

Some Austrian Perspectives on Unintended Consequences

Lowell Gallaway

One of the most overused notions in this about-to-expire century, is the concept of “unintended consequences.” In its strongest form, it emerges as the Law of Unintended Consequences, a generalized explanation for a host of public policy failures in American society. A seemingly innocent enough concept, it attempts to explain away why so many ventures into the realm of formulating public policy have gone awry, by asserting that things didn’t happen the way policymakers thought and “intended” that they would. (As if this excuses the nonsense that has passed as policy in our time.) In the vernacular, this is nothing but a “cop-out,” a *deus ex machina* that disguises the true source of failed public policy—a refusal to appreciate the full implications and ramifications of public policy initiatives for human action.¹

The choice of the words “human action” is not casual. It is symbolic, intending to call to mind the Austrian traditions of subjectivism and individualism. This is in contrast to the conventional social science approach of thinking in terms of mechanical analogues that seemingly parallel the physical, or “hard,” sciences. The adverb

Lowell Gallaway is professor of economics at Ohio University. This paper was presented at the 1997 Austrian Scholars Conference, Auburn, Alabama, April 5, 1997.

¹Of course, the phrase human action brings to mind Ludwig von Mises’s tome, *Human Action: A Treatise on Economics* (Chicago: Henry Regnery, 1966).

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“seemingly” is employed in fairness to the physical sciences. All too often, the parallelism that social scientists attempt to draw between their work and that of the physical sciences involves mere parodies of what the “hard” sciences do.

Example One: Tax Revenues and Tax Rates

Let us illustrate the pitfalls associated with this kind of crude mechanistic approach to economic phenomena. A marvelous example occurs in the area of anticipating the impact of changes in tax rates on the amount of revenues collected from the tax in question. What is involved here, depending on the direction of change in tax rates, is one of two basic principles: (1) If you tax something, you get less of it, or, (2) If you subsidize something, you get more of it.

Both of these notions derive from a very simple idea, namely, that individuals take the tax burden into account before choosing their work and entrepreneurial effort. The significance of these propositions is borne out by some very simple numbers produced by recent American experience.

What is reported is the percentage that personal tax and non-tax Federal government receipts, almost exclusively from the personal income tax, were of nominal (not real) Gross Domestic Product for three dates, 1979, 1989, and 1995.² These are all years of relatively high levels of economic activity. In 1979, these revenues amounted to 8.98 percent of GDP. Ten years later, following at least a 25 percent reduction in tax rates and the introduction of indexation of the tax rate schedules, they stood at 8.52 percent of GDP, a decline of only 5.79 percent, instead of the expected 25 percent. Almost 80 percent of the potential decline in revenues from the income tax rate cuts of the 1980s had been offset by the dynamic

²The basic data are from the National Income and Product Accounts, U.S. Department of Commerce, Bureau of Economic Analysis. See *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 1977), table B-80, p. 393.

effects of individuals responding to the cuts by increasing their work and entrepreneurial effort.

Move on to 1995. In the interval since 1989, there were two increases in personal income tax rates. What happened to the share of personal tax revenues out of GDP? It actually fell slightly, coming in at 8.48 percent as people adjusted their economic efforts to take account of higher tax rates.

There is a lesson to be learned here, one that those among us with some familiarity with American economic history and an appreciation for the role of individual behavior in shaping economic events already know. In recent years, it has been popularized in the form of the Laffer Curve.³ More generally, though, the lesson is that human behavioral responses to changes in economic parameters frequently lead to non-monotonic, that is Laffer-type, outcomes.

An Aside on "Mainstream" Economists

Apparently, the lesson just described is little understood by a substantial portion of the American economics profession. Just last September, some 546 economists, including seven Nobel laureates, signed a public statement released by the Economic Policy Institute in Washington, D.C., asserting the following⁴:

(1) the assumption that a substantial part of the revenue lost by reducing taxes will be offset by new revenues from additional growth is not credible.

(2) The . . . tax-cuts of the early 1980s were based on [this] claim, but . . . no sustainable increase of growth of supply took place.

³ Current interest in the Laffer Curve concept is rising. In the week following the presentation of this article, a conference with the theme "Innovative Applications of the Laffer Curve" was held in Washington, D.C.

⁴ Press release title *546 Prominent Economists Oppose Dole Tax Cuts: Plan's Assumptions "Not Credible" According to Group* (Washington, D.C.: Economic Policy Institute, September 24, 1996).

(3) The . . . tax-cuts of the early 1980s were appropriately called a riverboat gamble. The country lost a wager. . . . We appeal to our fellow citizens and our potential leaders not to repeat the tragic mistake.

This statement was circulated by Paul Samuelson, James Tobin, Kenneth Arrow, Franco Modigliani, and Robert Solow.

C'est la vie. Never mind that our imperfectly measured economic growth averaged 3.2 percent between 1981 and 1989, compared to 2.4 percent in the previous eight years and 1.8 percent since. This "sustained growth in supply" was just sufficient to insure that, in the long run, there was no decline in tax revenues associated with the reductions in income tax rates that took place in the 1980s. On the other hand, the end result of the tax increases of the 1990s was a fall in revenue of about 9 percent. Talk about unintended consequences.

