The Free Market

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TEN GREAT ECONOMIC MYTHS

by
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Our country is beset by a large number of economic myths that distort public thinking on important problems and lead us to accept unsound and dangerous government policies. Here are ten of the most dangerous of these myths and an analysis of what is wrong with them.

Myth #1

Deficits are the cause of inflation; deficits have nothing to do with inflation.

In recent decades we *always* have had federal deficits. The invariable response of the party *out* of power, whichever it may be, is to denounce those deficits as being the cause of our chronic inflation. And the invariable response of whatever party is *in* power has been to claim that deficits have nothing to do with inflation. *Both* opposing statements are myths.

Deficits mean that the federal government is spending more than it is taking in in taxes. Those deficits can be financed in two ways. If they are financed by selling Treasury bonds to the public, then the deficits are not inflationary. No new money is created; people and institutions simply draw down their bank deposits to pay for the bonds, and the Treasury spends that money. Money has simply been transferred from the public to the Treasury, and then the money is spent on other members of the public.

On the other hand, the deficit may be financed by selling bonds to the banking system. If that occurs, the banks create *new* money by creating new bank deposits and using them to buy the bonds. The new money, in the form of bank deposits, is then spent by the Treasury, and thereby enters permanently into the spending stream of the economy, raising prices and causing inflation. By a complex process, the Federal Reserve enables the banks to create the new money by generating bank reserves of one-tenth that

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amount. Thus, if banks are to buy $100 billion of new bonds to finance the deficit, the Fed buys approximately $10 billion of *old* Treasury bonds. This purchase increases bank reserves by $10 billion, allowing the banks to pyramid the creation of new bank deposits or money by ten times that amount. In short, the government and the banking system it controls in effect "print" new money to pay for the federal deficit.

Thus, deficits are inflationary to the extent that they are financed by the banking system; they are *not* inflationary to the extent they are underwritten by the public.

Some policymakers point to the 1982-83 period, when deficits were accelerating and inflation was abating, as a statistical "proof" that deficits and inflation have no relation to each other. This is no proof at all. General price changes are determined by two factors: the supply of, and the demand for, money. During 1982-83 the Fed created new money at a very high rate, approximately at 15 percent per annum. Much of this went to finance the expanding deficit. But on the other hand, the severe depression of those two

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years increased the demand for money (i.e. lowered the desire to spend money on goods), in response to the severe business losses. This temporarily compensating increase in the demand for money does not make deficits any the less inflationary. In fact, as recovery proceeds, spending will pick up and the demand for money will fall, and the spending of the new money will accelerate inflation.

Myth #2

Deficits do not have a crowding-out effect on private investment.

In recent years there has been an understandable worry over the low rate of saving and investment in the United States. One worry is that the enormous federal deficits will divert savings to unproductive government spending and thereby crowd out productive investment, generating ever-greater long-run problems in advancing or even maintaining the living standards of the public.

Some policymakers have once again attempted to rebut this charge by statistics. In 1982-83, they declare, deficits were high and increasing, while interest rates fell, thereby indicating that deficits have no crowding-out effect.

This argument once again shows the fallacy of trying to refute logic with statistics. Interest rates fell because of the drop of business borrowing in a recession. "Real" interest rates (interest rates minus the inflation rate) stayed unprecedentedly high, however — partly because most of us expect renewed heavy inflation, partly because of the crowding-out effect. In any case, statistics cannot refute logic; and logic tells us that if savings go into government bonds, there will necessarily be less savings available for productive investment *than there would have been*, and interest rates will be higher than they would have been without the deficits. If deficits are financed by the public, then this diversion of savings into government projects is direct and palpable. If the deficits are financed by bank inflation, then the diversion is indirect, the crowding-out now taking place by the new money "printed" by the government competing for resources with old money saved by the public.

Milton Friedman tries to rebut the crowding-out effect of deficits by claiming that *all* government spending, not just deficits, equally crowds out private savings and investment. It is true that money siphoned off by taxes could also have gone into private savings and investment. But deficits have a far greater crowding-out effect than overall spending, since deficits financed by the public obviously tap savings and savings alone, whereas taxes reduce the public's consumption as well as savings.

