow the state to recruit better people than otherwise and help provide the type of continuity in the political economy system that the weak party politics cannot provide.

The use of certain suppliers can be a politicized decision in any polity. In American defense contracting, a common claim is that subcontractors are chosen so as to have people working on a contract in as many congressional districts as possible. But this is a public contract, and these contracts are commonly politicized almost everywhere. For comparative differentiation, the politicization one would want to examine involves ordinary private business. An attempt by the state to influence the choice of suppliers in purely private business can become intensely political once started.

Intervention into the choice of vendors is most common with foreign versus domestic suppliers. Any Buy American policy (or Buy Missourian) policy which attempts to affect private contracts has this character. So do the continual interventions that most nations employ in trade policy. Federal law prohibits the export of Alaskan oil, effectively requiring it to

be shipped to the Pacific coast, where oil spills have become a major political problem. This prohibition was part of the price paid by the domestic oil firms to get the Trans-Alaska Pipeline built, but some sort of control on export might have been required so long as crude oil price controls were in existence. This interaction of controls and trade is discussed further in Section B.1.

### ***Effort Allocation***

Perhaps the largest costs involved in the politicization of prices occur through the new incentives that they create and the reallocation of effort by private firms that these incentives call forth. These effects have been well discussed by others, including the media, although they have generated only aggregative forms of modeling efforts. Consider the time of the CEO of a large corporation in an industry in which some prices have become politicized. A substantial amount of the time of the CEO may now be devoted to dealing with politicians and regulators. The potential profitability of the firm may now depend more on what these politicians and bureaucrats do, than on what the firm itself does to improve its processes and products. With these rearranged incentives, the reallocation of effort makes profitable sense. The often-told story of the large number of Washington offices operated by corporations and the extensive use of Washington lawyers, lobbyists and public relations firms testifies to the new incentives created. The value of these efforts may be so substantial that they create a new barrier to entry for small firms in an industry. The need to have a presence in Washington becomes a cost of some minimal size that generates decreasing average costs up to a relatively large firm size. The presence of a jungle of federal regulations and regulatory bodies adds to the problem, as this clearly creates a substantial fixed cost not present before 1933. The example of Peru illustrates a near-limiting case of these problems. Almost every firm of any size at all has its headquarters in the capital city, Lima, in order to be able to deal continually with the bureaucracy. Complicating the problem in Peru is the fact that publication of regulations and bureaucratic decisions is not mandated. Thus, the 99% of laws which are produced by the administrative sector of the government can only be known by having agents talking regularly with the bureaucracy or by renting the services of such people. While this seems to be in stark contrast with U.S. federal operations under the Administrative Procedures Act, it is



closer to reality in those state governments which lack a counterpart state requirement. And county and municipal regulations add layers of complication to the problem in our federal system.

Let's now consider some recent examples of the politicizing of prices in the United States to see what other factors need to be measured to evaluate the extent of politicization of the prices in a market.

## **B. Requirements for Effective Price Politicization**

Not all markets can be politicized, and the politicization of many markets can take place only after they are insulated from similar markets outside the jurisdiction of the state which is attempting to politicize. At base, actual market contestability limits the ability of the state to affect pricing decisions, at least at the individual firm level. To the extent that the domestic market is linked to the world market, then contestability means that the ability to import or export the commodity involved reduces the ability of the state to affect industry-level results. These links with the rest of the world are often severed precisely because they reduce the power of the state to politicize prices.

### **International Features of a Politicized Market**

The significance of market politicization is greatly weakened if it is easy for buyers to substitute imported goods and of sellers to export price-controlled goods. Consider a control consisting of a maximum price for the output of an industry, which we presume to be a single, homogeneous good for simplicity. If the commodity can be exported, and no barriers exist on imports and exports of the commodity, then this attempt to influence the price can be avoided. Trying to lower the domestic price would cause firms to export the commodity, and would quickly dry up the domestic supply. The availability of the world market generates a perfectly elastic supply curve for the commodity at the world price (for a small country in that market), and any attempt at price controls would cause substantial shortages. This occurred during the Nixon Administration price controls in the

scrap copper markets (Rockoff, p. 225). The attempt to control the price domestically caused the metal to be exported to satisfy increasing world demand. Even though the United States is not a small country with respect to the copper market and it can influence world price, the controls still generated a shortage very quickly, and forced the regulators to free the price in both the virgin and scrap copper markets.

Suppose that the state attempts to force down the price of an input used by an industry. The subsequent reduction in quantity supplied would normally create a higher price in equilibrium for the products of any downstream industry. Such a result would raise the shadow price of the controlled input for the industry, and cause them to attempt to try to get around the controls. Besides various quid pro quos for access to the scarce input, imports may supply the demand. Once again, the availability of a perfect world market implies a perfectly elastic supply of the input to the industry, and would enable the firms to still get their supplies, even though at the higher import price. Competition for the controlled domestic supply would be expected to generate quasi-rents for access to it, and a variety of methods used to bid for access. But if the input commodity can be imported, then it could also be exported, and the state would have to control exports to preserve the price control. This is what occurred in the American oil market after 1973 with the systems of price control that were introduced and evolved in order to maintain control. The attempt to insulate the American market from world market phenomena required continual changes to deal with the import and export opportunities that were created by the controls. Any attempt to control the price of a product in international trade requires control on import and export in order to have a chance of affecting monetary transaction prices. Whether the system can actually affect the "full prices" inclusive of the resources devoted to gaining access to the commodity, finding customers, or bribing the enforcement bureaucracy, is a different question which we leave to later work. One recent paper has claimed that price controls cannot change full prices. While this result is obviously wrong if multiple equilibria exist, the analysis suggests that costs incurred in the new forms of competition generated by the price controls are likely to wipe out or exceed any gains that the supposed beneficiaries of the controls may have expected to receive.

Tables 1 through 3 show some of the questions which one would like to ask concerning the international features of the markets in which a firm

operates. The intended initial use for these questions is in Latin America. Several of us at Washington University are trying to measure transaction costs which limit the extent of markets, and make the use of modern production methods with substantial fixed capital a very risky proposition for a private firm. We have focused on Peru, given the study by de Soto which shows how a government can, in the name of paternalism and equity, ruin the private sector of the economy. Table 4 then shows the questions concerning price-setting that constitute the basic means of measuring the politicization of an output or input market.

### **Domestic Market Contestability**

The contestability of the domestic market itself can greatly limit the ability of the state to influence prices. One means is the domestic counterpart of the international effects described in Section B. Suppose that a sub-jurisdiction of the state, say a state or city in the United States, tried to control prices within its jurisdiction. Its ability to do so would certainly be affected by markets outside itself. The survey just used, with appropriate changes to avoid questions involving foreign exchange or currency, would allow one to measure these features. Beyond this, how could market contestability affect the ability of a jurisdiction to politicize prices?

**Table 1 International Aspects of a Politicized Market  
Foreign Exchange and Inputs**

1) Could some of the products that your firm uses in order to make your product(s) be purchased from firms or suppliers in other countries?

Suppose that your firm were trying to import some parts needed for equipment used by your firm. Suppose that the cost of the parts is about \$100 (U.S.). If your answer would differ if the amount were much larger, say \$1,000 (U.S.), then please state so and try to provide answers for that case also.

2) Is it possible to get foreign exchange legally for importing goods without approval of a governmental official?

2A) If not, how difficult is the approval process, without special influence?

- Impossible
- Almost impossible
- Very difficult
- Difficult
- Somewhat difficult
- Easy
- Automatic on application

2B) How likely is it for a bribe to be requested? Try to answer with a percentage of the time this is likely to happen.

2C) Would you have to pay the bribe? About what percentage of the time would the bribe be necessary to get approval?

2D) If a bribe were paid, about how much would you expect to pay?

3) Are there laws or regulations that affect your ability to buy the inputs you need from foreign vendors?

3A) If there are laws and regulations that would affect your buying internationally, then how easy is it to satisfy these laws? In particular, can you decide yourself whether you are complying with these laws, or must you get approval from a government agency?

3B) If you need approval from the government, must you get approval from more than one agency?

3C) Would this approval be automatic, or is it possible for the request to be rejected?

3D) How likely is such a rejection without incurring costs beyond simply making the request for approval? Try to state what percentage of such requests are likely to be rejected without your incurring additional costs.

3E) If costs would have to be incurred to gain approval, including bribes, what would you expect would be the smallest amount that would make you quite sure of approval?

**Table 2 International Aspects of a Politicized Market  
Industry Conditions  
Exporting**

1) Could the good that your firm produces be sold to buyers in other countries? If not, please go to the importing questions.

Suppose that you were contacted by a buyer from another country who wished to purchase some of your product. Suppose that the amount involved in the sale would be \$100 (U.S.). If the amount were larger, say \$1,000 (U.S.), would the answer be different? If so, please try to provide both the answers for a \$100 sale and a \$1,000 sale.

2) Are there laws or regulations that affect your ability to sell to foreign buyers?

2A) If there are laws and regulations that would affect your selling internationally, then how easy is it to satisfy these laws? In particular, can you decide yourself whether you are complying with these laws, or must you get approval from a government agency?

2B) If you need approval from the government, must you get approval from more than one agency?

2C) Would this approval be automatic, or is it possible for the request to be rejected?

2D) How likely is such a rejection without incurring costs beyond simply making the request for approval? Try to state what percentage of such requests are likely to be rejected without your incurring additional costs.

2E) If costs would have to be incurred to gain approval, including bribes, what would you expect would be the smallest amount that would make you quite sure of approval?

**Table 3 International Aspects of a Politicized Market  
Industry Conditions  
Importing**

1) Could the good that your firm produces be purchased from suppliers in other countries? If not, this is the end of the International Aspects survey.

Suppose that there were a very large increase in demand for one of your products that can be imported. Suppose further that you can buy the product at a reasonable price from a foreign firm, and that the amount involved in the purchase would be \$100 (U.S.). If the amount were larger, say \$1,000 (U.S.), would the answers be different? If so, please try to provide both the answers for a \$100 sale and a \$1,000 sale.

2) Are there laws or regulations that affect your ability to buy from foreign firms?

2A) If there are laws and regulations, other than those involving foreign exchange, that would affect your buying internationally, then how easy is it to satisfy these laws? In particular, can you decide yourself whether you are complying with these laws, or must you get approval from a government agency?

2B) If you need approval from the government, must you get approval from more than one agency?

2C) Would this approval be automatic, or is it possible for the request to be rejected?

2D) How likely is such a rejection without incurring costs beyond simply making the request for approval? Try to state what percentage of such requests are likely to be rejected without your incurring additional costs.

2E) If costs would have to be incurred to gain approval, including bribes, what would you expect would be the smallest amount that would make you quite sure of approval?

### Table 4 Controls on Pricing

Suppose that you wished to raise the price on one of your products by a substantial amount.

1) Would you have to notify anyone other than people in your own firm and the firms to which you sell?

2) Do you have to post your price in some prominent place?

Or post some maximum or minimum price anywhere? If so, where?

3) Are there any price controls imposed by the government on the products that you currently make and sell? In other words, are there laws or regulations that affect your power to raise or lower the price substantially on any of your products?

If not, then go to question 10.

4) To raise a price substantially, must you get approval from some governmental office? If so, who? If not, what is the nature of the controls?

If approval need not be obtained, go to question 7.

5) Is the required approval relatively automatic, or are a substantial fraction of increases turned down?

If relatively automatic, go to question 7.

6) If your firm produces a new product and tries to sell it, must you obtain approval of the price you charge before selling it?

7) If you raised your price without notifying the appropriate officials, or without the required approval, is it likely that this would be detected by the authorities?

8) If it were detected, what type of sanction might be used against you?

9) Is it likely that a bribe would be expected by the official telling you of your violation?

10) Are there any restrictions on the prices you can pay to any of your suppliers? Describe these.

If no restrictions, go to question 14.

11) If you paid a price in violation of these restrictions, is it likely that this would be detected by the authorities?

12) If it were detected, what type of sanction might be used against you?

13) Is it likely that a bribe would be expected by the official telling you of your violation?

14) What sort of controls are there on the wages you pay your employees? Are there minimum or maximum wages set by the government?

If there are no controls, or only maximum wage controls, then end the survey.

15) When the government raises the legal minimum wage for unskilled workers, does this affect the minimum wages you are supposed to pay? If so, about what proportion of your employees are affected by such a change? State as a percentage.

16) Can you pay less than the official minimum wage, legally?

17) If you paid less than the minimum wage for a job without the required approval, is it likely that this would be detected by the authorities?

18) If it were detected, what type of sanction might be used against you?

19) Is it likely that a bribe would be expected by the official telling you of your violation?

## **Entry**

Suppose that the state attempts to control the output price of the subject firm. Suppose that entry into the industry is easy whenever profits are being earned by incumbents, or when potential entrants believe that they could make money. If the state attempts to set a maximum price on the output of the industry, then this would not seem to induce entry, as it would reduce potential profits for the incumbents. However, entry may still occur due to imperfections in the regulatory apparatus.

The incumbents are producing output before the imposition of controls which can be compared with the post-controls output. This may, in the case of physical goods, enable the regulators to better control quality degradation. If it did, then entrants may be advantaged since they can enter with a lower quality product than the average incumbent and charge a higher effective price for that output. By suitably changing the product so that it would be sufficiently different from the incumbent output, the new entrants may be able to bypass comparisons with the output of the incumbents. While this still means that the price controls do lower the quality of the product, as we expect from theory, it would be the potential for entry that reduces the ability of the authorities to attempt to delay this change by controlling the quality of the incumbent firms.

Entry is much more of a problem when the state attempts to set a minimum price on industry output. Tullock has discussed the problems present in this case, and a literature has developed around this problem. The basic notion is that raising the price of a product without restricting the supply of that product has little long-run effect on the profits earned by incumbent firms. Even when an agreement has been reached by incumbent firms on market-sharing, such as O.P.E.C. has, this does not directly affect potential entrants, and entry can spoil the market for the incumbents and the attempt of the state to raise prices.

The common experience of agricultural programs throughout the developed market economies reflects this problem. Attempts to raise output price always require the removal of some of the output from market supply. The removal may be through state purchase, mandatory destruction of part of the output, or restrictions on the use of inputs. All have been used in American agricultural policy. But state purchase or destruction alone are not enough. They may raise the price, but give incentive to further production and new entry. Entry restrictions are commonly imposed now when



any policy is employed to raise output prices. By grandfathering incumbent producers and inputs, such restrictions hinder future innovation and competitiveness. They also create perverse incentives and images that can create forces for further politicization in the future. A new minority labor-market entrant who is told she should stand on her own two feet may resent the payments made to absentee tobacco land owners by Virginia tobacco farmers. The right to grow tobacco on an acre of land can be worth several thousand dollars. The infamous taxicab medallion systems, with medallions worth over \$100,000, similarly can generate demands for the politicization of other markets and prices to reduce the unfair concentration of such governmental largess.

A final type of price control involves input prices. An attempt to reduce the price of a key input, whether labor or material, to an industry so as to lower its costs normally backfires without additional constraints. The system of oil price controls in the United States after 1973 and the Nixon price controls generally reflected the problems with such approaches. Suppose that one controls the price of crude oil or the price a manufacturer charges for its output. The natural result of this control is to reduce the quantity supplied by producers. The reduced supply is all that the distribution channels and refiners have to work with, and thus the supply of refined products or the supply of goods at retail are reduced. The reduction in supply now has an obvious effect: higher prices. The upstream controls on price would not reduce downstream prices without additional and more widespread controls. The attempts to lower input prices by command simply pushes up the prices downstream. Of course, this means that somewhere between the controlled upstream source and the downstream profits there must be rents to be earned by gaining access to the reduced supply. Access to the supply is going to be rationed by some means, and additional cash payments, bundling with other commodities, non-pecuniary payments and discrimination of all forms are likely to result.

Table 5 is an attempt to measure restrictions on entry. Using the data obtained from the survey, one can ascertain the extent of the politicization of an industry, and determine to what extent that potential entry can restrict the power of the political authorities. The job of determining which types of entry restrictions are the most important is one for future research with these measures.

### Table 5 Entry Controls

1) Suppose that you wished to set up a new business making and selling some particular products. Would you be able legally to set up such a business and get it going quickly, assuming that you had all the other requisites, such as financing, technical personnel, facilities, etc?

If the answer is yes, then this part of the survey is over. If the subject states some particular business to make the questions concrete, write down the business.

2) What governmental agencies would have to approve for you to operate this new business?

2A) Is this approval automatic, or are such requests often rejected?

Suppose that you did not get approval but still went ahead and set up the business.

3) Would you think it likely that someone in authority would discover that you would be operating illegally?

4) What type of sanction might be imposed on you as a violator?

5) Would the official involved typically expect a bribe to be offered?

### ***Controls on Operation or Resources***

Incumbent firms can be forced to behave somewhat differently than those in the process just described. Their operations can be affected or influenced by legal restrictions and requirements. The regulations can be directed at the market relationships in the industry, marketing methods, or production techniques used. As the public school movement gained momentum in the nineteenth century, the continuing competition from private and religious schools was viewed as irritating. Gradually increasing interventions into controlling these schools were attempted, with some states during the 1920s banning them. This ban, aimed at Catholic schools by Ku Klux Klan related politicians, was declared unconstitutional in 1925 in the case of *Pierce v. Society of Sisters*, but other restrictions and requirements have been maintained.

One basic means of controlling an industry so as to gain leverage over pricing exists when the government has something that firms in the industry want. This can be a license or a permit that is necessary to do business, or can be the use of eminent domain to take land or rights-of-way to put in a railroad or pipeline. The threat of no longer helping a firm by providing these services can be very powerful, as they can easily force a firm out of business or greatly reduce profits. In such circumstances, the state can usually get a lot of what it wants in terms of prices charged.