Thus, deficits, whichever way you look at them, cause grave economic problems. If they are financed by the banking system, they are inflationary. But even if they are financed by the public, they will still cause severe crowding-out effects, diverting much-needed savings from productive private investment to wasteful government projects. And, furthermore, the greater the deficits the greater the permanent income tax burden on the American people to pay for the mounting interest payments, a problem aggravated by the high interest rates brought about by inflationary deficits.

Myth #3

Tax increases are a cure for deficits.

Those people who are properly worried about the deficit unfortunately offer an unacceptable solution: increasing taxes. Curing deficits by raising taxes is equivalent to curing someone's bronchitis by shooting him. The "cure" is far worse than the disease.

For one reason, as many critics have pointed out, raising taxes simply gives the government more money, and so the politicians and bureaucrats are likely to react by raising expenditures still further. Parkinson said it all in his famous "Law": "Expenditures rise to meet income." If the government is willing to have, say, a 20 percent deficit, it will handle high revenues by raising spending still more to maintain the same proportion of deficit.

But even apart from this shrewd judgment in political psychology, why should anyone believe that a *tax* is better than a higher price? It is true that inflation is a form of taxation, in which the government and other early receivers of new money are able to expropriate the members of the public whose income rises later in the process of inflation. But, at least with inflation, people are still reaping some of the benefits of exchange. If bread rises to $10 a loaf, this is unfortunate, but *at least* you can still eat the bread. But if taxes go up, your money is expropriated for the benefit of politicians and bureaucrats, and you are left with no service or benefit. The only result is that the producers' money is confiscated for the benefit of a bureaucracy that adds insult to injury by using part of that confiscated money to push the public around.

No, the only sound cure for deficits is a simple but virtually unmentioned one: cut the federal budget. How and where? Anywhere and everywhere.

Myth #8

The best tax is a "flat" income tax, proportionate to income across the board, with no exemptions or deductions.

It is usually added by flat-tax proponents, that eliminating such exemptions would enable the federal government to cut the current tax rate substantially.

But this view assumes, for one thing, that present deductions from the income tax are immoral subsidies or "loopholes" that should be closed for the benefit of all. A deduction or exemption is only a "loophole" if you assume that the government owns 100 percent of everyone's income and that allowing some of that income to remain untaxed constitutes an irritating "loophole." Allowing someone to keep some of his own income is neither a loophole nor a subsidy. Lowering the overall tax by abolishing deductions for medical care, for interest payments, or for uninsured losses, is simply lowering the taxes of one set of people (those that have little interest to pay, or medical expenses, or uninsured losses) at the expense of raising them for those who have incurred such expenses.

There is furthermore neither any guarantee nor even likelihood that, once the exemptions and deductions are safely out of the way, the government would keep its tax rate at the lower level. Looking at the record of governments, past and present, there is every reason to assume that more of our money would be taken by the government as it raised the tax rate back up (at least) to the old level, with a consequently greater overall drain from the producers to the bureaucracy.

It is supposed that the tax system should be roughly that of pricing or incomes on the market. But market pricing is *not* proportional to incomes. It would be a peculiar world, for example, if Rockefeller were forced to pay $1,000 for a loaf of bread — that is, a payment proportionate to his income relative to the average man. That would mean a world in which equality of incomes was enforced in a particularly bizarre and inefficient manner. If a tax were levied like a market price, it would be *equal* to every "customer," not proportionate to each customer's income.

Myth #9

An income tax cut helps everyone because not only the taxpayer but also the government will benefit, since tax revenues will rise when the rate is cut.

This is the so-called "Laffer curve," set forth by California economist Arthur Laffer. It was advanced as a means of allowing politicians to square the circle; to come out for tax cuts, keeping spending at the current level, *and* balance the budget all at the same time. In that way, the public would enjoy their tax cuts, be happy at the balanced budget, and still receive the same level of subsidies from the government.

It is true that if tax rates are 99 percent, and they are cut to 95 percent, tax revenue will go up. But there is no reason to assume such simple connections at any other time. In fact, this relationship works much better for a local excise tax than for a national income tax. A few years ago, the government of the District of Columbia decided to procure some revenue by sharply raising the District's gasoline tax. But, then, drivers could simply nip over the border to Virginia or Maryland and fill up at a much cheaper price. D.C. gasoline tax revenues fell, and much to their chagrin and confusion, they had to repeal the tax.

But this is not likely to happen with the income tax. People are not going to stop working or leave the country because of a relatively small tax hike, or do the reverse because of a tax cut.

There are some problems with the Laffer curve. The amount of time it is supposed to take for the Laffer effect to work is never specified. But still more important: Laffer assumes that what all of us want is to maximize tax revenue to the government. If — a big if — we are really at the upper half of the Laffer Curve, we should then all want to set tax rates at that "optimum" point. But why? *Why* should it be the objective of every one of us to maximize government revenue? To push to the maximum, in short, the share of private product that gets siphoned off to the activities of government? I should think we would be more interested in *minimizing* government revenue by pushing tax rates far, far below whatever the Laffer Optimum might happen to be.

Myth #10

Imports from countries where labor is cheap cause unemployment in the United States.

One of the many problems with this doctrine is that it ignores the question: *why* are wages low in a foreign country and high in the United States? It starts with these wage rates as ultimate givens, and doesn't pursue the question why they are what they are. Basically, they are high in the United

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Myth #6

There is a tradeoff between unemployment and inflation.

Everytime someone calls for the government to abandon its inflationary policies, Establishment economists and politicians warn that the result can only be severe unemployment. We are trapped, therefore, into playing off inflation against high unemployment, and become persuaded that we must therefore accept some of both.

This doctrine is the fallback position for Keynesians. Originally, the Keynesians promised us that by manipulating and fine-tuning deficits and government spending, they could and would bring us permanent prosperity and full employment without inflation. Then, when inflation became chronic and ever-greater, they changed their tune to warn of the alleged tradeoff, so as to weaken any possible pressure upon the government to stop its inflationary creation of new money.

The tradeoff doctrine is based on the alleged "Phillips curve," a curve invented many years ago by the British economist A.W. Phillips. Phillips correlated wage rate increases with unemployment, and claimed that the two move inversely: the higher the increases in wage rates, the lower the unemployment. On its face, this is a peculiar doctrine, since it flies in the face of logical, commonsense theory. Theory tells us that the higher the wage rates, the *greater* the unemployment, and *vice versa*. If everyone went to their employer tomorrow and insisted on double or triple the wage rate, many of us would be promptly out of a job. Yet this bizarre finding was accepted as gospel by the Keynesian economic establishment.

By now, it should be clear that this statistical finding violates the facts as well as logical theory. For during the 1950s, inflation was only about one to two percent per year, and unemployment hovered around three or four percent, whereas nowadays unemployment ranges between eight and 11 percent, and inflation between five and 13 percent. In the last two or three decades, in short, *both* inflation *and* unemployment have increased sharply and severely. If anything, we have had a *reverse* Phillips curve. There has been anything but an inflation-unemployment tradeoff.

But ideologues seldom give way to the facts, even as they continually claim to "test" their theories by facts. To save the concept, they have simply concluded that the Phillips curve still remains as an inflation-unemployment tradeoff, except that the curve has unaccountably "shifted" to a new set of alleged tradeoffs. On this sort of mind-set, of course, no one could ever refute any theory.

In fact, inflation now, even if it reduces unemployment in the short-run by inducing prices to spurt ahead of wage rates (thereby reducing *real* wage rates), will only create more unemployment in the long run. Eventually, wage rates catch up with inflation, and inflation brings recession and unemployment inevitably in its wake. After more than two decades of inflation, we are all now living in that "long run."

Myth #7

Deflation — falling prices — is unthinkable, and would cause a catastrophic depression.

The public memory is short. We forget that, from the beginning of the Industrial Revolution in the mid-18th century until the beginning of World War II, prices generally went down, year after year. That's because continually increasing productivity and output of goods generated by free markets caused prices to fall. There was no depression, however, because costs fell along with selling prices. Usually, wage rates remained constant while the cost of living fell, so that "real" wages, or everyone's standard of living, rose steadily.

Virtually the only time when prices rose over those two centuries were periods of war (War of 1812, Civil War, World War I), when the warring governments inflated the money supply so heavily to pay for the war as to more than offset continuing gains in productivity.