In most countries, the government owns the mineral resources and must grant permission for extraction companies to remove the minerals. Since this is often done only before the initial investment by the company, this works just like a permit would. After the nationalization of oil resources by many countries during the 1960s and 1970s, foreign oil companies were required to either bid regularly for the production rights, or to bid for the crude that had been produced. To continue to be certified as a bidder, one must follow both formal and informal requirements of the state and this provides means by which the prices charged by a firm could be influenced. Since oil is traded in competitive international markets, this has relatively little influence on export sales, but can affect the prices charged to other domestic users. In general, the existence of any inputs monopolized by the state provides substantial leverage for affecting prices in ways the political authorities want.

In other situations, a firm is not allowed to sell on an open market at all. Argentina was an economic success until around 1900, when its liberal

economic policies were changed, and controls over importing and exporting were implemented. Since then, Argentina has regularly employed export controls, using a monopsony trading company for wheat and beef exports. The result has been that this nation which had a per capita income quite close to that of the United States in 1900 has fallen far behind in the century since. The use of a monopsony trading company and insulating domestic markets from foreign competition has resulted in the politicization of key prices in this economy. The government has operated much like those of Africa which are described by Bates. The urban proletariat is provided with lower-priced food through the imposition of export controls, the monopsonization of farm sales and the cross-subsidization of urban domestic food prices paid for by the profits of the monopsonized export products. This politicizes not only the prices paid to farmers and ranchers for their output but also the retail prices paid in the urban food markets. When the state can no longer maintain the urban food prices at their below equilibrium levels, their increase tends to generate riots and can topple the government. To avoid these effects, the state may attempt to offset the effect of the increased food prices by raising wages for all urban workers at the same time, extending the system of politicized prices to the labor markets. The resulting prices become so distorted that the resource allocation resulting from them takes on an Alice-in-Wonderland character, with resources devoted to arbitraging the domestic prices against world prices and also to gaining special licenses and privileges to buy at lower prices than the general public, or sell at higher prices. Competing for the rents created by the artificial scarcity becomes more profitable than competing by dealing with the real scarcity that exists.

Table 6 attempts to provide indicators of the politicization of the organization, operation and flexibility of a firm. In this area especially, there are many dimensions in which the state may try to influence a private firm, and a more open-ended investigation is required at the start of an empirical investigation. Once the particular means used in an industry have been discovered, then more specific questions about these means would have to be designed and asked.

### **Table 6 Regulations on Operations**

- 1) Suppose that you wished to change the way that your firm produces one of your products. Would this require your notifying some governmental agency or getting their approval?
- 2) If you were to change the location of your business, would this require your notifying some governmental agency or getting their approval?
- 3) Suppose that you were operating your business as a sole proprietorship. If you then added a partner, would this require your notifying some governmental agency or getting their approval?
- 4) Are there any restrictions imposed by the government on who your firm can hire for a job that is unfilled? Please describe them.
- 5) Suppose that you wished to change one of your suppliers of products used by your firm. Can you choose to use any other supplier, or would there be problems with the government caused by such a change? Please describe.

## ***Exit***

Exit controls have effects similar to those created by entry, but with reversed signs. One additional element created by exit controls is that the firms forced to remain in an unprofitable business are sometimes viewed by a particular government as deserving of offsetting help from the state. The results can be new distortions and controls that make the economic costs even larger than the exit controls themselves would have been.

For example, a steel company may not be allowed to go out of business because this would put too many urban workers out on the street. Urban workers are much more dangerous than the rural masses because it is much easier for them to organize and to create problems for the regime in power. Avoiding urban unemployment for the organized part of the urban labor force is particularly important politically. If the firm is not allowed to go out of business, or to lay off most of its workforce, then the private owners of the firm can easily threaten to simply abandon the assets and leave the nation. Alternatively, the obvious financial drain to the private owners may be important if they can present a political threat to the regime in some manner. This can result in several possible means to defuse the pressures.

Compensated nationalization may be a way out, with the state buying out the private owners. This requires financial resources that may not be available to the state, and may create political problems if the compensation is viewed negatively by the supporters of the government. Regardless, nationalization, whether compensated or not, creates new problems and distortions. Now that the firm is a State Enterprise (SE), its operation can become intensely politicized with pricing becoming quite arbitrary. Steel plants, whether in India or in Peru, have been viewed as evidence of the modernization of the economy that the state is creating, and these SEs must be kept alive at great cost. In Peru, the state steel plant sells its output for five times the world price of steel, and is obviously insulated from foreign competition in order to do so. It also is supposed to be insulated from domestic competition. All other SEs are required to buy Peruvian, if at all possible, as are private enterprises which need help from the state.

The higher price of the nationalized steel causes all steel-using firms to have much higher costs than similar firms in foreign countries, and these firms now demand help in turn. This same process has occurred in the United States with the steel and auto firms. While the auto firms may have been negatively impacted by other federal policies, and been complacent

about Japanese competition, an important cause of competitive problems for domestic auto firms in the United States has been the higher price of steel that they must pay, caused by two decades of protection for the domestic steel industry [see Denzau (1985)]. First the price of steel became politicized in 1969 with the Voluntary Export Restraint (VER) negotiated with Japan, and then the price of autos became politicized in 1981 with the Japanese automobile VER. It is also noteworthy that the federal government was a substantial investor in one of the threatened auto companies, Chrysler, at the time of the auto agreement. The VER probably saved Chrysler and Ford from bankruptcy. Both of their stocks fell in value in 1985 when President Reagan attempted to remove the VER with Japan, suggesting that investors understood the importance of politicization to the value of the firm assets.

Table 7 investigates the restrictions on exit that a state may impose. Some of the forms that these restriction may take are subtle and as with Table 6, the questions may have to be supplemented in each particular case. In addition, the means by which the state may help the industry in exchange for the exit restrictions may be quite difficult to measure without careful historical research. Open-ended questions of industry observers can provide paths to research and uncover unexpected links that depend greatly on context. For example, the payment for keeping open a business may be for a family member of the owner to get a lucrative government job. Finding such links may be very difficult for an investigator who lacks considerable background knowledge of the political economy being investigated.

Some examples of the politicization of prices can make more concrete some of the ideas suggested so far. In addition, these episodes can suggest some further data about markets to gather in order to determine how politicized a market is.

**Table 7 Exit Controls**

1) Suppose that you wished to close down your business entirely and fire all your workers. Would you have to notify any governmental agency in advance?

If no notification required, then end the survey.

2) If you did notify the agency, what would you expect that agency to try to do? Would they attempt to convince you to stay in business? Would they try to force you to do so? What might they do?

3) Would you have to gain the approval of some governmental agency?

4) How easy would it be to get the approval to close the business? Would it be relatively automatic?

5) What would be required to gain the approval to close the business?

6) If being forced to stay in operation caused your firm to incur substantial losses, would you be able to go to some governmental official for help? Who could you go to?

If there is no one to go to, then end the survey.

7) What sort of help might you request, and how likely would it be that you could get it?



## **C. Examples of Politicizing of Prices**

Recent history in the United States reveals many examples of the politicization of prices. Sometimes the means have been extremely direct and coercive, such as the seizure of the coal mines during World War II by President Roosevelt to avoid a strike, and the seizure of steel attempted by President Truman during the Korean War. The latter seizure was invalidated by the Supreme Court (Rockoff, p. 193), but the method was legal in the coal mine case. Less coercive in appearance was the jaw-boning of the steel companies by President Kennedy. It appeared that he simply requested that the price increase initiated by one of them not be followed. But the reality was much stronger, with the threat of cutting off all government contracts involving their steel actually being used. Exhortation and the velvet glove are normally ineffective as means of politicizing prices when large corporations are involved. The steel blade covered by the glove is often uncovered to make the point more cogent. On the other hand, exhortation by political authorities can be quite powerful if it so matches the mood of the public as to license vigilantes to beat up those who fail to follow it, such as small retailers. This means was used during the Revolution as part of price control schemes, and seemed effective for short periods in lowering food prices. The government in twentieth century America usually relies on legal pronouncements backed up by the full force of the federal government, if necessary.

The past four years reveal three episodes which reflect some quite diverse situations and means of politicization. These episodes are only a tiny sample of the diverse types of politicization that occurs at all levels in the world's largest market, the United States. But they do suggest additional features to measure which reflect on the politicization of prices.

### **Proposition 103**

California used to have a regulatory system in automobile insurance that relied heavily on market forces to keep prices in line. This system was praised in the Ford Administration Papers on Regulatory Reform edited by Paul MacAvoy. The system, however, exists no longer. In November, 1988, the voters of California adopted a popular initiative, Proposition 103, by a 51%-49% margin. During the 1980s, automobile insurance rates in Califor-

nia had risen substantially: by 12.2% from 1982 to 1986, and by 14% in 1987 and 1988. By the time of the vote on 103, California auto insurance premiums were 40% above the national average, at \$673.18 per insured auto (Zycher, p. 68).

While costs for claims had risen for the insurers, and they were earning only a 3.3% return on equity after taxes according to the California Department of Insurance, the most serious problem causing rates to rise was the state-mandated assigned risk program, the California Automobile Assigned Risk Plan (CAARP), which did seem to smell like a carp. Insurers were required to participate in this program in proportion to their market share. Drivers were eligible to buy assigned risk insurance if they were rejected by two insurers for regular coverage, and the assigned risk customers did tend to be the worst drivers. If eligible, what did one pay for coverage? By 1988, an adult male living in Watts (east Los Angeles) without the best driving record would pay \$1,640 for a regular policy, but only \$575 for an assigned risk policy with only slightly smaller coverage. If one were not already eligible for an assigned risk policy, it would seem to pay to get a bad driving record to qualify.

The large subsidy to bad California drivers existed because the price of assigned risk insurance had become a politicized price set by the insurance commissioner, an official appointed by the governor. More than 50% of each rate increase requested by the industry from 1983 to 1989 has been denied, with the February 1989 request of 112.3% increase totally denied. The result for the insurance companies is three-fold. They have losses of \$2 for each \$1 of premium collected on the assigned risk policies. These losses are a cost of doing regular insurance business in California and cause the companies to raise the rates on regular policies, resulting in the above-national rates mentioned above. Finally, CAARP creates a prisoner's dilemma situation for each company which causes the problem to grow. Any individual firm can cut its own payments of the assigned risk losses by redirecting customers from regular policies toward an assigned risk policy, as the assigned risk losses are socialized, being paid by all the firms in proportion to their market share. Even the largest auto insurer in California, State Farm, holds only 6.4% of the market. This means that 93.6% of the losses on the CAARP policies that State Farm writes are paid for by other insurers, while State Farm pays 100% of the losses on its regular policies. So long as it is earning less on its assets devoted to regular policies than

those assets cost, it certainly pays an insurer to sell CAARP policies rather than regular insurance. The result has been that CAARP policies grew from 94,400 policies in 1983 to 1,233,400 by 1989.

The subsidized growth of these politicized-price products resulted in a revolt in the Proposition 103 vote which mandated a 20% reduction in auto insurance rates from the November 1987 rates. This would have been more than 30% below the November 1988 rates. This rollback did not occur but not because of the court proceedings initiated by the industry. This occurred because the law also politicized the price-setting mechanism in the auto insurance industry. Only certain criteria were to be allowed to determine rates, and geographic location is not currently allowed. The result was that the rates would not actually drop for all drivers after 103's implementation. In fact, the rates were to increase in all except four counties in the state. The increase in Modoc County was nearly 58%. The insurance Commissioner Roxani Gillespie decided that these increases were unacceptable, and disallowed the large rollbacks for Orange and San Francisco counties—only Los Angeles would be granted the 30% rollback implied by the law. Rates also were to drop in Orange, Riverside and San Francisco counties, but increase in all other counties. This result is somewhat different from the 20% rollback stated in the law, but the votes by county seem to reflect a pretty accurate understanding of the eventual results by the voters of California (Zycher, p. 74). That is why almost 50% of the voters voted against a 30% price cut.

One other feature of the initiative was that the insurance commissioner who would be setting the rates in the future was no longer to be appointed by the governor. Instead, this was to be an elected office. This is helping to further politicize auto insurance rates in California, as the campaigning for insurance commissioner has heated up. Several of the candidates are campaigning on a platform of not being fair to the insurance companies, but instead in being their worst nightmare. The ads sound more like professional wrestling promotions than competition to perform public service. Clearly, the means of getting into an office that deals with politicized prices and the means of removal affect how politicized those prices are, and need to be discovered.

## **Gasoline Prices and OPEC**

When OPEC raised its crude oil prices in 1973 from \$3 a barrel to \$10, the U.S. government intervened with price controls to buffer consumer-voters from the effects of these increases. The controls continued into the Reagan Administration, costing the oil-patch states an estimated \$30 billion p.a. (Kalt). While most of this system of controls was dismantled by the Reagan Administration, some parts of it are still around or could easily be revived.

The invasion of Kuwait by Iraq in August 1990 has generated calls for a new energy policy and for reinstating controls on energy prices. The only response by President Bush was a statement in mid-August asking the oil firms to avoid unnecessary price increases. Two oil firms stated publicly that they would freeze their prices for a week, but a week later operated just as the other firms had. After the process of conjectured price increase and market response as discussed above, the result was an average increase of 15 cents per gallon at retail for unleaded gasoline. The crude oil futures price in New York as of October 1990 was still \$6 a barrel above the pre-invasion price, approximately 30% higher, and exceeded the before tax increase in the gasoline price. The politicization of this price has been more attenuated than in 1974.

The Kuwaiti invasion and American military response focused attention on the price of gasoline that far exceeded the attention that the eventual increases would have generated. Such media visibility are important in helping to generate demands for politicizing prices and would need to be measured in studying the process of politicization. Media events that hit the nightly news programs have far greater potential for politicization than those which are generally ignored by the media.

## **DRAMs and Computers**

Practically all major innovations in the design, production and products of the semiconductor industry have been made by American companies. This helped create an industry which the United States dominated in 1980. But in the largest dollar volume product, the Dynamic Random Access Memory (DRAM) used as memories in computers and various other electronic equipment, the Japanese were making considerable progress. Today, this market is about \$7 billion p.a., and the Japanese have over half of the global

market in DRAMs. This situation has been infuriating to some American firms and they have responded in several ways. One governmental response occurred in 1984 with the adoption of copyright protection for the photographic masks used to produce integrated circuit chips. Prior to that passage, the Japanese had been photographically copying the masks from finished parts and producing copies without payments to the designers. A standard myth from that period is that Hitachi made a chip which had Texas Instruments' logo, a map of Texas, on the chip. Such obvious copying has ended and the Japanese have been making substantial royalty payments on numerous designs, as the American industry is well ahead in its ability to define marketable chips and to design them.

The mask copyright protection simply defined a set of intellectual property rights which are relatively innocuous, and are probably promotive of efficiency. The second stage of the governmental response, however, had little of this innocuous character. In 1983 and 1984, the home computer boom of the early 1980s turned into a bust as consumers told the producers that they really wanted home video game machines (which most already owned) and might buy a computer if it was like those used at the office. Between 1984 and 1986, the downturn in demand for integrated circuit chips and especially DRAMs resulted in billions of dollars of losses for American and Japanese producers. In 1985, negotiations between the U.S. Department of Commerce and the Japanese government began. The Americans were responding to complaints about the dumping of DRAM chips by the Japanese, complaints from American firms and by the trade association, the Semiconductor Industry Association (SIA).

Dumping, in terms of selling chips at below production cost, is a well-established practice in an industry like semiconductors which has very large learning curve effects. By selling output early on at below cost, a firm can increase its market share, sell and produce more product and achieve lower costs than other firms through learning effects. The American firms could complain about foreign firms selling at below cost, but they themselves regularly have done this for years. In spite of this problem, the SIA convinced the Administration that the industry needed help. By around March of 1986, an agreement in principle had been worked out and was announced in July as the Semiconductor Trade Agreement of 1986 (STA). The STA required Japanese firms to sell DRAMs at prices above their Foreign Market Value (FMV), which was to be based on historical account-

ing cost data and updated quarterly. The price of DRAMs had become politicized.

After indications of grey market leakage from Japan to other Asian markets was discovered, the Administration announced in March 1987 a 100% tariff on certain electronic equipment produced by the Japanese firms making DRAMs. When this leakage ended, half of the tariffs were removed, but the remainder continued. This tariff continued as the secret letter agreement which accompanied the STA had not been carried out. The secret letter, which leaked out within months of the STA, stated that American semiconductor firms should have a 20% share of the Japanese semiconductor market. The 1986 share was 10.3%, and has risen to about 14% since. The attempt at managed trade has largely been a failure, partly due to disagreements as to how to measure market share. The SIA and the Electronics Industry Association of Japan (EIAJ) have quite different numbers for the American market share, with the SIA number always being lower than the EIAJ one. After the Japanese government washed its hands of enforcing the letter, the EIAJ has attempted to help increase its members' purchases of American parts.

The STA helped prop up American prices for DRAMs, raising them to at least double the internal Japanese transfer prices charged their electronics divisions which used the parts. As only two U.S. firms still were producing DRAMs, the positive effects of these higher prices were quite small. While other firms announced their return to the DRAM market, some actually were producing a related part, the Static Random Access Memory (SRAM), and produced DRAMs in only small quantities, if at all. The higher prices hurt our globally dominant computer industry and threatened our successful software industry which writes the programs that allow the computers to do anything useful. The damage was most severe in 1988 when the prices of some types of DRAMs had tripled over their 1986 price and were practically unavailable on the open spot market. A huge grey market developed in DRAMs with some 7,000 brokers estimated to be in the business by the summer of 1988. Stories of Japanese and Korean firms offering DRAMs to American computer firms in exchange for licenses to their key proprietary technology were very common. In the spring of 1988, the SIA asked the Department of Commerce to get the Japanese government to end the DRAM production quota it had imposed on the Japanese firms, and prices slowly started falling by the winter of 1989.