We can see how free market capitalism, unburdened by governmental or central bank inflation, works if we look at what has happened in the last few years to the prices of computers. A computer used to have to be enormous, costing millions of dollars. Now, in a remarkable surge of productivity brought about by the microchip revolution, computers are falling in price even as I write. Computer firms are successful despite the falling prices because their costs have been falling, and productivity rising. In fact, these falling costs and prices have enabled them to tap a mass market characteristic of the dynamic growth of free market capitalism. "Deflation" has brought no disaster to this industry.

The same is true of other high-growth industries, such as electronic calculators, plastics, TV sets, and VCRs. Deflation, far from bringing catastrophe, is the hallmark of sound and dynamic economic growth.

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Myth #4

Every time the Fed tightens the money supply, interest rates rise (or fall); every time the Fed expands the money supply, interest rates rise (or fall).

The financial press now knows enough economics to watch weekly money supply figures like hawks; but they inevitably interpret these figures in a chaotic fashion. If the money supply rises, this is interpreted as lowering interest rates and inflationary; it is *also* interpreted, often in the very same article, as raising interest rates. And vice versa. If the Fed tightens the growth of money, it is interpreted as both raising interest rates and lowering them. Sometimes it seems that *all* Fed actions, no matter how contradictory, must result in raising interest rates. Clearly something is very wrong here.

The problem here is that, as in the case of price levels, there are several causal factors operating on interest rates and in different directions. If the Fed expands the money supply, it does so by generating more bank reserves and thereby expanding the supply of bank credit and bank deposits. The expansion of credit necessarily means an increased supply in the credit market and hence a lowering of the price of credit, or the rate of interest. On the other hand, if the Fed restricts the supply of credit and the growth of the money supply, this means that the supply in the credit market declines, and this should mean a rise in interest rates.

And this is precisely what happens in the first decade or two of chronic inflation. Fed expansion lowers interest rates; Fed tightening raises them. But after this period, the public and the market begin to catch on to what is happening. They begin to realize that inflation is chronic because of the systemic expansion of the money supply. When they realize this fact of life, they will also realize that inflation wipes out the creditor for the benefit of the debtor. Thus, if someone grants a loan at 5% for one year, and there is 7% inflation for that year, the creditor loses, not gains. He loses 2%, since he gets paid back in dollars that are now worth 7% less in purchasing power. Correspondingly, the debtor gains by inflation. As creditors begin to catch on, they place an inflation premium on the interest rate, and debtors will be willing to pay. Hence, in the long-run anything which fuels the expectations of inflation will raise inflation premiums on interest rates; and anything which dampens those expectations will lower those premiums. Therefore, a Fed tightening will now tend to dampen inflationary expectations and *lower* interest rates; a Fed expansion will whip up those expectations again and *raise* them. There are two, opposite causal chains at work. And so Fed expansion or contraction can either raise or lower interest rates, depending on which causal chain is stronger.

Which will be stronger? There is no way to know for sure. In the early decades of inflation, there is no inflation premium; in the later decades, such as we are now in, there is. The relative strength and reaction times depend on the subjective expectations of the public, and these cannot be forecast with certainty. And this is one reason why economic forecasts can never be made with certainty.

Myth #5

Economists, using charts or high speed computer models, can accurately forecast the future.

The problem of forecasting interest rates illustrates the pitfalls of forecasting in general. People are contrary cusses whose behavior, thank goodness, cannot be forecast precisely in advance. Their values, ideas, expectations, and knowledge change all the time, and change in an unpredictable manner. What economist, for example, could have forecast (or *did* forecast) the Cabbage Patch Kid craze of the Christmas season of 1983? Every economic quantity, every price, purchase, or income figure is the embodiment of thousands, even millions, of unpredictable choices by individuals.

Many studies, formal and informal, have been made of the record of forecasting by economists, and it has been consistently abysmal. Forecasters often complain that they can do well enough as long as current trends continue; what they have difficulty in doing is catching *changes* in trend. But of course there is no trick in extrapolating current trends into the near future. You don't need sophisticated computer models for *that*; you can do it better and far more cheaply by using a ruler. The real trick is precisely to forecast when and how trends will change, and forecasters have been notoriously bad at that. No economist forecast the depth of the 1981-82 depression, and none predicted the strength of the 1983 boom.