The STA episode illustrates how attractive politicized prices are for firms, just as they are for consumers. Our most innovative industry, the semiconductor producers, have been sucked into the political arena and many semiconductor firms came to view their profitability almost totally determined by decisions in Washington and Tokyo. Our other most innovative industry, the computer industry, found itself a victim of the resulting politicization of DRAM prices and it too was forced to fight back with political weapons. The resulting diversion of attention and effort of the management of the firms in these industries was not helpful to efforts to improve productivity or discover new products. Prices in many industries may be politicized if insulated from external markets and the downstream impacts require defensive politicization in turn.

## D. Conclusions

The politicization of prices is at the heart of myriad problems in every nation of the world, especially the lack of economic development in much of the Third World. As usual, we could wait for political scientists to take up this effort. We could wait for sociologists to start examining how economic and political variables are related to collective phenomenon such as riots. The response by these other disciplines seems only to occur when the turf of that discipline is challenged by outsiders, and we can trigger those responses.

The *explananda* include the politicization of prices itself. Economists need to look beyond their ordinary concerns and try to discern the determinants of politicization. Which prices are politicized, and how? What determines the form and timing of politicization? Given that politicization, what social outcomes does it affect? Does the form and extent of politicization, or the level and type of government involved, affect what happens when such politicized prices change? The usual normative analyses of efficiency and fairness need to be done as well, but so does a new form of normative analysis. The implications of politicization for the type of dynamic or adaptive efficiency analyzed by Pelikan also needs to be studied. Chapter 26 of my forthcoming intermediate microeconomics text includes an example of standard policy analysis which attempts to ascertain the implications of the policy for this dynamic efficiency. If Joseph Schumpeter

has taught the economics profession anything useful at all, it is that an economy that is efficient dynamically may be far more valuable to be a member of than an economy which attains 100% static efficiency.

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## Discussion

Ed Hudgins remarked that we often have government agencies intervening to insure the firms whose prices they have distorted in the first place. This leaves no incentives to change the system. This is especially true with the IMF, the World Bank and AID. Walter Block noticed that although there are fights over particular regions in British Columbia which might be used for logging, there are few fights over baseballs and hockey sticks. The problem is that there is a very unclear definition of private property. Hudgins saw that in Washington both the left and right push for controls over their prices albeit for different nominal reasons. Richard Rahn remarked that in Bulgaria they had a system for allocating foreign exchange for different firms all of which were government-owned. Many export firms do not have foreign exchange to buy imports.

Ed Hudgins suggested that politicized prices breed more politicized prices. They create a dynamic of their own. Juan Bendfeldt argued that the reason that there are riots over prices in some countries is that people know where those prices are going to be set. They are out of the usual market. Thus, quite naturally, people go under the president's balcony. In Latin America, generally speaking, even the mayor of a town has the legal right to set the prices in the local market. This is seldom exercised, but nonetheless the law is on the books. And this points out a very bad trend associated with the human rights discourse. We start linking human rights to social

rights, and to environmental rights, and even to so-called economic rights. But these are really transfer or entitlement systems. It is incredible to make such linkages, and it is being developed under the auspices of the United Nations. Quotas on textiles, sugar and coffee to the U.S. cause no end of political allocations in Latin America as each government now organizes a single monopoly to meet the quota. Milton Friedman remarked that in response to a *Newsweek* column he had written that suggested that government actions often create more problems with the situation they are attempting to solve, it was suggested he call this "law" the "invisible foot of government." Should the loss created in other countries be included in our measure of economic freedom? Ron Jones suggested that the answer is, yes, as it is a consequence of the restriction.

James Ahiakpor argued that by informing people of the costs of regulated prices we can remove them since the common people actually lose through the price controls. The importance is to explain so they understand they are last in line. Ed Hudgins agreed and stressed that the media have little incentive to do so. Walter Block described the free trade debate within Canada in which although by survey 95% of economists favour free trade, on the state radio, the CBC, only two percent of the time were economists interviewed, and of these, half were for it and half against. Alan Stockman indicated that the reason for this is that the media is there as a result of market forces, and this means they attempt to create entertainment. This has to be sufficiently differentiated so as to allow many people to add their little bit to a basic story.

Returning to the theme that Ahiakpor had raised, Melanie Tammin argued that in the cases of the USSR and Eastern Europe, it is important to privatize property before liberalizing prices. Arthur Denzau agreed and pointed out that the whole process may break down to the extent you cannot do it all at once and the first owners are the biggest winners. Zane Spindler suggested that what must happen is that there will be a collapse of the security system and then, and only then, will there be a sensible allocation of property rights. Richard Rahn disagreed. Rather than a breakdown, he suggested that it must be an open process so as to be free from the taint of the "nomenclatura" who have been running things for so long. There is a "chicken and egg problem" as property rights, freer prices, and the difficult task of valuing assets must be accomplished in a proper sequence. Milton Friedman felt that speed of privatization and freedom are

not incompatible. Instead, the property should be given to the people since they own it, but you must do a lot of things at once. The political process, still controlled by many of the same interests that have been in power for many years, will not let you do it, and as Spindler suggests, it will happen almost inadvertently or by breakdown—in spite of the people who are trying to run it. The political structure has no incentive to provide the kind of public good (economic freedom) that we would like to see. This, Richard Stroup suggested, is an application of Mancur Olsen's idea that there must be some kind of revolution to make significant changes in the economic structure. The old ossified government must be swept away—as happened in Japan and Germany. Juan Bendfeldt argued that in decontrolling the economy, the reformers should leave selling the assets as the last option. Those who would have money to buy would be those who have been in power which is now seen as illegitimate. If you must sell, then you soak up all the liquid assets and concentrate them in the hands of the government. Not a happy prospect. If you must sell, then collect the currency and burn it!

# Labour Markets and Liberty

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## **Introduction**

**T**HIS PAPER SUGGESTS A WAY of thinking about one of the most important economic freedoms—the freedom to earn a living. Economic freedom may be defined generally as the freedom to trade or to engage in any consensual economic activity.<sup>1</sup> In the context of the labour market, economic freedom means the freedom of an employee or a group of employees to “trade” labour services in return for remuneration. Since free trade in the labour market is mutually advantageous, it benefits both parties. Moreover, labour market freedom entails many other freedoms, such as freedom of

contract, of choice, and of association. To maximize their own well being, workers and employers must be free to contract with whomever they want, to associate with whomever they want to, and to have as wide a choice of labour market options as possible, as long as they don't interfere with the equal rights of others. Thus, an unregulated labour market is most conducive to individual workers' (and employers') pursuit of happiness and economic well being as they subjectively value it.

Government can play two different roles regarding the labour market. One role is to serve as a "referee" by enforcing voluntary contracts, protecting private property rights, and generally maintaining the rule of law. Government, in other words, can enforce the rules of the game without directly determining the outcome.

The second role of government is to make rules that determine the outcome by passing legislation and issuing regulations that affect wages, working conditions, and other aspects of labour markets. This second role is the predominant objective of governmental labour policy in democratic countries, and it conflicts with the objective of economic freedom. Rather than protecting private contracts and private property, government all too often attenuates the rights of both individual workers and employers.

The reason governments do a poor job of protecting these rights is the basic asymmetry in political decision making in democratic countries. Generally speaking, governments pass legislation to benefit relatively small, well-organized, and well-financed interest groups. The costs of the legislation are usually hidden and widely dispersed among the general population. To promise voters well defined and exaggerated benefits, and to hide the costs, is the route to a successful political career. Thus, labour legislation is typically (but not always) intended to improve the economic well being of one group by diminishing another's. Such laws infringe on the economic liberties of individuals and groups that are less politically effective.<sup>2</sup> Most labour legislation, in other words, amounts to protectionism—it tries to protect the jobs and incomes of one group of employees by restricting the opportunities of others. Like protectionist trade policies, such laws tend to impoverish an entire nation while providing benefits to a relatively small, politically-active minority.

This paper attempts to explain how labour legislation has reduced economic freedom and suggests a way of ranking countries in terms of the

degree of labour market freedom. Four countries—the U.S., Canada, Great Britain, and Japan—are then tentatively ranked.

The types of legislation (and its economic effects) to be discussed are: 1) union legislation; 2) domestic labour legislation; and 3) immigration legislation. Because there are literally thousands of labour laws and regulations, the following analysis is at best a preliminary assessment of economic freedom in the labour market. Only the most severe labour market interventions are considered.

Although preliminary, such an analysis is important because labour market freedom is arguably the most important economic freedom of all. Without the freedom to earn a living, citizens are bound to become ever more subservient to the state.

## Union Legislation

Much labour legislation deals with the relationships between unions and employers. From the perspective of economic freedom—particularly freedom of association—there is nothing particularly objectionable about “combinations of labour” any more than there is about any other combinations of individuals for whatever purpose, as long as the group does not interfere with the equal rights of others. A government that respects economic freedom will not restrict the rights of individuals to associate freely with one another, nor will it restrict the rights of individuals who choose *not* to be associated with any such groups.

Labour law in democratic countries contains much rhetoric about protecting freedom of association, but in reality it does a poor job of it. Governments interfere or meddle with private contractual relationships between workers (or their unions) and employers on a massive scale. Most union legislation attempts to replace private, voluntary labour contracts and agreements with governmental edicts. It in essence socializes labour relations. Furthermore, much legislation confers special privileges on labour *unions* often to the detriment of individual workers and employers.

## Compulsory Unionism

One example of such legislation is laws that encourage or even mandate unionization. In the U.S., for example, labour legislation discusses the

importance of freedom of association, but then it talks of such freedom in terms of freedoms “to form, join, or assist labour *organizations*” for the purpose of *collective* bargaining (emphasis added).<sup>3</sup> Many of the employee “rights” that are protected by U.S. labour law are ones that can be advanced only through unionization.

Thus, an important measure of labour market freedom is the degree to which labour law protects *individual workers* rather than unions as organizations. Since the interests of individual workers are quite often in conflict with the interests of union officials, a legal framework that encourages or mandates unionization diminishes individual economic freedom. Laws that mandate collective bargaining, for example, are a restriction of workers’ (and employers’) freedom. A worker may prefer to bargain individually and an employer may prefer to just ignore a union.

The benefits of individual, rather than collective, bargaining is clear. Research in labour economics has shown that collective bargaining tends to reduce the dispersion of wages. More specifically, more productive workers are usually paid less than they could earn had they bargained individually, whereas less productive workers often earn more, as union wages are set at something close to the median wage within a bargaining unit. Thus, if collective bargaining *imposes* an outcome on all employees, it is bound to make some of them—usually the most productive ones—worse off.

Despite the fact that some workers are made worse off, it is illegal for workers in a unionized industry in the U.S. and many other countries to bargain individually. Such bargaining is deemed an “unfair labour practice” and is a punishable offense. Thus, the ability to bargain individually is one measure of labour market freedom that will be examined. Of particular interest will be various “union security” laws which deprive workers of individual bargaining rights by compelling them to participate in union bargaining.

### Yellow-Dog Contracts

With regard to employers’ rights, it is illegal in many countries for an employer to refuse to bargain with a union. In the U.S. it is a *per se* violation of the National Labour Relations Act to refuse to bargain with a union, but it is not illegal for a union to refuse to bargain with an employer.<sup>4</sup> So-called “yellow-dog” contracts—agreements between employers and employees

not to have a union—have been illegal in the U.S. and many other countries for decades.

Labour historians have found that one of the reasons for such contracts (which, it is worth stressing, were voluntary) is the desire by *workers* to avoid the work disruptions and loss of wages during strikes that characterize unionized industries.<sup>5</sup> Moreover, since such agreements were voluntary, they must have benefitted employers *and* employees, just as all voluntary free market agreements do. Either party was free to end the employment relationship “at will” if dissatisfied.

The only way that such agreements could persist in a free marketplace is if they were “efficient” in the sense that they enhanced the welfare of both parties—the anti-union employees and employers who must have believed that unionization would not be in their best interest. Thus, legislation that outlaws such contracts must necessarily make some workers and employers worse off. In international comparisons the existence of so-called yellow-dog contracts reflects positively on economic freedom.

## Exclusivity

Another aspect of labour legislation that grants special privileges to unions at the expense of economic freedom for workers is so-called exclusive representation. Exclusivity gives a union, once it has been certified, the legal right to be the *exclusive* bargaining agent for all workers in a bargaining unit, whether they wish to be represented or not. Any attempt by employers or workers to bargain individually—even over the most mundane things—is illegal.

Exclusivity gives unions a legal monopoly in the employee representation business. It is not only illegal for workers to bargain individually with their employers; exclusive representation legislation also prohibits bargaining through another, competing union, or any other agent.<sup>6</sup>

Protected from competition by exclusive representation laws, unions act like all other monopolists: they restrict their “output” and raise their prices. Because unions face no competition in the employee representation business, they are less constrained than they would otherwise be to charge excessive dues and other obligations and are also likely to provide fewer services to their members. Evidence of the latter type of behavior abounds. In the U.S. unions are major participants in all sorts of political causes that are unrelated to labour relations or to the economic welfare of their mem-



bers. Unions have been active in the pro-abortion movement; they have spent considerable resources in support of left-wing authoritarian governments in Central America, Africa, and elsewhere; they are part of the anti-nuclear power movement; they have lobbied for sanctions against the South African government; and they actively lobby for socialistic economic policies (i.e., price controls and nationalization of some industries) that, by hampering economic growth, are not in the best interests of the workers they represent.<sup>7</sup>

Exclusivity allows unions to shirk some of their basic responsibilities, such as contract administration, bargaining, and grievance handling, in order to pursue political causes that are irrelevant or even harmful to the economic welfare of workers. An indication of how far afield U.S. unions have strayed from their basic responsibilities is a recent decision by the U.S. Supreme Court that it is unconstitutional to compel workers to pay union dues to finance activities that are not directly related to bargaining, contract administration, and grievance procedures. In the case of *Beck vs. Communication Workers of America*, the Court found that the union spent less than 20 percent of its dues revenues on appropriate expenses. The other 80 percent was spent on politics. Other cases have found that as little as 10 percent of dues revenues are spent on legitimate purposes. The Supreme Court ruling will likely weaken the monopolistic grip that unions have over their members, but exclusivity continues to entrench much of their monopoly power.

Because of the monopoly powers granted to them by exclusivity legislation, unions may also be unresponsive to their members' demands for changes in collective bargaining strategies. There have been many cases in the U.S., for example, where workers were convinced that they would have to make concessions if they wanted to remain employed. Union officials, however, have often refused to heed the preferences of their members, sometimes causing the members to lose their jobs. Unions would be more likely to cater to their members' preferences if there were competitors in the employee representation business, but such freedom of choice is precluded by law.

### **Pushbutton Unionism**

In a number of countries unions and businesses are given quasi-governmental powers to the extent that they are able to coerce workers to finan-

cially support or even join a union as a condition of employment. For example, in the U.S. a new automobile plant built by the Saturn Corporation, a spinoff of General Motors, has a unionized work force because before the plant opened, Saturn management agreed with the United Autoworkers union (UAW) that its employees would be represented by the UAW. No certification election was ever held where the workers would be given the opportunity to vote on whether or not they wanted to join the union. Indeed, the agreement was signed before employees were even hired.

The Saturn plant is in Tennessee, a "right-to-work" state. This means that workers cannot be compelled to join the union, although the union is still given the privilege of exclusive representation. This form of "pushbutton unionism" is not as coercive as closed shop agreements which compel union membership as a condition of employment, but it is still a diminution of labour market freedom.

## **Agency Shop**

A further infringement on the economic liberties of workers is the so-called agency shop, whereby workers who do not belong to a union must nevertheless pay union dues. The rationale for agency shop is derived from exclusivity. Since unions are required to bargain for all workers (union and non-union) in a bargaining unit, it is supposedly necessary to compel all workers to pay for bargaining services.

In the terminology of economics, collective bargaining is said to provide workers with "public goods," and compulsory union dues are supposedly necessary to prohibit free riding. But since government created the situation where all workers are forced to submit to a single monopoly bargaining agent, a better phrase than "free riders" would probably be "forced riders." Workers are forced to accept the results of union bargaining and, where agency shop exists, are also forced to financially support the union. To workers who are worse off because of this arrangement, exclusivity creates a "public bad," not a public good: they are forced to pay dues for the "privilege" of being made worse off. Agency shop literally constitutes taxation without representation and is a serious encroachment on economic freedom.

## **Union Violence**

The long history of union violence can be readily explained by economic theory. In order to push wages above competitive levels, unions must restrict the supply of labour services on the market. They strike or threaten to strike in order to do this, and strikes are often more effective if workers who choose not to strike can be intimidated by violence. Employers can also be subjected to violence, threats of violence, and the destruction of property unless they acquiesce in union demands.

Accordingly, another measure of economic freedom for labour is the extent to which governments protect workers and employers from union violence. Critical questions here are: How are nonunion workers treated during strikes? How well do governments protect non-striking workers from union violence? Do workers who are victims of union violence have recourse to the courts? Do employers whose property is vandalized have recourse to the courts? These questions must all be answered in order to rank countries according to this criteria.

## **Domestic Labour Legislation**

Governments also deprive workers of economic freedom through laws and regulations that affect wages and working conditions. Although these restrictions vary greatly, they all share the common element that they substitute governmental for individual (or market) decision making. They are all carried out under the pretense that government somehow has better knowledge of the “best” wages, hours of work, types of jobs, etc. than individual workers and employers do. This type of thinking is what F.A. Hayek calls “the fatal conceit” because of the dire economic consequences it lends intellectual support to.

### **Minimum Wage Legislation**

Most democratic countries have a minimum wage law that raises wages of low-skilled workers above going market rates. Virtually any economics text explains that mandating above-market rates causes unemployment by pricing low-skilled workers out of jobs. There is no better example of a law that hurts those whom it purports to help or which constitutes a clearer

infringement on economic liberties. As Adam Smith said in *The Wealth of Nations*, "the patrimony of a poor man lies in the strength and dexterity of his hands," and to deprive him of this through restrictive labour legislation "is a manifest encroachment upon the just liberty...of the workman, and those who might...employ him."

The minimum wage law even harms workers who are not priced out of the market by it. If employers are forced to pay higher wages, they will either lay off some workers or cut back on other fringe benefits so that the total compensation package does not exceed each worker's marginal productivity. Thus, freedom of choice is diminished for workers who may prefer a different mix of wages and fringe benefits.<sup>8</sup>

The minimum wage law is inefficient and inequitable, but it persists for several political reasons. First, it lends itself to demagoguery better than most government policies. It is natural for politicians to claim to be able to solve social problems by simply passing a law, and what nicer law than one mandating higher wages for the poor?

A second reason is that unions want to price unskilled nonunion labour, which competes with more skilled, union labour, out of the market. In the name of compassion for the poor, unions lobby for legislation that makes the poor even poorer. The minimum wage is a device through which the poor are used as political pawns to the benefit of demagogic politicians and politically-active unions seeking protectionist legislation.

How detrimental the minimum wage law will be depends on its level compared to the market rate for unskilled labour. For example, in the U.S. the federal minimum wage in 1989 was \$3.35 per hour, but in many cities entry level jobs at fast-food restaurants paid as much as \$8.00 per hour. The harmful effects of the minimum wage were limited to smaller cities and rural areas where market wages for entry-level employment would be below \$3.35.

For purposes of cross-country comparisons, the minimum wage in a country should be compared to some standard wage, ideally the market wage for unskilled labour, in order to rank its severity. To the extent that such data are not available, a possible substitute would be an average hourly wage. Thus, a useful standard might be the degree to which the statutory minimum wage in a country diverges from the average wage.

## Maximum-Hour Legislation

Another infringement on economic liberties is maximum-hour legislation which, in general, limits the number of hours that workers can work and/or mandates that higher wages must be paid for any work hours over a specified amount. Since overtime pay provisions increase labour costs, the effect is to reduce the level of production and, consequently, the number of hours worked. Individuals who prefer to work more hours or to vary their work hours over the course of a week may be precluded from doing so.

## Davis-Bacon Laws

Another related measure of labour market freedom is the existence of laws, such as the Davis-Bacon Act in the U.S., which mandate that government-specified wages be paid. In the case of Davis-Bacon, the government-specified “prevailing wage” in an area must be paid on all federally-supported construction projects, even if the federal support is less than 1 percent of the cost of the project. The “prevailing” wage is almost always the union wage, and the effect of the Act is to drive from the market lower wage, nonunion labour. Making wages artificially high restricts competition from lower-wage firms, depriving their owners, managers, and employees of economic opportunities.

## Restrictions on Child and Female Labour

For over a century various countries have prohibited or limited child and female labour. The rationale behind the restrictions is that they are supposedly needed to protect women and children from being exploited by employers.

Even though this rationale for regulation is widely believed by the general public, the regulations are not likely to protect the intended beneficiaries. It is difficult to perceive that regulations prohibiting such work would benefit those individuals who *voluntarily* chose to work. If they felt they were being made worse off by their employment situation, they could simply quit.

There is evidence, moreover, that when such regulation was originally being proposed in England there was fierce opposition to it *by the women who the regulation was supposed to help*. It is likely, therefore, that such

regulation may always have been designed to protect incumbent workers from competition. Thus, an examination of laws and regulations across countries that deprive these groups of employment opportunities will be another measure of labour market freedom.

## Occupational Licensing Laws

Occupational licensing laws have been shown to create barriers to entry in literally hundreds of professions in the U.S. and many other countries.<sup>9</sup> The restrictions come in many forms, such as license fees, educational requirements, and regional or national examinations.

Licensing has been defended on the grounds that it assures professional competence and protects consumers from lower-quality products and services. These arguments may or may not have merit and they will not be discussed in detail here. But regardless of the motivation for the laws, their effect is to make it more difficult to enter regulated professions. Consequently, many individuals are deprived of employment opportunities.

This licensing-induced reduction of employment opportunities likely imposes a greater burden on lower- rather than on higher-income individuals since it often deprives the former group of valuable opportunities to accumulate human capital—opportunities they may not be able to otherwise obtain.

Again, there is much evidence that occupational licensing is often a *political* response to pressures from incumbent practitioners who want protection from competition. An anecdote will illustrate what I believe to be typical of the politics of occupational licensure.

Economist Walter Williams recently appeared on a televised debate with U.S. Congressman Charles Rangel. Williams made the point that the licensing of hairdressers in Rangel's home state of New York discriminates against blacks. It does so, said Williams, because to become certified as a hairdresser one must pass a practical exam as well as a more academic one that includes math problems. (The relationship between the ability to coif hair and the ability to do mathematics is, to say the least, dubious.) Williams pointed out that an equivalent percentage of blacks passed the practical exam as whites, but the failure rate of blacks on the academic exam was several times higher than the whites. Williams blamed the discrepancy on

inferior government schools that so many black New Yorkers are compelled to attend.

Congressman Rangel, who is black, did not dispute the test results and did not deny that the system kept many of his constituents unemployed. But he nevertheless supported the licensing system. His preferred "remedy" for urban unemployment was not to eliminate the sources of unemployment, such as occupational licensing laws, but to suggest more welfare spending.

This type of behavior is readily explained by elementary public choice logic. On the "demand side," the unionized practitioners are well organized and well financed politically, and are able to use the political process to protect themselves from competition with occupational licensing regulations. Those who are harmed by the regulations are not well organized and, hence, are less politically effective.

From a "supply side" perspective, politicians can win votes from the incumbents by supporting licensing, and they can also win votes from those who are denied employment opportunities because of licensing by offering them welfare payments or government patronage jobs.

In this instance the citizens whose liberties are abridged are made effective wards of the state either as welfare recipients or by relying on another form of handout—a government job—for their livelihood. Thus, occupational licensing is yet another way in which the poor are used as mere political pawns by cynical political opportunists.

Ideally, to measure the extent to which occupational licensing restricts employment opportunities across countries one might want to know what percentage of the labour force is subjected to licensing or what proportion of all professions require formal licensing. This information is difficult, if not impossible, to obtain. Furthermore, it is difficult to discover how severe licensing restrictions are for various occupations in a country. For example, an occupation that requires only a small license fee is not as restrictive or harmful as one that requires a large fee, years of schooling, and rigorous state-sponsored examinations.

## **Equal Pay for Equal Work Laws**

These laws are intended to protect certain groups, particularly women, from wage discrimination by mandating that employers pay equal wages for the "same" work performed by workers of different sex and race. The

irony is that these laws result in reduced employment opportunities for those who are supposedly helped.

If an employer pays females less than males, for example, it is because he subjectively values female labour less highly. He may genuinely believe that his female employees are less productive and less capable, or he may simply be discriminating against them because they are women. In either case, equal-pay-for-equal-work laws will induce the employer to hire fewer female workers. If forced to pay equal wages, the employer will prefer male workers. Thus, women who are willing to work at least temporarily for lower wages in order to prove that they can do the job are denied the opportunity.

In other words, women can provide employers with *economic* incentives to hire them, despite discrimination, but are not permitted to do so because of "equal pay" laws. Thus, equal-pay-for-equal-work rules, which are supposed to reduce discrimination, actually increase it.

That these laws harm the groups they are supposed to help is made clear by the fact that in some countries, such as South Africa, there is no pretense that the laws are supposed to protect people who are discriminated against. In South Africa, white racist labour unions lobbied for "equal pay" laws for black workers because they knew the laws would protect white employees from competition by relatively less skilled black workers. Since most blacks were less experienced, forcing employers to pay them wages that exceeded their marginal productivity would price them out of jobs.<sup>10</sup> In other countries the motivation behind the laws may be well intentioned, but the effects are the same.

Equal-pay-for-equal-work laws reduce economic freedom, but "equal pay for work of comparable value" legislation would be even worse. This is a proposed system of governmental wage determination, whereby government bureaucrats, rather than the marketplace, would set wages. I will not say anything more about this other than it's already been tried—in the former Soviet Union, China, and Eastern Europe—and it doesn't work. History shows that such governmental control over wages is grossly inefficient and inequitable.

## Employment Quotas

Most democratic governments have policies that require employers to make some of their hiring and promotional decisions solely on the basis of



noneconomic factors, such as race or sex. Obviously, this denies individuals the freedom to seek employment or career advancement based on merit.

In the U.S. employment quotas were originally enacted with the promise that they would *not* be used to force employers to make decisions based solely on race. The late Senator Hubert Humphrey promised that the Civil Rights Act of 1964 "does not require an employer to achieve any kind of racial balance in his work force by giving preferential treatment to any individual or group." The phrase "affirmative action" was coined by President Kennedy in his executive order that "affirmative action" should be taken to assure that governmental contractors *do not* make employment decisions based on race, creed, color, or national origin.<sup>11</sup>

In practice so-called affirmative action policies do exactly the opposite of what their proponents claimed they would. They *require* that employment decisions be made specifically according to employees' race, creed, color, or national origin. Consequently, "non-preferred" individuals who may be more qualified are passed over by employers who must satisfy the *government's* preferences for discrimination in the workplace. There is mounting evidence, moreover, that even many of the "protected" minorities are denied economic opportunities because of affirmative action policies.

Economist Thomas Sowell has found that the relative economic position of "protected" minority groups in the U.S. actually *fell* after employment quotas were instituted. "In 1969, *before* the federal imposition of numerical 'goals and timetables,' Puerto Rican family income was 63 percent of the national average. By 1977, it was down to 50 percent. In 1969, Mexican American family income was 76 percent of the national average; by 1977 it was down to 73 percent. Black family income fell from 62 percent of the national average to 60 percent over the same time span."<sup>12</sup>

Sowell also found that blacks with less education and job experience have fallen further behind, while blacks with more education and experience have been advancing even faster than their white counterparts. He offers a clear explanation of this phenomenon: affirmative action hiring pressures make it costly to have no minority employees, but continuing affirmative action pressures at the promotion and discharge phases also make it costly to have minority employees who do not work out well. The net effect is to increase the demand for highly qualified minority employees while decreasing the demand for less qualified minority employees or for

those without a sufficient track record to reassure employers. Those who are most vocal about the need for affirmative action are of course the more articulate minority members—the advantaged who speak in the name of the disadvantaged. Their position on the issue may accord with their own personal experience, as well as their own self-interest.<sup>13</sup> Thus, like the minimum wage and occupational licensing laws, employment quotas deny employment opportunities to those who need them the most—relatively unskilled and uneducated minorities who are “targeted” for help by the government.

In making international comparisons, one benchmark that may be useful is the number of racial “categories” the governmental authorities have created in order to enforce such policies. The more racial categories the less economic freedom. Another criteria may be the proportion of governmental budgets allocated to enforcement activities. In theory there should be a positive correlation between regulatory budgets (or regulatory employment) and enforcement activity.

### **Government “Jobs” Programs**

All democratic governments have long been involved in employment or job training programs. Despite their popularity, however, they *reduce* economic liberties *and* employment opportunities. It is impossible for government to “create” jobs because of the law of opportunity cost. Government may “create” some jobs with such programs, but it necessarily destroys other private-sector jobs by diverting financial resources from the private sector (through either taxes, government borrowing, or inflationary money creation) to pay for the government jobs. At best, government “jobs” programs alter the *composition* of employment, but not the aggregate level.

Furthermore, many government jobs are wasteful because they do not meet legitimate consumer demands. The history of government job programs is filled with examples of “make work” jobs that seem to emphasize political patronage more than employment opportunity.<sup>14</sup>

The reason government jobs programs remain popular despite their failure to stimulate employment (or training, for that matter) is that the benefits are well defined—job recipients know where the jobs came from and who to thank (or vote for)—whereas the costs are hidden. Those who are unemployed because of the crowding out effect of these programs have no idea of the cause of their unemployment.

This is one way—generating unemployment—that government jobs programs diminish economic freedom. Economic freedom and opportunity is also impaired by government jobs programs because of the fact that the kind of jobs and training provided are determined by government bureaucrats, not individuals in the private sector. This allows government bureaucrats to exert a degree of control over what *kind* of jobs will exist in the economy and what kind of skills people will possess. It is likely that the types of jobs and skills that individuals may choose for themselves will differ from the type the governmental labour market “planners” will prefer.

Giving government such powers opens the door for ever-expanding governmental control of the allocation of labour. In totalitarian regimes such as the former Soviet Union there was a nearly complete domination of the labour market by government. Its “jobs programs” were so extensive that *everyone* worked for the state. The only “real” jobs in the Soviet Union were ones held by black marketeers.

In Nazi Germany, government officials were allowed to monitor and control every proposed job change, thereby directing workers into those endeavors the bureaucrats thought served “national interests” regardless of the interests of individuals who comprised the nation. Of course, modern democratic governments do not possess anything like the powers over labour markets that the Soviet Union or Nazi Germany did. But the differences are only a matter of degree (albeit a large degree). Along with extensive employment programs, all democratic countries keep extremely detailed personal information on labourers and labour markets and they use that information to shape government policy.

Government employment programs threaten economic freedom in a very general sense in that consumer sovereignty is replaced by bureaucratic sovereignty. In a free market the type of jobs created are those which serve the desires of consumers. Government jobs, on the other hand, are usually designed to serve the whims of the political authorities, which are often in conflict with consumers. After all, if there is a legitimate consumer demand, there is an incentive for a private entrepreneur to meet it and to hire workers to assist him in doing so. Thus, to a large extent, government jobs are created specifically to provide goods or services that consumers have either not expressed a preference for or, if they have expressed any preference at all, it was a negative one.

Where there is a clear demand for a good or service which government provides, government often competes unfairly with private-sector providers. For example, outside of national defense and a few other activities, most of what governments provide in the U.S. are purely private goods that are also supplied by the private sector. A U.S. Senate hearing once revealed that the federal government alone provides more than 11,000 different goods and services in competition with the private sector. Thus, government uses its powers of taxation, and its ability to exempt itself from regulations it imposes on its private-sector competitors, to monopolize markets for private goods and services.<sup>15</sup>

Since in my view nearly all government employment diminishes economic freedom (and many other freedoms as well), a possible measure of the “costs” of jobs programs in terms of economic freedom is the proportion of a nation’s labour force that is employed by government in whatever capacity—as permanent employees or as participants in temporary “jobs” programs.

## **Mandatory Government Arbitration**

All the labour market interventions discussed thus far involve government’s attempt to intervene in private contractual relations between workers (or their unions) and employers by setting wages, establishing bargaining procedures, etc. In addition, governments also intervene in the *arbitration* of labour disputes. The U.S. government, for example, has a “Federal Mediation and Conciliation Service” which cajoles negotiating parties into “voluntarily” cooperating in order to end a labour dispute. The U.S. government doesn’t yet have the power to mandate a settlement, but it can apply significant political pressures to achieve that end. The effect of this intervention is that disagreements between workers (or their unions) and employers are often settled according to criteria established by the Federal Mediation and Conciliation Service, not by the negotiating parties.

Even though there is no formal power to coerce such agreements in the U.S., the ability of the government to indirectly force an agreement should not be underestimated. U.S. industry is so heavily regulated, and so many corporations accept government subsidies, that government has a tremendous amount of “leverage” over the private sector. Government has a long list of “carrots and sticks” it can use to affect private bargaining outcomes. It can threaten regulation and the withdrawal of subsidies, or it can bribe

the bargaining firms and unions with promises of subsidies and other governmental favors.

Thus, another measure of economic freedom is the degree to which governments can compel the settlement of labour disputes. Countries that clearly have that legal right would of course receive a lower ranking than those without it.

## **Occupational Safety and Health Regulation**

Modern democracies also heavily regulate "occupational safety and health." This intervention gives government enormous powers over private labour relations because an argument can be made that almost any aspect of a business operation can be interpreted as at least tangentially related to safety and health. Governments have taken advantage of these broad powers to regulate everything from the construction of ladders to the shape of toilet seats.

Research has shown, however, that occupational safety and health regulation is not likely to have improved workplace safety at all, despite massive expenditures.<sup>16</sup> Furthermore, the regulation has interfered with market forces, which "address" the problem through compensating wage differentials. That is, in a free market, employees in more dangerous jobs will be paid higher wages, all other things equal. Employers must pay higher wages to attract workers to more dangerous jobs. This will not necessarily eliminate or even reduce the incidence of workplace accidents, but then, neither does regulation. Furthermore, reliance on compensating wage differentials, rather than regulation, would avoid the loss of jobs associated with the heavy costs of occupational safety and health regulation. It would also give workers and employers more freedom in determining how to improve workplace safety, rather than relying on bureaucratic edicts.

There is much to commend this former approach, for no one has stronger incentives to assure a safe workplace than employees themselves. Regardless of how well intentioned the safety regulators may be, they just don't have either the incentive or the detailed knowledge required.

It should be kept in mind that there are economic (and common sense) incentives to reduce workplace accidents, for accidents are costly to employers and especially to workers. And it should also be remembered that

governmental "safety" regulation can provide a false sense of security. Job safety depends ultimately on how careful and responsible individual workers are. If they are told by governmental safety inspectors that their workplace is "safe," they may be less inclined to take their own precautions. The end result may very well be a *less* safe workplace.

For purposes of international comparisons, data on governmental expenditures for occupational safety and health regulation, perhaps standardized according to the size of a country's labour force, would be useful. Spending \$1 billion annually is likely, for example, to be far more onerous in a country with a labour force of 10 million than in another with a labour force of 100 million.

### **Employer Payroll Taxes**

All democratic countries have mandatory employer payroll taxes, the most significant of which are taxes for unemployment insurance and old-age pensions, or social security. A detailed examination of the economic effects of such programs is beyond the scope of this paper, but several aspects of them are particularly relevant to economic freedom.

First, these programs constitute what might be called "mandated benefits," whereby governments compel employers to finance certain benefits on behalf of their employees. One implication of this is that employees consequently have less freedom of choice to determine their own mix of wage and non-wage remuneration. Furthermore, even though the taxes are at least partly paid by employers, they are passed on to employees in the form of lower wages or other benefits, thereby constituting a hidden tax on workers. Because the tax is hidden, workers are less able to make well-informed choices regarding their own compensation mix.