The next time you are swayed by the jargon or seeming expertise of the economic forecaster, ask yourself this question: If he can really predict the future so well, *why* is he wasting his time putting out newsletters or doing consulting when he himself could be making trillions of dollars in the stock and commodity markets?

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States because labor productivity is high — because workers here are aided by large amounts of technologically advanced capital equipment. Wage rates are low in many foreign countries because capital equipment is small and technologically primitive. Unaided by much capital, worker productivity is far lower than in the U.S. Wage rates in every country are determined by the productivity of the workers in that country. Hence, high wages in the United States are not a standing threat to American prosperity; they are the *result* of that prosperity.

But what of certain industries in the U.S. that complain loudly and chronically about the "unfair" competition of products from low-wage countries? Here, we must realize that wages in each country are interconnected from one industry and occupation and region to another. All workers compete with each other, and if wages in industry A are far lower than in other industries, workers — spearheaded by young workers starting their careers — would leave or refuse to enter industry A and move to other firms or industries where the wage rate is higher.

Wages in the complaining industries, then, are high because they have been bid high by *all* industries in the United States. If the steel or textile industries in the United States find it difficult to compete with their counterparts abroad, it is not because foreign firms are paying low wages, but because other *American* industries have bid up American wage rates to such a high level that steel and textile cannot afford to pay. In short, what's really happening is that steel, textile, and other such firms are using labor inefficiently as compared to other American industries. Tariffs or import quotas to keep inefficient firms or industries in operation hurt everyone, in every country, who is not in that industry. They injure all American consumers by keeping up prices, keeping down quality and competition, and distorting production. A tariff or an import quota is equivalent to chopping up a railroad or destroying an airline — for its point is to make international transportation artificially expensive.

Tariffs and import quotas also injure other, efficient American industries by tying up resources that would otherwise move to more efficient uses. And, in the long run, the tariffs and quotas, like any sort of monopoly privilege conferred by government, are no bonanza even for the firms being protected and subsidized. For, as we have seen in the cases of railroads and airlines, industries enjoying government monopoly (whether through tariffs or regulation) eventually become so inefficient that they lose money anyway, and can only call for more and more bailouts, for ev more of a privileged shelter from free competition.

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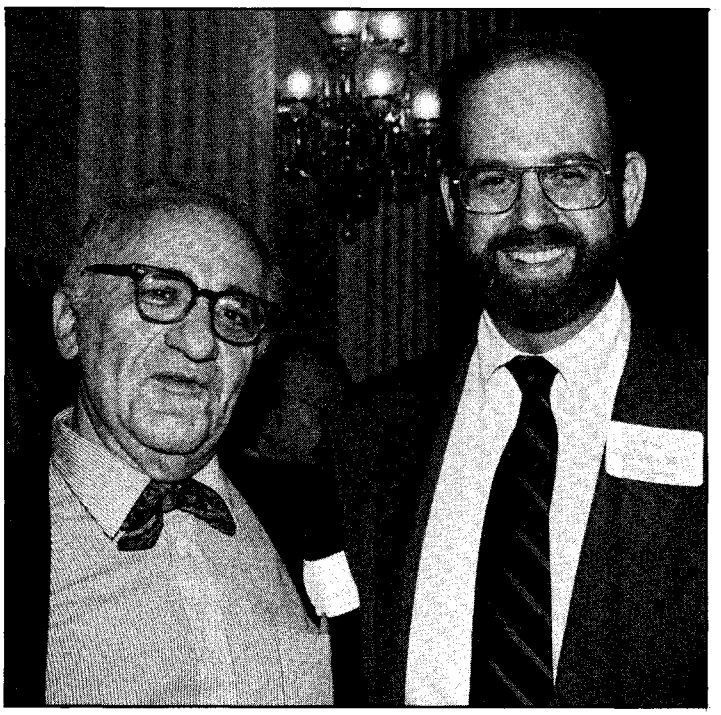

Professor Murray Rothbard and Director Lew Rockwell at the Mises Institute's Gold Standard Conference.

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