Government-operated unemployment insurance and social security programs often allow governments to become monopolists in the provision of those services. There are many actual and potential substitutes for these government-controlled programs but it is difficult, if not impossible, for them to compete with government. For example, individual retirement accounts (IRAs) compete with the social security system in the U.S., but since the system drains so much income from workers through mandatory payments, there is much less available for private retirement plans.

It would also be possible for individual workers to contribute to an IRA-type account to be used as unemployment insurance, but governments

usually prohibit such options. This is especially unfortunate in light of the many failures of governmental unemployment insurance, which essentially pays people not to work by offering unemployed workers “replacement income” as a percentage—sometimes close to 100 percent—of their prior wages. By reducing the cost to workers of being unemployed, unemployment insurance lengthens the duration of unemployment. It also increases unemployment by indirectly subsidizing industries that experience seasonal or cyclical variations in employment. For example, without unemployment insurance a firm with an unstable employment pattern would have to pay higher wages to attract workers. The higher wage would be necessary to compensate workers for the risk of becoming unemployed. But with unemployment insurance the *government* compensates workers for becoming unemployed. This in turn makes unstable employment more attractive to workers than it otherwise would be. The increased supply of labour in those industries will reduce wage rates, which in turn reduce the incentive for firms to do anything to reduce instability in employment. Thus, unemployment insurance encourages unstable sectors of the economy to expand, resulting in a higher overall unemployment rate.

Both unemployment insurance and social security taxes are major infringements on the economic liberties of workers and employers, because they place severe limitations on freedom of choice, freedom of exchange, freedom of contract, and freedom of association. Because government controls a significant portion of workers’ income through these programs, and because the programs crowd out private-sector alternatives—if the law permits alternatives at all—individuals are denied all these freedoms.

Peter Ferrara described how the social security system infringes upon individual economic liberties. Government-controlled social security programs, writes Ferrara, force individuals to enter into contracts, exchanges, and associations with the government that they should have the right to refuse. It prohibits individuals from entering into alternative contracts, exchanges, and associations with others concerning the portion of their incomes that social security consumes. It prevents individuals from choosing courses of action other than participation in social security, although these courses of action will hurt no one. It prevents individuals from enjoying the fruits of their own labour by taking control of a major portion of each individual’s income. The program prevents individuals from arranging their own affairs and controlling their own lives. It operates by the

use of force and coercion against individuals rather than through voluntary consent. The social security program thus restricts individual liberty in major and significant ways, violating rights that are worthy of great respect.<sup>17</sup>

The same can be said for any governmental mandated benefit program. For our international comparisons, an appropriate measuring rod might be the percentage of labour income that is extracted to finance unemployment insurance and social security programs. The greater the tax burden, the lesser the degree of economic liberty.

### **Taxes on Labour Income**

Perhaps the most important interference with an individual worker's economic freedom is the income tax. The income tax denies a worker the ability to keep the fruits of his or her own labour, and is truly a way in which workers are exploited—by government. Karl Marx's labour exploitation thesis was half right. He complained that labour was unfairly exploited because it supposedly produced *all* value—an incredibly naive and simplistic assumption—yet it received only a small part of it in the form of wages. Marx was correct about labour being exploited, but he was wrong about who the exploiters were. By blaming capitalists, he ignored the productive contributions of capital and entrepreneurs. He also ignored the fact that government is the major source of worker exploitation by expropriating income that government itself has no legitimate claim to. Ironically, Marx was a strong proponent of progressive income taxation, which exploits workers even more than proportional taxation.

Income taxation is, in effect, a form of slavery or forced labour. It forces individuals to work and to pay income taxes so that part of their income is given away to someone else—farmers, corporations, welfare recipients, defense contractors, unions, and thousands of other well-organized special-interest groups—who did nothing to earn or deserve it. H.L. Mencken's dictum that an election is an advance auction on stolen property is as trite as it is true.

Of course, not all income that is taxed is necessarily used for government-mandated income transfers. To the extent that some of it is used to finance a criminal justice system, national defense, and generally maintaining the rule of law, it enhances rather than diminishes economic freedoms. However, these functions are a relatively minor aspect of the modern



welfare state. The modern state is a vast income redistribution machine that shuffles wealth around *within* the middle class.

For purposes of measurement, it would in theory be desirable to separate the amount of income tax revenue that is used for redistributive purposes and the amount used for the justice system, national defense, etc. In reality, such a task is virtually impossible. One problem is that a government that spends X billions on national defense will include in that amount some legitimate defense expenditures as well as a considerable amount of patronage payments to consultants and contractors and academicians and others who do not necessarily contribute to the national defense. The same is likely to be true for spending on the justice system and virtually every other government program. I will ignore these intractable problems and consider the percentage of wage income extracted through income taxation as another measure of the loss of economic freedom.

### **Employment in the Military**

Another relative measure of labour market freedom will be whether or not a country raises an army through conscription or through more voluntaristic means, such as by offering competitive wages. Obviously, the existence of a military draft will count negatively against a country's standing in terms of economic freedom.

### **Mandating Job Security**

Many countries have various laws and regulations that supposedly guarantee "job security" by restricting the flow of capital. Laws that make it more costly or prohibitive to close down a plant are examples. Such laws may be well intentioned, but they deprive workers and business owners of economic freedom and are undeniably harmful to a nation's economy. By hampering economic growth, they ultimately impoverish the workers in whose name the laws are enacted. Job security laws, in other words, reduce job security.

Advocates of such legislation usually ignore the fact that workers and employers do negotiate various types of "job security" provisions in their contracts. It must be realized that if, for example, a union wants a contract that includes severance pay in the event that the plant closes down, that provision will be "paid" for by a negotiated reduction in wages or other

fringe benefits. There is no free lunch; acquiring such benefits requires tradeoffs. That's why laws that mandate job security provisions reduce economic freedom. They deprive workers of freedom of choice by forcing them to accept one particular benefit—a benefit they may not want if they know how much it cost them in terms of foregone wages. So-called job security regulation also deprives employers and business owners (i.e., shareholders) of economic freedom. It prohibits them from making the best use of their resources, which can only be impoverishing. The extent to which governments control the flow of capital through "job security" regulation is another measure of labour market freedom. Countries will be evaluated according to such criteria as whether they actually make plant closings or relocations costly or prohibitive or if they have milder restrictions, such as the plant-closing notification law that exists in the U.S.

## **Immigration**

Freedom of migration is a basic human right that is essential if individuals are to be free from governmental oppression. The ability to change employment or to seek employment elsewhere—even in another country—is a hallmark of economic freedom. Thus, free immigration and emigration is most conducive to economic freedom and opportunity.

No country in the world has perfectly free immigration. The U.S. is generally regarded as among the most free—there are about twice as many immigrants entering the U.S. each year as there are in all the rest of the world combined. Yet the U.S. does place restrictions on immigration.

Since freedom of migration is so essential to labour market freedom generally, there are a number of criteria that can be used in combination to try to measure this aspect of economic freedom.

### **Overall Limits on Immigration**

Since all countries place some limits on immigration, one method of comparing them is by calculating the allowable number of immigrants as a percentage of the nation's population.

## Taxes on Immigration

Some countries charge immigrants fees or taxes. In such cases large statutory numbers of allowable immigrants may not be very meaningful if the charges are so high as to exclude large numbers of people. Therefore, the existence of "entrance fees" into a country is another criteria that may be used. The amount of the fee may be standardized as a percentage of average annual income in the country receiving the immigrants.

## Enforcement

Many countries are concerned about illegal immigrants. From the perspective of labour market freedom, however, the more illegals the better. The fact that the U.S. claims that its enforcement of illegal immigration is weak, and that its borders are "out of control," is a plus. Consequently, another possible measure of labour market freedom is the budget of the appropriate immigration enforcement agency as a percentage of the nation's total governmental budget. The higher the budget allocation, the stronger is enforcement, and the lesser the degree of economic freedom.

## Labour Market Tests

In some countries immigration laws specifically outlaw immigration if the immigration enhances rather than stifles a free market in labour. In the U.S. immigrants are required to prove that their employment will not displace a U.S. worker *and* that their presence will not cause a reduction in wages. This is clearly a protectionist law instigated by organized labour. The existence of such tests will cause a country to be ranked lower on our economic freedom scale.

## Lists of "Undesirables"

Some countries limit immigration according to racial or ethnic criteria. The U.S. has a long history of discriminating against Chinese and Japanese immigrants in this way, although such discrimination was outlawed in 1965. Thus, another criteria is the existence of a list of racially or ethnically "undesirable" immigrants.

## **Amnesty**

Granting amnesty to illegal immigrants who have over a period of years established "roots" in a country is another way in which immigration restrictions are diluted and, consequently, economic freedom is enhanced. Thus, the existence of an amnesty program will provide a country with a more favorable economic freedom rating.

## **Temporary Workers**

Since a half a loaf is better than none, countries that allow temporary "guest workers" exhibit a higher degree of economic freedom, all other things equal, than those that don't.

## **Emigration**

Of course, the "supply side" of immigration depends on the ability of individuals to leave. Some measure of governmental impediments to emigration is therefore essential in our measurement. One criterion is the existence of limits on emigration expressed as a percentage of the population.

# **Measuring Labour Market Freedom**

It's worth repeating that the above template is by no means comprehensive. In many countries there are literally thousands of labour laws and regulations and the number is growing almost daily. Heldman, Bennett, and Johnson provide the following partial view of the enormity of labour law and regulation in the U.S.

Among the standard, heavily used tools of the labour specialists' trade are (as of 1980) 250 volumes of NLRB decisions, 87 volumes of *Labour Cases*, 103 volumes of the...*Labour Relations Reference Manual*, 11 volumes of *Federal Regulation of Employment Service*, 26 volumes of various publications of the Bureau of National Affairs dealing with labour relations, 22 volumes of *Fair Employment Practice Cases*, literally untold volumes of cases and decisions emanating from state-level employment relations boards and commissions, and a virtual avalanche of materials on private and public sector arbitration decisions. It is possible that no other topic enjoys (if that is the right word for it) the massive amount of legal reference

materials as that which must be mastered if any particular party in an employment relationship is to act in accordance with the standards of behavior laid down by agencies of government.<sup>18</sup>

The sheer magnitude of regulation, i.e., the number of pages of regulations, might conceivably be another measure of economic freedom—the more pages the less freedom. But such a measurement would not be very enlightening because it does not distinguish between irrelevant regulations, such as a declaration of a “national farmworkers’ week,” and substantive regulations such as a minimum wage law.

That we have omitted many regulations—some trivial and some not so trivial—need not impair the accuracy of our rankings. It is reasonable to assume that countries with a high (or low) economic freedom rating based on the above criteria will probably also have a high (or low) rating if the myriad other regulations were included. It would seem highly unlikely that a country with a high ranking based on the major forms of labour market regulation would be ranked very differently on most of its other interventions.

The following table contains the preliminary ranking of the U.S., Canada, Great Britain, and Japan in terms of our criteria. The rankings are based on a scale of 1 to 10 for each criteria, with a 10 being the highest degree of economic freedom. Since not all criteria are “either-or” criteria, I will attempt to classify the countries in light of the above discussion. For example, a country that has statutory restrictions on immigration but which does not enforce them will receive a higher rating than a country with identical restrictions that are in fact enforced. The rankings are necessarily subjective, but I will discuss the rationales for the various *ordinal* rankings in the table. Finally, I will attempt to collapse all the individual rankings into an overall ranking for each country.

**Table 1. Measuring Labour Market Freedom**

Criteria	U.S.	Canada	England	Japan
Compulsory Collective Bargaining	0	0	10	0
Yellow-Dog Contracts Permitted	0	0	0	0
Exclusive Representation Laws	0	0	10	10
Pushbutton Unionism	0	3	0	10
Agency Shop	5	5	0	7
Are Strikebreakers Protected?	5	5	3	5
Can Workers Sue Unions?	3	3	10	3
Can Employers Sue Unions?	0	3	10	0
Minimum Wage	7	-	-	-
Maximum-Hour Legislation	0	0	0	0
Davis-Bacon Laws	0	0	0	0
Child and Female Labour Restrictions	7	5	5	5
Occupational Licensing	-	-	-	-
Equal Pay for Equal Work Laws	0	0	0	0
Equal Pay for "Comparable" Work	10	10	10	10
Employment Quotas	5	5	5	3
Government Employment	-	-	-	-
Mandatory Government Arbitration	5	0	0	5
Safety and Health Regulation	-	-	-	-
Employer Payroll Taxes	5	7	7	3
Taxes on Labour Income	5	7	5	7
Military Employment	10	10	10	10
Regulating Job "Security"	7	-	-	-
Immigration Limits	7	5	5	3
Taxes on Immigration	10	-	-	-
Immigration Enforcement	9	3	3	3
Labour Market Immigration Tests	0	0	0	0
List of "Undesirable" Immigrants	5	0	3	0
Amnesty for Illegal Immigrants	10	10	10	0
Are Temporary Workers Permitted?	10	10	10	3
Emigration	10	10	10	10
Overall Ranking	118	101	126	100

## **Analysis**

I was unable to obtain all the relevant information, for example, the number of occupations with licensing regulation is particularly difficult to discern, especially across countries.<sup>19</sup> Thus, in the overall ranking a computation is made only if data were available for all four countries. Since not all of the criteria are "either-or" criteria, some were given an intermediate ranking on our 1-10 scale. I have provided a purely subjective ordinal ranking, but that should not bias the overall ranking as long as the same subjective criteria are applied to each country. For example, both the U.S. and Canada have agency shop agreements, but they are not universal, so each country was given a ranking of "5." I have also assigned a score of "3" for a "low" degree of economic freedom and "7" for a relatively high degree. For example, the U.S. was given a "7" for Immigration Enforcement because it does a poor job of it, thereby creating relatively free immigration. Japan was given a score of "3" because, even though it allows some immigration, it is only a trickle. I have used only these three rankings—3, 5, and 7—in cases where there is not a simple "either-or" decision. This will hopefully minimize debate over whether a country should be scored a 4 or a 5, a 7 or an 8, etc.

To determine what constitutes a "high" and "low" ranking it was sometimes necessary to choose one country as a benchmark. For example, the literature on immigration describes the U.S. as perhaps the most open country in the world. Thus, the U.S. was ranked "high," and the other three countries were ranked low because they all appeared to be considerably more restrictive.

I suppose it might be desirable to weight the criteria in some fashion, but I can think of no way of doing so that would not lead to endless debate over any type of weighting scheme. For now I have decided to weight all the criteria equally. That in itself will elicit some debate but not as much as an arbitrary weighting scheme is likely to.

The overall results tentatively rank England first, with the U.S. a close second, Canada third, and Japan last. However, these results are only intended as an example of how one might begin constructing such a ranking, not as a definitive ranking. Because of data limitations, some of the most important categories remain unranked. The minimum wage law, for example, is set by local governments in some of these countries, so data

on the various levels of minimum wages are scattered. The same is true for data on occupational licensure and several other criteria. A little more digging will be rewarded with a more meaningful ranking.

Since this is only a preliminary attempt at ranking countries according to their respective degrees of labour market freedom, and since this paper is already quite lengthy, I will conclude with a few thoughts on other possible criteria not yet mentioned and some further data problems.

## **The Prevalence of Unions**

The proportion of unionized workers to the total labour force might have been an appropriate criterion, presumably assigning an inverse relationship. The more dominant are unions, the less free are labour markets. One problem with this criterion, however, is that there is no clear way to separate out the cartel behavior of unions from other types of behavior. For example, some unions do train workers, administer grievances, and act as bargaining agents for their members, which is not necessarily a negative function in terms of economic freedom. Thus, the prevalence of unions says nothing about the actual functions of unions.

## **Strikes**

The number of strike days lost, perhaps on a per capita basis, has also been suggested. More strike days lost can be interpreted as conducive to less economic freedom. A problem with this criteria, at least from my perspective, is that legal *prohibitions* of strike activity have historically been a hallmark of totalitarian governments, particularly Mussolini's Italy.

Circumstances in Japan connote another problem. In that country strikes during the past several decades have been numerous, but many of them have been symbolic. Workers go on strike for one day just to make a point or to publicize their grievances, and then they go back to work. The data on Japanese strike days lost might imply a great deal of strike activity, but very little diminution of economic freedom to the extent that strikes are used to forcefully restrict the supply of (nonunion) labour, as they often are.

## **Union Political Power**

How politically powerful the union sector is would be especially relevant to this paper, but is difficult to quantify in any meaningful way. Unions are



major sponsors of restrictive labour legislation aimed at cartelizing labour markets for the benefit of their members. One problem with quantifying this effect is that much union political muscle is “in-kind” and labour intensive—voter registration drives, phone banks, house-to-house campaigning by union members, etc. Some estimates have been made of the monetary value of these political services, but they are so wide ranging (from \$100 million to \$350 million annually in the U.S.) that they are not yet very reliable.

It is possible that in countries such as Great Britain, where there is a formal political party controlled by unions, that union political strength would be stronger. But an argument can be made that the British Labour party has been quite impotent compared to, say, the U.S. union movement, which has had some major legislative victories in recent years. Thus, the existence of a formal political party controlled by unions may not be of much help in constructing our economic freedom index.

## **Government Employment**

As discussed above, the role of government employment is relevant to our discussion, but it is also plagued by data problems. First, government statistics on employment are inaccurate because they omit contract employees who are not formally counted as government employees even though they perform work for governments and are paid with tax money.

Second, government employment statistics are often “cooked” so as to understate the true numbers. In the U.S., for example, thousands of federal employees are known within the bureaucracy as “twenty-five and ones.”<sup>20</sup> They are on the federal payroll for 25 weeks, and then when U.S. Census Bureau employment statistics are gathered—every 26th week—they work as private contractors. Once the census has been taken they return to the fulltime government payroll.

Third, despite a great deal of research on the size and growth of government, we still do not have a generally accepted definition of what constitutes “government” and government employment. Off-budget enterprises are usually omitted, and there is also the problem of how to treat the so-called private, nonprofit sector.

In the U.S., more than 60 percent of the “income” of nonprofits is from federal grants. Many of these nonprofits were established to administer government programs and the literature on nonprofits often refers to them

as "shadow governments." For all practical purposes, a large part of the private nonprofit sector in the U.S., which produces approximately 9 percent of GNP, is an arm of government and so their employees are government employees.<sup>21</sup> In short, the government sector is larger than we generally acknowledge, which hinders our ability to construct reliable estimates of government employment.

In light of these and other limitations, perhaps the main objective of this paper is to stimulate further discussion of labour market freedom and how it might be measured. Given the enormity of labour law and regulation, this seems almost as insurmountable as getting one's arms around an elephant. I have tried to embrace the labour market elephant and I hope I have persuaded others that this is a worthy task.

## Notes

<sup>1</sup> Economic freedom requires a set of customs, moral constraints, or laws that prevent individuals or groups from committing violent or coercive acts against others. Thus, mutual consent between two burglars plotting a robbery, for example, is not an example of economic freedom in the sense we are discussing.

<sup>2</sup> See Bernard Siegan, *Economic Liberties and the Constitution* (Chicago: Univ. of Chicago Press, 1980); Richard Epstein, *Takings* (Cambridge: Harvard Univ. Press, 1985); and Terry Anderson and Peter J. Hill, *The Birth of a Transfer Society*, (Stanford, Ca.: Hoover Institution Press, 1980).

<sup>3</sup> See James T. Bennett, Dan Heldman, and Manuel Johnson, *Deregulating Labour Relations* (Dallas: Fisher Institute, 1981), p. 50.

<sup>4</sup> *Ibid.*

<sup>5</sup> Morgan Reynolds, *Power and Privilege: Labour Unions in America*, (New York: Universe Books, 1984), p. 98.

<sup>6</sup> Thomas J. DiLorenzo, "Exclusive Representation in Public Employment: A Public Choice Perspective," *Journal of Labour Research*, Fall 1984, pp. 371-90.

<sup>7</sup> For a detailed discussion of the political agenda of organized labour in the U.S. see James T. Bennett and Thomas J. DiLorenzo, *Destroying Democracy: How Government Funds Partisan Politics* (Washington, D.C.: Cato Institute, 1985), chapter 13.

<sup>8</sup> For a survey of some of the literature on the minimum wage see Thomas Rustici, "The Minimum Wage: A Public Choice Approach," *Cato Journal*, Fall 1986.

<sup>9</sup> For a thorough discussion of the economics of occupational licensing see S. David Young, *The Rule of Experts: Occupational Licensing in America* (Washington, D.C.: Cato Institute, 1987). Also see R.D. Blair and S. Rubin, *Regulating the Professions* (Lexington, Mass.: Lexington Books, 1980); and Timothy R. Muzondo and Bohumir Pazderka, "Occupational Licensing and Professional Incomes in Canada," *Canadian Journal of Economics*, Nov. 1980, pp. 659-67.

<sup>10</sup> Walter Williams, *Apartheid: South Africa's Assault on Capitalism*, (Washington, D.C.: Cato Institute, 1989).

<sup>11</sup> Thomas Sowell, *Civil Rights: Rhetoric or Reality?* (New York: William Morrow & Co., 1984), p. 39.

<sup>12</sup> *Ibid.*, p. 51.

<sup>13</sup> *Ibid.*, p. 53.

<sup>14</sup> Thomas J. DiLorenzo, "The Myth of Government Job Creation," *Cato Institute Policy Analysis*, February 1984.

<sup>15</sup> James T. Bennett and Thomas J. DiLorenzo, *Unfair Competition: The Profits of Nonprofits* (Lanham, MD: Madison Books, 1988), chapters 1 and 7.

<sup>16</sup> W. Kip Viscusi, "The Impact of Occupational Safety and Health Regulation," *Bell Journal of Economics*, Spring 1979.

<sup>17</sup> Peter J. Ferrara, *Social Security: The Inherent Contradiction* (Washington, D.C.: Cato Institute, 1980), p. 276.

<sup>18</sup> *Deregulating Labour Relations*, p. 74.

<sup>19</sup> Data sources included: Organization for Economic Cooperation and Development, *Social Expenditure, 1960-1990* (Washington, D.C.: OECD, 1985); OECD, *Labour Force Statistics* (Washington, D.C.: OECD, 1988); OECD, *Taxation in Developed Countries*, (Washington, D.C.: OECD, 1987); OECD, *Financial Accounting in OECD Countries* (Washington, D.C.: OECD, 1988); R. Blanpain, *International Encyclopedia for Labour Law and Industrial Relations*, (Boston: Kluwer, 1978); International Labour Organization, *Yearbook of Labor Statistics*, (Geneva: ILO, 1988); and Albert A. Blum, *International Handbook of Industrial Relations* (Westport, Conn.: Greenwood Press, 1981). Other information was obtained from country-specific books on Canadian immigration policy, Japanese immigration policy, etc.

<sup>20</sup> James T. Bennett and Manuel H. Johnson, *The Political Economy of Federal Government Growth: 1959-1978* (College Station, Texas: Center for Research and Education in Free Enterprise, 1980), chapter 2.

<sup>21</sup> James T. Bennett and Thomas J. DiLorenzo, *Unfair Competition: The Profits of Nonprofits* (Lanham, MD: Madison Books, 1988).

I wish to thank James T. Bennett and Walter Block for their helpful suggestions. The usual caveat applies.

## Discussion

Ed Crane liked the rating scale and thought the scoring was at an appropriate aggregate level. He did not like the push-button unionism. He argued that employers and employees can always agree to form a union. A "right to work" law reduces freedom to voluntarily associate. Tom DiLorenzo felt that the "right to work" tended to enhance freedom. Milton Friedman responded that although freedom reducing in principle, in fact, where used they are almost always freedom enhancing. They are really second best solutions.

Alan Reynolds felt that consumption taxation is every bit as damaging as income taxation and that DiLorenzo over emphasized income taxation. Bernard Siegan wondered why zoning or other kinds of regulation that were particularly important to labour contracts were not included. DiLorenzo responded that he thought someone else would do this.

James Gwartney found two legal restraints that impact freedom that were not dealt with directly. First, there is the mandatory requirement of collective bargaining. This is what gives bite to all the other issues which would otherwise be secondary. Second, there is the prohibition of the company association. This also highlights why unions across countries are very different. For example, Japanese unions are often company organized. DiLorenzo speculated that this may account for Japanese companies' strength.

Gerald Scully looked at Table 1 and wondered what to conclude in that Canada and Japan have the least free labour markets, England has the most free, more or less like the U.S., but in general there is little to choose among them. He thought the metric was not sufficiently fine, or the measure itself

was flawed. DiLorenzo argued that the use of the many categories was a first pass. Jack Carr looked at Table 1 noticing that 18% of the U.S. labour force is unionized compared to 36% in Canada. The problem here is that they both get the same weight yet Canada is more impeded than the U.S. This bears on the issue of competition among jurisdictions. Richard McKenzie felt that some measure that will evolve over time is needed. Milton Friedman wanted to have some external referent by which to judge the results in Table 1. Does Canada have more or less freedom than the U.S.? He found it absurd to suggest that among the group, Canada, the United States, England and Japan, that England has more labour freedom. If these measures lead to such a bad result, they do not appear to be very useful. Cliff Lewis wanted to look at issues such as education rather than labour markets narrowly conceived. The California university system, he asserted, is subsidized to the tune of \$15,000 per capita. This would lead to a very different sense of the distortions among the different countries. James Gwartney emphasized that the scores for Britain were at variance with his knowledge of the rankings. Walter Block felt that the total rankings were roughly correct in comparing the U.S. to Canada even though Canada appeared more free than the U.S. on the degree of unionization. But clearly there were other variables that could be measured. Further, Block did not like the idea that just because we don't like the result, the identification of a loss in economic freedom may be incorrect.

Richard McKenzie suggested that the values of the categories could be weighted by the number of people to whom the legislation applied. This may make things consistent. In the case of unions, the U.S. is at 16% while Britain is 36% of the population. Similarly, the minimum wage affects 2.4% of the population in the U.S. and thus the values are weighted more appropriately. Charles Murray suggested that after subsequent analysis the raw percent of unionization may in fact act as a proxy measure for a host of other variables affecting economic freedom.

Walter Block argued that it would be very difficult to measure the costs of immigration restrictions in any way other than categorical. Milton Friedman responded that the way to do an impediments analysis is to take each impediment and to look at how much it distorts transactions. This is not the same as the effect on wealth even though it is a dollar measure—as used in Easton's paper. If there are no transactions, then there are no distortions so if we think of immigration, it means that we analyze how the

flows are impeded. Walter Block argued that a flaw in the “dollarization method” proposed by Easton is that with an optimal tariff it suggests a benefit for the country imposing the tariff, even though it is undesirable from an international point of view. Since we are measuring the effects by country, it gives a spurious view of what is taking place. Easton responded that in his example of the optimal tariff, quite clearly domestic income rises even though economic freedom is reduced. There was nothing inconsistent with this method of measuring economic freedom. Milton Friedman agreed using the example of immigration in which no assertion is made about per capita income even though barring immigration will impose a loss of economic freedom.

Responding to a question by Bernard Siegan, DiLorenzo thought that creating dollar measures in labour markets would involve a book length manuscript, but that it could be done. Milton Friedman suggested that we must also be prepared to test our notions of economic freedom. We have far more confidence in our knowledge that Hong Kong is more economically free than other countries than we have in any particular set of numbers. What we need is a way to evaluate the indexes that are being produced.

# **International Comparisons of Taxes and Government Spending**

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## **Introduction**

**T**HE SPECIFIC DETAILS OF THE structure of taxation were largely neglected before the mid-1970s—relegated to a minor branch of “microeconomics.” Instead, the superstars of the economics profession battled over whether budget deficits or money supplies were the best way to manipulate private spending, and thus manage aggregate demand. In a 1960 essay, Tobin favored “restriction of consumption by [an] increase in personal income tax at all levels,” in order “to bring under public decision the broad allocation of national output.” In a 1971 book on taxation, Thurow stressed that “the aim of the macroeconomic policymaker is to raise or lower the demand,” and that “different taxes have different effects [only] because they affect the incomes of groups with different propensities to consumer or invest.” In such cases, any effect of steep tax rates in discouraging

productive effort were either brushed aside with flimsy logic and surveys, or simply ignored. Taxes were only considered a device for discouraging demand, not for discouraging supply. Neglect of tax incentives was a natural outcome of the Keynesian fetish. In his classic 1937 essay on "Mr. Keynes and the Classics," Hicks writes that, "I assume that...the quantity of physical equipment of all kinds available can be taken as fixed. I assume homogeneous labor." With both physical and human capital thus assumed to be insignificant, there was no reason for Keynesian economists to worry how they might be affected by tax policies. Incentives to produce were considered less interesting than incentives to consume, since demand was thought to create its own supply.

By the mid-1970s, though, Keynesian "demand management" had been discredited by the experience of chronic stagflation, and the effects of various taxes and subsidies on human behavior and incentives began to receive considerably more attention. This was partly due to intellectual advances, such as the pioneering work of Mirrlees on the theory of optimal taxation, and the renewed emphasis on the microeconomic conditions for economic growth among "new classical" economists, such as Barro and Davies. Under the banner of "supply-side economics," a new band of unapologetic pro-capitalist politicians, led by Jack Kemp, Ronald Reagan and Margaret Thatcher, turned tax reform into a major, worldwide movement. By the end of the 1980s, over 50 countries — including *all* major industrial countries — had significantly reduced their highest marginal tax rates (see Appendix). Limited interest in similar reforms (which often encompass privatization and deregulation as well as reduced tax rates), has even spread to the Soviet Union, Poland, Hungary, China and Vietnam.

Taxes are an important part of the cost of production, as well as the cost of living. People generally have to produce more to earn more, except in cases of theft or legal "rent-seeking" (wasteful, negative-sum games involving the abuse of government power to acquire lucrative special privileges at the expense of others). It follows that a tax system which penalizes added income will also penalize added output. Aside from the unrealistic, hypothetical case of non-distorting taxes (e.g., a tax of so many dollars per person), the specific details of the tax structure have an enormous impact on behavior of individuals, and therefore of entire economies. Most taxes introduce a "wedge" between what a productive activity is worth to consumers and what the suppliers of labor and capital actually receive. Just



as excise taxes on liquor and tobacco are partly designed to discourage the use of those products, taxes on earning additional personal or business income must likewise discourage the process of wealth-creation that lead to such increased income. When taxes on effort and savings are high, for example, choices are distorted in favor of additional leisure rather than additional income and in favor of current consumption rather than future consumption. The typical welfare state blend of demoralizing taxes on success and generous subsidies for failure tends to produce fewer successes and more failures.

At one extreme, the compulsion of taxation could be used to purchase *all* goods and services, which could then be distributed to individuals on the basis of various criteria, particularly political influence. Workers and investors would, in effect, endorse their entire paychecks over to government agencies, which would then decide who gets what sort of food, housing and shelter. Such a system would have enormous difficulties in motivating people to produce up to their true potential, since they would have so little choice as to how the fruits of their efforts would be used. The political marketplace, even in its most democratic forms, typically offers the electorate only an infrequent choice between two or three package deals. Voters might want some parts of the package offered by one political party, some parts of those offered by another, and many things (such as maximum individual choice) that are not offered by either. The package deals that are offered are often meaningless anyway, since political officials who get votes by offering something they do not deliver cannot be sued for fraud.

A so-called "national economy" is nothing more than the activities of individuals that involve producing and trading with one another. Not so long ago, many observers thought the extent of government control over these activities would become more and more extensive and detailed, leaving fewer and fewer economic decisions to individuals. Heilbroner, writing in 1959, expressed a view that remained common if not dominant among Anglo-American intellectuals in the first three decades of the post-war era:

As a means of beginning the huge transformation of a society, an economic authoritarian command has every advantage over the incentives of enterprise....Taking the long perspective of the decades ahead, it is difficult to ignore the relative 'efficiency' of authoritarian over parliamentary regimes as a means of inaugurat-

ing growth....Today and over the foreseeable future, traditional capitalism throughout most of the world has been thrown on a defensive from which it is doubtful that it can ever recover.... [The] road to abundance lead subtly but surely into the society of control....[The] trend of all industrialized nations, ourselves included [is] toward some form of economic collectivism.

The confident consensus of the early postwar era — that economic liberty would be increasingly obsolete, replaced by governmental control — has been undermined by the evident stagnation or decline of living standards in countries with socialist economies. The alleged advantages of authoritarian planning have also been refuted by the vibrant success of every economy that instead moved in the direction of reducing government barriers to commerce and government disincentives to personal effort, investment and entrepreneurship. The embarrassing success of capitalist economies, most obviously in Asia, has now put socialism on a defensive from which it is doubtful that it can ever recover. One reason is the increased international mobility of capital, including human capital, and the new information technologies that make it impossible to conceal how well or how badly an economy is performing. Gordon thus notes “the restrictions capital mobility and tax competition impose on [a country’s] tax policy.”

Governments, like companies, must compete in producing the most value at the lowest possible cost. Countries in which the marginal cost of government is relatively high, particularly in relation to the value of government services, will find it more difficult to attract and retain physical capital, financial capital and human capital. Just as so-called “tax havens” attract investment and immigrants, countries with punitive tax systems face chronic “capital flight,” and a “brain drain.” When the effects of taxation on international movement of resources are considered (as in Gordon), the results can be quite different than when each country is analyzed as an isolated island.

In addition to the new concern about keeping tax expenses competitive among industrial economies, which is a key issue in the effort to integrate European economies by 1992, there is also renewed interest in “market-oriented” reforms in the Third World and Communist countries. Unfortunately, the literature on “market-oriented” reform tends to be *extremely vague*, typically calling attention to *objectives* rather than specific policies to achieve those objectives. Wilson and Gordon, of the University of

Michigan's Center for Research on Economic Development, thus define reform in such terms as "promoting the private sector" and "ending capital flight and promoting foreign investment." Within seven such empty boxes, there is virtually no mention of taxation, except to "shift taxation burden away from export sector." In rare cases when specific policies are mentioned, they are not obviously "market-oriented." For example, Wilson and Gordon suggest "ending government fixing of the exchange rate." Yet defining a weak currency in terms of a more credible currency (or gold), and making it freely convertible, has always been a necessary, though not sufficient, component of all successful plans for stopping a runaway inflation — most recently in Hong Kong, Israel and Bolivia (Bruno).

There have been relatively few systematic attempts to compare taxes and government spending between countries. The few global comparisons that have been undertaken by official agencies, such as the International Monetary Fund or U.S. State Department, typically rely on diplomatic obfuscations ("market-oriented reforms" or "outward-looking strategies") and unacceptable simplifications. One such simplification is to look at tax receipts as a percentage of gross national product (GNP) or gross domestic product (GDP). Another is to focus on one particular tax, usually the corporate profits tax. A third simplification, related to the other two, is to look only at average tax rates on existing income rather than marginal tax rates on additions to output and income.

## **Taxes "As a Percentage of GNP" Ignores Incentives**

A recent book from the International Monetary Fund, entitled *Supply-Side Tax Policy: It's Relevance to Developing Countries* (Gandhi, pp. 27 & 46), illustrates a common confusion between marginal tax rates and average tax revenues actually collected at those rates:

Revenues from personal income taxes in industrial countries are generally much higher than in developing countries both in relation to gross domestic product and as a share of total tax revenue. Presumably this explains why the great bulk of the literature on the incentive effects of tax regimes and of changes in marginal tax rates on labor, savings, and investment decisions pertains to the devel-

oped world....Regressions show that the ratio of income taxes to total revenue (as well as to GDP) and the growth rate of output are negatively related and that the regression coefficients are significant, but this result does not hold in all specifications.

In these remarks, the IMF economists are simply treating the amount of money collected from income taxes as equivalent to the impact of these and other taxes on incentives. Because revenues from income taxes are a tiny fraction of GDP, writes Tanzi, "it can be concluded that these taxes are much less important...in developing countries than in developed countries." Yet taxes can have extremely damaging effects on efficient economic activity without yielding significant revenues. Indeed, the more damaging the tax system is, the less revenue it will yield over time, because incomes and sales will stagnate or decline in the overtaxed sector, and more and more productive activity will disappear into the tax-free "underground economy." This is actually most obvious in developing countries, where extremely high tax rates often push *most* productive activity underground, thus yielding little or no revenue. Failure to generate revenue, though, certainly does not mean the high tax rates have no bad effects, as Tanzi and other IMF economists suggest. On the contrary, underground enterprises lose economies of scale by the necessity to stay small in order to avoid detection. They also lose efficiencies of communication, such as the ability to advertise or to efficiently recruit the best workers. Even the vital efficiencies of a monetary economy are often lost, as commerce instead resorts to primitive barter in order to avoid both explicit taxes and also to avoid the tax on cash balances due to chronic devaluation and inflation.

Ironically, the bibliography of the IMF volume cites a few of the earliest studies on the effects of changes in marginal rates in developing countries, including Reynolds, Rabushka-Bartlett and Wanniski. All of these comparative studies emphasize very clearly that steep tax rates both damage economic growth and make taxes virtually uncollectible. Since GDP grows slowly, if at all, the tax base likewise grows slowly, if at all. Far from indicating that "the incentive effects of...changes in marginal tax rates" are insignificant in developing countries, as the IMF volume repeatedly suggests, the poor revenue yield from extremely high tax rates instead indicates that marginal tax rates can be sharply reduced, with the government then collecting a smaller increment of an expanding economy rather than attempting to collect a huge percentage of zero growth.

## Excessive Emphasis on Corporate Income Taxes

Another excessive simplification is to focus almost exclusively on a single category of taxes. Most of the IMF volume thus concentrates on income taxes, as though production decisions and costs were completely unaffected by Social Security taxes, sales taxes or tariffs. Even worse, many international comparisons have been limited to only the corporate income tax. A recent report for the U.S. Agency for International Development, by Frost & Sullivan Inc., ranks the "investment climate for international business" by 14 criteria, such as "labor conditions" and "regime stability." Following the State Department as the "primary source," only 2 of the 14 criteria listed by Frost and Sullivan have to do with tax policy. The only taxes that matter, in this State Department-AID view, are the "level of corporate taxes" and "investment incentives...in the form of tax holidays...and subsidies."

This quasi-official emphasis on corporate taxes and subsidies is far too narrow on both factual and theoretical grounds. At the factual level, corporations typically exert sufficient political clout to keep corporate tax rates *relatively* low, particularly for foreign corporations, and subsidies and special tax breaks relatively high. Prior to 1989 tax reforms, for example, the highest corporate tax rates were 33-35% in Mexico, Brazil and Argentina, while maximum individual tax rates were 45-50%. One reason that large multinational corporations are often able to gain preferential tax treatment, aside from their obvious importance as a source of funds for politicians, is that the employment consequences of a large company locating in a country, or leaving, are far more conspicuous than the inability of a small, local enterprise to even get started (without evading taxes and regulations).

It is not even correct to regard the corporate tax as the only relevant direct tax on the income of business enterprises, since many *domestic* businesses are not incorporated, and are thus taxed at the higher rates typically imposed on individual income. Even incorporated domestic firms do not qualify for the "tax holidays" apparently favored by State Department researchers, and instead bear higher tax rates to compensate for revenue loss of a temporary zero tax on new foreign competitors.

Corporations are not organic entities that are able to bear tax burdens, any more than their buildings can bear a tax. A tax on corporate profits must either be paid by those who invest in the company, those who work for it, or those who buy its products. But replacing any corporate profits tax with a more obvious and direct tax on a company's stockholders, workers and customers would have a similar effect in reducing the company's opportunities for profitable production, and its offers of employment.

The familiar distinction between "business taxes" and "people taxes," which is the subject of considerable corporate lobbying (sometimes disguised as "studies") is essentially irrelevant. All taxes are paid by individual producers, as suppliers of labor and capital. It is relatively insignificant, in most cases, whether taxes are direct or indirect, corporate or personal. Capital and labor bear all taxes, either through lower incomes or higher prices. Indeed any tax itself may be considered a price —the price of government—so that *all* taxes might thus be properly included in a broad concept of the "cost of living." Since accounting conventions instead count only sales taxes as part of the cost of living, substituting an income tax for a sales tax may *appear* to reduce the usual measures of consumer prices. Yet the reality of reduced purchasing power for producers would not be changed at all, even though the burden might be shifted from some people to others.

Any "consumption tax" must actually fall on producers, because consumption is the only motive for production. Moreover, the whole purpose of taxes is to divert a portion of production away from uses determined by markets toward uses determined by political authorities, so that any form of taxation *must* reduce real rewards to producers in the market economy. A proper comparison of taxation between countries must therefore attempt to include the combined effects of *all* taxes.

## **Spending Measures the Average, Not Marginal, Burden**

Although expressing tax receipts as a percent of GNP is a wholly inadequate measure of the distortions and disincentives of a tax system, the same is not true of government *spending* as a percent of GNP (or GDP). The ratio

of government spending to GNP has considerable merit as a rough measure of the *average* burden of government activities on the voluntary activities of private producers and consumers. Wolf estimates that "a 10% increase in the ratio of government spending to GDP results in an expected decrease of 1% in the average annual rate of growth in GDP" among developed countries, and a 4% decrease among low-income countries. Spending ratios, though, are incomplete, static and too aggregated.

Government purchases of goods and services (as opposed to transfer payments) represent one form of claim on society's productive resources (labor, capital and natural resources) that are allocated through political decisions rather than through markets. At reasonably full employment, resources devoted to politically-determined uses are simply unavailable for market-determined uses, regardless of whether the government's purchases are financed by taxes, borrowing or creating new money. Persons employed by the government cannot simultaneously be employed in producing what consumers choose to buy. Energy and land devoted to government offices cannot simultaneously be used to produce, say, food, clothing or shelter (which are still mainly produced and marketed by the private sector, even in most socialist economies).

Subsidies and other transfer payments are often said to be different than purchases, since they "merely" redistribute purchasing power among people in the private sector rather than deflecting resources from private to governmental uses. Yet this observation neglects incentives. The essence of most transfer payments is to take part of the rewards away from productive individuals and firms and give them to those who do not work, do not plant crops, or do not manage viable enterprises. That is, transfer payments punish success in the marketplace and reward failure (they also punish those who lack political clout and reward those who can best manipulate the political system). Because transfer payments *are* a huge burden on the *productive* portion of the private sector, they cannot be ignored. If all that government did was to transfer more and more resources from workers to non-workers, for example, the result would surely be fewer workers and more non-workers, reducing the amount of real output left to redistribute. As Gwartney and Stroup observe, "While the income transfers do not *directly* reduce total income, the substitution effect associated with the transfer will induce *both* the taxpayer-donors and the transfer recipients to reduce their work effort." For certain analytical purposes, it may indeed be

legitimate to separate transfer payments from purchases, and even to further divide government purchases between capital outlays and current consumption, or between substitutes for private services (e.g., nationalized health insurance) and services that the private sector is not permitted to provide (e.g., defense, currency). But the use of *total* government spending is nonetheless almost always sufficient to capture the general burden of strictly fiscal costs of government, even though it excludes important *regulatory* costs and uncertainties.

Although government spending thus approximates the true burden of government on the private sector, the ratio of government spending to GNP only measures the *average* burden at the moment, not the *marginal* burden over time. Two countries could have the same percentage of GNP currently channeled through government and yet have enormously different *marginal* tax burdens on future additions to GNP. The country with the lower marginal penalty on added output and income would experience more rapid growth of real GNP, so that real government spending could increase just as rapidly as in the country with higher marginal tax rates and yet nonetheless become smaller over time as a percentage of GNP. For this reason, *current* government spending as a percentage of *current* GNP should not be assigned *too* high a weight in evaluating the dynamic trends toward more or less economic liberty. In many cases, a reduction in marginal tax rates can reduce the *future* ratio of government spending to GNP *by increasing private GNP*. Indeed, an econometric comparison of 63 countries, by Koester and Kormendi, estimates that "a 10% revenue neutral reduction in marginal tax rates would yield a 12.8% increase in per capita income for LDCs and a 6.1% increase...for non-LDCs."

## **Ratios of Public Debt to GNP**

Just as the ratio of government spending to GNP can increase because of relative weakness in private GNP, rather than unusual growth of government, the ratio of government deficits or debt to GNP may likewise conceal more than it reveals. Past debts may decline as a percentage of GNP because the central bank is buying too much debt with new bank reserves or currency. Such an inflationary monetary policy inflates *nominal* GNP relative to older debt issued at fixed interest rates. Switching to a less-inflation-



ary monetary regime, as the U.S. did in the 1980s, may therefore appear to increase debt relative to GNP. Yet the more responsible method of financing government debt is nonetheless a beneficial reduction of the "inflation tax" on those who hold cash balances and older bonds. To the extent that governments can be bound by a credible commitment to non-inflationary methods of financing their debts, they will be able to issue new debt (for emergencies or capital outlays) at lower interest rates, thus reducing interest outlays and the nominal budget deficit.

Using chronic inflation to reduce the ratio of domestic debt to GNP is often worse than futile, since it can virtually destroy the government's ability to raise funds through either taxation or additional debt, as an IMF study by Blejer and Chu points out:

If inflation brings about a fall in the capacity to raise taxes, to collect the inflation tax on the monetary base, and to borrow abroad, it will also increase the risk of default on the public debt...As such, it may reduce the willingness of individuals to lend to the government. This attitude on the part of the public will be reinforced by the fact that the deterioration of the inflationary situation will increase the probability of adoption of adjustment programs that might include ...higher income taxes on interest incomes....When individuals receive nominal interest payments, they are taxed on the total of these payments without an adjustment for the effect of inflation. This fact, *per se*, would induce a shift from financial assets (including government bonds) toward real assets or foreign investments, since the unrealized capital gains on real assets are tax free while the foreign investments are often totally tax free.

Blejer and Chu also note that "the fiscal deficit is, under any circumstances, a crude tool for assessing the impact of fiscal policy on the economy." In a situation of high inflation, though, conventional measures of the budget deficit become virtually useless. Attempts to reduce nominal budget deficits through "adjustment programs" involving higher income taxes can prove disastrous to incentives, as well as having the adverse effects on the financial system that were emphasized by Blejer and Chu (e.g., provoking capital flight and destroying the ability of government to sell bonds rather than printing money). Despite the enormous emphasis typically given to nominal budget deficits, particularly among developing countries, this appears far less useful than a detailed investigation of the structure of

taxes and expenditures, as well as the possible abuse of inflationary methods of financing deficits.

There is a somewhat better case to be made for comparing accumulated debt-to-GNP ratios between governments, rather than just current budget deficits. Those who analyze debts of developing countries often place undue emphasis on *foreign* debt, and insufficient attention to domestic debt — which is often much larger and always pays a higher rate of interest. The rationale for emphasizing foreign debt is that debts denominated in a foreign currency must be serviced from hard currency earnings, which requires either a trade surplus in excess of interest outlays on foreign debt or a net capital inflow (i.e., a reversal of “capital flight”). A large foreign debt might also appear to encourage inflation in countries like the United States, where the debt is in the debtor’s own currency. For developing countries, though, the common IMF advice to repeatedly devalue currencies will raise the amount of domestic currency needed to pay the equivalent amount of dollars to creditors. That effect of devaluation increases the nominal budget deficit, which has to be financed with new money because chronic devaluation destroys the market for government bonds. Once again, the usual emphasis on *symptoms* of bad policies — namely, budget deficits and foreign debts — may actually lead to policies that make these symptoms even worse, such as chronic currency debasement and oppressive taxation. The prolonged efforts to impose “austerity” on troubled economies (which invariably means austerity for the private sector) is as flawed in concept as it has proven in practice. It is not possible to improve the creditworthiness of debtors by reducing their prospective income.

Gordon points out some other difficulties arising from excessive emphasis on foreign debt:

Because of the tax system, governments of countries with a higher inflation rate must pay a higher *real* interest on their debt. This is necessary in equilibrium to compensate those who purchase the debt for their higher taxable income....A high inflation country could borrow in a foreign currency (for example, debt denominated in dollars), and use the funds to retire any debt issued in its own currency.

The idea of using debt-for-equity swaps to reduce the *foreign* debt of developing countries illustrates a common confusion arising from insufficient attention to domestic debt, and to the necessity of financing that debt

honestly, without simply issuing new money. Aside from direct swaps of foreign debt for new shares of privatized companies, any other debt-equity swap requires providing foreign creditors with more domestic currency, such as pesos, with which to make direct or portfolio equity investments. If the added pesos are simply printed, the result is higher inflation. If new domestic bonds are instead sold to acquire the needed pesos, this merely substitutes high-cost domestic debt for foreign debt that bears a lower interest expense.

Although the ratio of overall foreign and domestic government debt to GNP may provide a rough guide to the future *average* burden on taxpayers, it must be handled with great care. Whether the debt can be financed in an inflationary or non-inflationary manner (that is, whether a viable market for fixed-income bonds can be restored) is often at least as important as the current level of debt itself, though the two issues cannot be entirely separated. Moreover, the *marginal* cost of taxation can usually be alleviated, with favorable effects on future economic expansion. A larger economy, particularly one with low inflation, can more easily service existing debts, and also finance plant and equipment with new issues of private equity instead of new government debt. In the absence of any single measure that adequately captures important marginal and dynamic elements of alternative methods of servicing past debts, it appears preferable to instead focus on minimizing government consumption expenditures and transfer payments, while reforming the tax, tariff and regulatory structure to make the marginal cost of government less damaging to productive effort and investment.

## How to Compare Tax Structures

The Table, "Maximum Tax Rates," summarizes the key features of tax systems among five Latin American countries. Under the category "Individual Income Tax," we use the maximum marginal tax rate (reported for a number of countries in the Appendix) and the income level, or "threshold," at which individuals and unincorporated enterprises encounter that highest tax bracket. The thresholds are expressed in U.S. dollars (and rounded) to make them comparable, using market exchange rates at the end of 1988. Wherever key features of the tax system are automatically

indexed for inflation, such as individual thresholds in Argentina, this is indicated by the word "indexed" in the appropriate category. In general, the lower the maximum tax rate and higher the threshold, the higher a country would rank in this particular tax category. A number of countries have no income tax at all, so Bolivia's new 10% flat tax (with value-added taxes deducted from it) only scores 9 on a scale of 1-to-10, rather than a "perfect 10." Bolivia's combined income-VAT rate is so low, that the low threshold (which exempts double the low minimum wage) scarcely matters.

Although Mexico's newly-reduced 40% tax rate for 1989 does not appear much worse than Argentina's reduced 35% rate, the top tax rate in Mexico is reached by people with only one-fourth the level of those in Argentina's highest bracket. Moreover, the absence of indexing in Mexico (there was some *de facto* indexing only in 1979-82) could make the difference even wider in the future. To make matters worse, moving from Mexico's 38% bracket (at an income of only about \$7000 a year) to the 40% bracket at \$13,000 involves subjecting *total* income to the 40% rate, not simply the marginal increase. For these reasons, Argentina (and the similar tax in El Salvador) gets a score of 5 in this category, and Mexico is downgraded to a 3. Brazil's low tax rate, cut in half for 1989, is partly offset by the low threshold and recent repeal of indexing, but still rates a 6.

The fact that Mexico's individual tax system still looks relatively harmful, despite two recent reforms cutting the tax rate to 40% from 55%, is another lesson in why tax *revenues* can be an extremely misleading guide to the importance of tax *rates*. Mexico's top tax rate was 35% in the mid-1960s, and the threshold at which top rate applied remained reasonably high well into the 1970s—about \$120,000 in 1979, for example. As chronic currency devaluations and virulent inflation pushed more and more people into the highest tax brackets, though, economic activity either stopped or went underground, provoking further currency crises, etc. Mexico thus provided an extreme example of the "stagflation" that infected many countries even earlier, and for the same reasons—mainly, easy money and punitive taxation (see Reynolds, 1985). By the early 1980s, the largely tax-exempt "informal" sector was already estimated to account for 42% of Mexico's urban employment (Inter-American Development Bank, 1987). At the same time that Mexico's tax rates were at an all-time high, and thresholds reduced to one-tenth of what they were in 1979, revenues from Mexico's individual income tax have fallen dramatically in real terms.

<b>Maximum Tax Rates: 1989</b>					
	Argentina	Brazil	Mexico	El Salvador	Bolivia
Individual Income Tax	35% @ \$51,000 indexed	25% @ \$13,000	40% @ \$13,000	35% @ \$50,000	10% @ \$100
Social Security Tax	47.5% no limit. worker deducts 10% of 16% from income tax	18-22% \$581 max corp. deduction only	9-11% \$600 max corp. deduction only	2-8% \$277 max full deduction	12% no limit full deduction
VAT or Sales Tax	14% VAT	8-300% on goods 9-25% on services	15% VAT 20% on luxuries	selective exercises & 2-5% stamp fee	10% VAT deductible from income tax
Wealth Tax	1.5% (1.25% corp.)	none	2% on business assets w/ credit against income tax	2.5% on business — no deduction	2% on corp. net worth
Investor Taxes	zero on interest from bank deposits & govts. 0-15% on capital gains. 32% on dividends	taxed as income @ 25% with some special incentives	0-21% on interest from bank deposits & govts. 10% on dividends or 40% if no corp. tax or capital gain on stock	30% on capital gains. up to 60% interest dividend	interest & dividends taxed @ 10% zero tax on capital gain & foreign investments
Corporate Profits Tax	33% + local license	30% (6% farm) + 10% surcharge 5% local	37% (35% in '91) indexed + compulsory profit sharing 10% of profit	35% tax on corporate vehicles w/ income tax	1% + property & credit against

Source: Price Waterhouse

Expressing individual tax receipts in 1980 pesos, using the consumer price index, real revenues fell by 82% from 1982 to 1987 — from \$121.2 billion to \$66.6 billion (in 1980 pesos). Since real GDP also declined, revenues did not fall so badly “as a percentage of GDP,” but that method of calculation ignores the bad effects of onerous taxes on GDP itself. Governments cannot pay their bills with “percentages of GDP,” but instead need growth of real revenues, which ultimately must come from growth of the real tax base (mainly, private jobs and profits).

The next category in the table, Social Security, assumes that all payroll taxes are borne by workers, even if ostensibly financed by employers. Employers are indifferent between paying higher wages or higher wage-related taxes, and the sum of the two cannot exceed the workers’ marginal product or the employer will go bankrupt. Social Security tax is Argentina’s disaster area. The employer and employee each pay 13% of wages and salaries for state pensions. Employers also pay 4.5% for social health, and employees 3%. Employers alone pay another 9% for a family allowance fund, plus 5% for a housing fund. It all adds up to an astonishing 47.5%. The 47.5% is also the *marginal* burden since there is, as the table indicates, *no limit*, or ceiling, on the amount of income subject to these taxes. In countries where there is such a limit, the approximate maximum tax is shown. A maximum Social Security tax means the *marginal* rate on added income declines to *zero* at some income, since added income brings no added tax. Moreover, the ceiling on income subject to this tax, where it exists at all, is not terribly high within this sample, so three countries *with* such a limit gain 1 or 2 added points in our ratings.

Corporations can almost always deduct Social Security tax payments from the corporate income tax, but this is *not* always the case with individuals (even in the U.S.). In Argentina, individuals are supposed to pay 16% for Social Security and health, but only 10% (including, quite reasonably, private pension plans) can be deducted from income tax. In reality, the Social Security tax is so onerous that employers and employees have a powerful incentive to evade the tax and split the savings. In the process, they must also evade individual income taxes (which wouldn’t be so bad if they were not added to huge Social Security taxes) simply in order to avoid detection. Tanzi shows that Argentina’s absurd Social Security taxes collect relatively little revenue — only 3.4% of GDP, less than half of what Brazil collects. The individual income tax, when rates were much higher

than they are now, collected virtually nothing — less than one-half of one percent of GDP. This illustrates, once again, why revenues are such a poor guide to the destructive nature of punitive tax rates.

Argentina clearly rates a score of 1 on Social Security tax, only because we're not handing out zeros. El Salvador is the best in this group, with a tax that declines to 1% on employers and employees as income rises, and then stops altogether at a modest level. To make it even better, ordinary workers can deduct their Social Security tax from income tax. Give El Salvador a 7 for this tax. Mexico and Bolivia each get a 5, for different reasons (Mexico's tax has a ceiling, Bolivia's is deductible). Brazil rates a 3 for high tax rates (albeit with a ceiling), and no deduction for individuals.

The next category is VAT or sales taxes, which would include turnover taxes and excises as well. Some of the best economies in the world, such as Japan and the U.S., have gotten along just fine with very modest sales taxes, which has to give nearly all the Latin American countries a low score. The worst, perhaps in the world, is surely Brazil. Brazil slaps a variety of sales taxes on everything, including services, with rates up to 300%. On domestic sales taxes alone, Brazil gets a score of 1. And that isn't even counting steep sales taxes on imports (which have recently been reduced a bit).

Tariffs are somewhat beyond the scope of this paper, since they are an implicit subsidy to protected industries as well as a revenue source. It is worth recalling, though, the idea of *prohibitive* tariffs — tariffs that yield little or no revenue because they make it impossible to conduct the activity being taxed. The relevance is that there are prohibitive taxes, as well as prohibitive tariffs, and these too yield less revenue than a lower tax would yield. Mexico, for example, found that revenues fell when tax rates were increased from 10% to 30% on furs and jewels (Gil Diaz). The sharp reduction of tariffs in Chile was followed by so much more rapid an economic expansion that the effect on overall revenues (not just the tariffs themselves) was undoubtedly positive.

Scoring other countries on sales tax, Bolivia's deductible VAT is the best, but there are still some 30-50% taxes on "sins" and "luxuries" that brings the score down to 5. El Salvador also distorts choices with selective taxes on consumer goods the government doesn't like, though these taxes are not nearly as bad as in Brazil. El Salvador's stamp tax of 2-5% on all sorts of documents is a primitive nuisance. Give El Salvador and Argentina a 4. Mexico's VAT is fairly new, introduced at a lower rate at the start of the

decade, and it may be no coincidence that the economy's worst performance in history (and therefore falling real revenues from other sources) has been while the VAT has been in effect. To be generous, score Mexico a 3 on sales taxes.

Wealth tax should properly include property, gift and inheritance taxes, which are not very significant in this particular group of countries. There are, though, direct taxes on corporate net worth in four countries in our sample, and one on individual net worth. In fairness, these taxes have to be viewed in combination with the following categories — taxes on individual investors and on corporate profits. Bolivia, for example, uses a corporate net worth as a virtual alternative to a corporate profits tax, and Argentina's wealth tax on individuals is combined with fairly light taxes on interest, dividends and capital gains. But those features will result in fairly good scores in the other categories. The sheer existence of *any* wealth tax, which is quite rare among successful economies, precludes a high score. After all, individuals and corporations acquire wealth out of after-tax income (which is also true of assets left to heirs), so it is an inherently nasty double tax on the virtues of acquiring assets and keeping debts down (as opposed to spending everything on champagne and caviar, and then buying more on credit).

Brazil gets a 10 for not having a wealth tax. Mexico gets a 6 for allowing a credit against business income tax. Bolivia's score is 5, El Salvador's is 4, and Argentina's (because individuals are included, at a higher rate) is 3.

Investor taxes obviously overlap with corporate and wealth taxes, but are separated in order to convey the flavor of the ways in which the overall tax system treats income from capital relative to income from labor. This distinction is rarely neat. Social Security taxes are clearly taxes on labor, and wealth taxes invariably exclude human capital (e.g., a doctorate degree). But consumption taxes fall on consumption from either labor income or capital assets. And although wages and salaries account for 76% of the individual income tax collections in Mexico, for example (Tanzi), income from noncorporate business and capital investments is small relative to labor income, so that a 24% share means non-human capital is nonetheless quite heavily taxed by the individual income tax.

Nearly all of our sample countries, like many advanced industrial countries, tax capital gains on financial assets relatively lightly, or not at all. A purist might properly object that this distorts investments toward assets



expected to appreciate, rather than yield interest or dividends. Yet no country has found a practical way to tax capital gains in ways that theorists would prefer — which would involve full deduction of capital losses (which makes it easy to avoid the tax by timing strategies), indexing for inflation (which ought to apply to old assets too, though that would lose a lot of revenue), and taxation as gain accrue rather than when realized (which is simply too difficult). Any capital gains tax is essentially voluntary, since nobody has to sell the assets they have, or to buy more of the kinds of assets subject to that tax (a high capital gains tax in the U.S., for example, may well have made interest on junk bonds more attractive than holding stocks in promising new companies that do not yet pay dividends). Indeed, the problems are so tricky, and evasion so easy, that a low tax rate on capital gains may be the best of possible worlds. Mexico's capital gains tax of zero on stocks, though, looks a bit *too* generous, since revenues foregone must be replaced with some other tax.

For our comparative ratings, it is reasonable to assume that any low tax rate is almost always preferable to a higher tax rate. A country in which all tax rates are low and investors get no special deals will always get a better overall score (closer to 10) than a country that taxes the stuffing out of, say, payrolls and sales, and then gives a big break for capital gains. Tax breaks for investors are not obviously more desirable than tax breaks for, say, working overtime or going to school. Yet nearly everyone is both a worker and investor at some point in his or her life cycle, so tax relief for investors is better than taxing everything at steep rates.

Taxes on investors are too often a device for tilting capital toward uses determined by political rather than market forces. Argentina and Mexico give investors a special break on bonds issued by the government, for example, rather than bonds issued by private companies. Capital gains on certain investments in the same countries are completely exempt (usually investments in big companies), while other gains are not. Brazil's new 25% tax is less distortionary, and thus rates the same score of 5 given to Argentina and Mexico, whose rates are sometimes lower, sometimes higher. El Salvador's tax rates are the highest in this group, and investors don't fare much better, so the country gets a 3. Bolivia tops the list again, with rates of 10% or zero deserving an 8, even though letting Bolivians pay zero only on *foreign* investments sounds like an open invitation to capital flight (Balassa).

The final category is too often the first or only tax considered, namely, the corporate profits tax. In reality, this tax is almost always lower than individual income tax rates, and much lower than the combined effect of income, payroll and sales taxes on workers. Bolivia has virtually no corporate income tax, and thus rates a 9. Argentina, Brazil and El Salvador have comparable effective rates, for a score of 5. Mexico imposes compulsory profit sharing, at 10% of taxable profit, which cuts that country's score to 4.

The Table, "A Scorecard on Tax Regimes," summarizes the ratings discussed above. The trick is to weight the relative importance of various taxes. Weightings could be based on the relative importance of various taxes as revenue sources, but some of the worst taxes yield the least revenues. The individual income tax is surely by far the most important, since virtually all activity is subject to it. Indeed, the individual tax on corporate interest, dividends and capital gains is often more significant than the corporate tax itself. Having assigned a 40% weight to the individual income tax, the rest of the weighing scheme must be regarded as a matter of rather arbitrary judgement. Actually, the most onerous tax in each country merits the highest weight, so that Social Security tax could be given a higher weight in Argentina, consumption taxes a higher weight in Brazil, and so on. This notion seems worth exploring, but this paper will nonetheless use the same weight for each country.

<b>A Scorecard on Tax Regimes</b>					
<b>(scale of 1 to 10, where 10 is perfect)</b>					
	Argentina	Brazil	Mexico	Salvador	Bolivia
Individual Income (40%)	5	6	3	5	9
Social Security (15%)	1	3	5	7	5
VAT or Sales (15%)	4	1	3	4	5
Wealth (5%)	3	10	6	4	5
Invest (10%)	5	5	5	3	8
Profits (15%)	5	5	4	5	9
<b>TOTAL</b>	4.2	4.8	3.8	4.9	7.5

The tax scorecard may be compared with two very aggregate measures often used to evaluate countries, namely budget deficits and government spending expressed as a percentage of GDP.

Central Government Spending and Budget Deficits as a Percentage of Gross Domestic Product (1987, or most recent available year)					
	Argentina	Brazil	Mexico	Salvador	Bolivia
Deficit	8.0	11.8	14.0	1.5	0.6 %
Spending	19.1	37.9	30.7	15.5	12.2

These summary measures of government spending and borrowing, relative to the overall size of the economy, happen to rank countries in ways not so different from our tax scorecard (Bolivia is still the best and Mexico the worst). Yet these conventional aggregate measures nonetheless seem more primitive and misleading than our details about the tax structure. Looking at the ratio of spending to GDP, Argentina appears to be a country in which government is relatively small and unobtrusive, but its taxes and regulations are usually worse than those of Brazil. Bolivia really does have a small government, but was nonetheless forced to finance it with hyperinflationary money creation until 1986, when the top tax rate was slashed to 10% and real revenues soared (Reynolds, 1990). Besides, these measures are largely determined by *past* policies (including monetary policies that can inflate nominal interest rates and therefore the apparent deficit). A new government which plans significant reforms to increase individual choice and opportunity ought not to be prematurely condemned because of inherited debts, or even because of spending that may look high (relative to GDP) largely because private GDP is so low.

## Conclusion

Systematic comparisons of tax and spending regimes are of interest to private entrepreneurs, professionals and investors, to help them to decide where to locate their skills and capital. For similar reasons, tax comparisons

are of interest to government policymakers, to help them to understand whether their tax systems are competitive, attracting or repelling productive effort and investment. Conventional measures of spending and debt as a percentage of GNP often merely measure symptoms of other problems—including oppressive taxation, capricious regulations, insecure property rights, protected and subsidized government monopolies, and money of unpredictable value.

The details of the tax structure capture one of the principal means by which statism constrains the productive actions of individuals. These details can be measured with reasonable accuracy and (unlike spending “priorities”) compared with minimal subjectivity. There is no reason to isolate a particular region, as we have done in this paper, because the competition for industrious people and their capital knows no national boundaries. An iron curtain may keep people’s bodies within a country, against their will, but they will scarcely be motivated to work to their potential.

Case studies of national tax and spending systems would be a useful supplement to the relatively mechanical overview of this paper. Yet existing case studies, such as Pechman or Fels & Von Furstenberg, are usually written by several different economists, with different views on what is important. As a result, they are not suitable for comparative studies. There have been a few efforts to compare overall average tax rates (Marsden), and, far better, even marginal rates (Reynolds 1985, 1989; Rabushka-Bartlett). But the methodology of calculating the combined marginal effect of numerous taxes (some with deductions and ceilings) requires courageous assumptions and some complexity, which makes the exercise relatively inaccessible to busy businessmen and politicians (Frenkel). The concept of “average marginal rates” is also no substitute for the details. A country in which half the population (employees of multinationals) faced a 90% tax bracket, while the other half (farmers and cocaine merchants) were completely exempt might be said to have an “average marginal rate” of 45%, yet the effect would be much more discouraging and distorting than a flat 45% rate.

Assigning index numbers to the various elements of the tax code, such as the 1 to 10 scale used here, holds considerable promise as a relatively clear, and therefore effective, measure of this important aspect of economic liberty.

<b>Maximum Marginal Tax Rates on Individual Income</b>			
	1979	1989	1991
Argentina	45	35	30
Australia	62	49	47
Austria	62	50	50
Belgium	76	71	55
Bolivia	48	10	10
Botswana	75	50	40
Brazil	55	25	25
Canada (Ontario)	58	45	47
Chile	60	50	50
Colombia	56	30	30
Denmark	73	73	68
Egypt	80	65	65
Finland	71	44	39
France	60	53	53
West Germany	56	56	57
Greece	60	50	50
Guatemala	40	34	34
Hungary	60	55	50
India	60	53	50
Indonesia	50	35	35
Ireland	65	53	53
Israel	66	48	48
Italy	72	50	50
Jamaica	58	33	33
Japan	75	50	50
S. Korea	89	50	50
Malaysia	60	45	35
Mauritius	50	35	35
Mexico	55	40	35
Netherlands	72	72	60
New Zealand	60	33	33
Norway	75	54	49
Pakistan	55	45	50

<b>Maximum Marginal Tax Rates on Individual Income</b>			
	1979	1989	1991
Philippines	70	35	35
Portugal	84	68	40
Puerto Rico	79	43	36
Singapore	55	33	33
Spain	66	56	56
Sweden	87	75	50
Thailand	60	55	55
Trinidad & Tobago	70	53	35
Turkey	75	50	50
United Kingdom	83	40	40
United States	70	28	31

Sources: Price Waterhouse, International Bureau of Fiscal Documentation, Tax Notes, Reuters, Financial Times.

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## Discussion

Tom DiLorenzo thought that some marginal measure should be used to see how government absorbs additional income each year. Alvin Rabushka worried that Price Waterhouse figures about tax rates may often refer to foreign residents, and domestic residents may be very different. The best source of evidence on this, he suggested, is from the International Bureau of Fiscal Documentation. Milton Friedman pointed out that the measurement of taxation goes hand in hand with the attempt to measure regulation. It makes no difference if the government taxes a company to prevent pollution or requires a company to install pollution equipment. They both



create the same kind of distortions. Similarly, zoning regulation is a wealth tax. Alvin Rabushka mentioned that he had been involved in developing some measures of this kind of indirect taxation and that you have to be careful not to double count. For example, an overvalued exchange rate is an indirect tax on exporters. Thus if you study this problem area by area, you may pick-up some of this in specific categories.

Jack Carr mentioned that this assumes that more taxes reduce economic freedom. Yet a country like Israel may pay more taxes to safeguard its economic freedom in the future. You need to look at the whole to see what the taxes are spent on. Milton Friedman suggested that some of Israel's tax burden is for the military safeguarding of freedom, but there is a large component of their expenditures that reduce the economic freedom they are trying to safeguard. Alvin Rabushka took issue with Jack Carr arguing that although you might want to assess expenditures as to their freedom enhancing or diminishing effects, the cost of the taxes will reduce freedom regardless of the use to which they are put. A tax is a tax is a tax.

Easton argued that Reynolds should measure both the marginal and average tax rates. The marginal shows distortions, the average helps capture a total amount of the distortion. Milton Friedman pointed out that the cost of taxation is much higher than the proceeds to the government. James Gwartney reminded the audience that there are at least two tax rates that generate the same level of tax revenue, yet one may be more onerous than the other.

Juan Bendfeldt felt that other tax measures should be taken into account. The social security taxes should be considered. Further the quality of service should be counted in any measure. Regardless of the rates of tax, it is hard to tell what you are getting. The mix of both taxation and expenditure is an important element in considering the effect on economic freedom which may be diminished both from the tax and expenditure sides of the equation. Jack Carr responded that there is a complex problem here. If there is some kind of agreement—say an original confederation—and the winners are going to compensate the losers, then we run the risk of looking at the compensation devices and claiming that they are reductions in economic freedom. We need to know the nature of the original agreements in place to evaluate the pattern of taxes and expenditures. We are assuming that benefits should equal costs for every taxpayer. Further, we need to look at the whole tax system. If one country has a tax on gasoline and another a

toll for road use, we will count the first as less free even though the cost of collecting the toll may far outweigh the costs of collecting the tax on gasoline. Walter Block suggested that this would not be a problem for an index as the tolls will be picked up in the regulation section which would correspond to a lower tax rate while the tax measure would be higher in the other country which would correspond with a lower cost of regulation.