Example Two: Income Maintenance and Poverty

The tax episode is not the only instance of economists and policy-makers ignoring individual behavioral responses to changes in economic circumstances. Let us go back in time a third of a century, to the early and mid-1960s. The poverty issue becomes the crisis *du jour* for the intellectual and policy elites, and becomes enshrined in American history in the form of Lyndon Johnson's euphemism, "The War on Poverty." The basic premise of the first generation of poverty warriors was that America's relatively disadvantaged were becoming increasingly isolated from the mainstream of economic and social life in the United States. In short, the argument was made that a permanent underclass would emerge in America unless substantial policy interventions were implemented.

Initially, the rhetoric surrounding the proposed public policy initiatives was opposed to income transfers, *per se*, focusing instead on programs that supposedly would better equip the economically disadvantaged to participate in American economic life. For example, in February 1962, the *New York Times* commented (favorably) on

John Kennedy's message to Congress that accompanied his proposals for welfare reform. It noted that the President's position "stems from a recognition that no lasting solution to the [poverty] problem can be bought with a welfare check."⁵ As to Lyndon Johnson, when he signed the first substantial anti-poverty legislation in August 1964, he proclaimed, "the days of the dole in this country are numbered."⁶ I use this statement frequently in my *Economics of Poverty* class, and I can never resist adding something to it, namely, that, "Unfortunately, Lyndon forgot to tell us that it was a very, very, large number," now approaching 12,000. Within two years of the passage of the 1964 legislation, a monumental escalation of the volume of Federal public aid (in real terms) occurred. Between 1954 and 1966, the *per capita* volume of such aid roughly doubled, an annual growth rate of about 6 percent. In the next 12 years, it *doubled not once, but twice, representing annual growth of about 12 percent.*⁷

Refer back to the two basic propositions mentioned earlier. In this case, we have a subsidization of non-work effort. The expected outcome of this is an increase in the volume of non-work effort and a decrease in work activity. As Walter Williams once said, "The poor may be poor, but they are not stupid."⁸ The behavioral changes brought on by the escalation of subsidies for not working impacted dramatically on another of our terribly flawed government statistics—the poverty rate, which is measured by a paradigm that counts only cash—money income towards meeting the poverty threshold. Since a large part of public aid expenditures are not in the form of cash money, the work disincentive effects associated with public aid

⁵"Relief is no Solution," *New York Times*, February 2, 1962.

⁶"Johnson Signs Bill to Fight Poverty: Pledges New Era," *New York Times*, August 21, 1964.

⁷For details of the escalation, see Lowell Gallaway and Richard Vedder, *Poverty, Income Distribution, the Family, and Public Policy* (Washington, D.C.: U.S. Government Printing Office, 1986), pp. 36–37.

⁸This remark was made in a personal conversation during a visit to the Ohio University campus by Professor Williams in October 1986.

will at some point lead to a reduction in the money income of the poor. Because of this, as the volume of public aid increased after 1966, the decline in the poverty rate first slowed, then stopped, and, ultimately, began to increase, producing another Laffer-style relationship, one that Professor Vedder and I have called, "The Poverty-Welfare Curve."⁹ Just one more unintended consequence.

Example Three: The Distribution of Income

One more example is appropriate. As we have moved through the twentieth century, the rhetoric of "envy" has become progressively more strident. Perhaps it was inevitable once the United States committed itself to a "progressive" income tax. Given the potential of the income tax to raise revenue and its avowed philosophy of taxing the "rich" more heavily than the "non-rich," the development of a tax-and-transfer mode of government was predictable. The ultimate justification for a tax-and-transfer society is expressed quite well in a quote from the most recent *Economic Report of the President*¹⁰:

Without government intervention, the distribution of income would be even more dispersed than it is. A progressive Federal income tax and a variety of Federal and State transfer programs have for decades worked to reduce inequality.

This allegation appears plausible, at first glance. However, reflect on the contents of the previous section of this paper, where it was noted that individual behavioral responses to the provision on in-

⁹The Poverty-Welfare Curve was introduced at a June 20, 1985, hearing held by the Joint Economic Committee of the U.S. Congress. See Lowell Gallaway, Richard Vedder, and Therese Foster, "The 'New' Structural Poverty: A Quantitative Analysis, in *War on Poverty—Victory or Defeat?* (Washington, D.C.: U.S. Government Printing Office, 1986).

¹⁰*Economic Report of the President*, 1977.

come transfers not only negated their supposed beneficial effects in reducing poverty but actually increased the number of people officially recorded as being among the poverty population. Apparently, the same thing happens with respect to the distribution of income.

Once more I will refer to some empirical data. In 1969, income transfers to persons in the United States amounted to 9 percent of all personal income. Twenty-five years later, that figure was 16.6 percent.¹¹ What happened to income inequality over this interval? Using a very simple measure of inequality, the ratio of mean income of the bottom 20 percent, it increased substantially. This ratio rose by almost 45 percent between 1969 and 1994.¹² Once more, we have an “unintended consequence” emanating from a public policy initiative.

The Curse of “Unintended Consequences”

The three examples outlined here illustrate a very basic point, namely, that a failure to take into account behavioral responses in structuring public policy leads to results that are often the opposite of what the rhetoric of the public policy debate suggests will happen. The instinctive response to this is usually, “How unfortunate. The designers of the public policy meant well. Their motives were good. We shouldn’t think badly of them for their efforts.” But, were their motives really good? Perhaps one mistake of this sort would be understandable, but multiple ones, in the face of powerful evidence documenting the nature of the errors? That is another matter. Perhaps the Law of Unintended Consequences should be relabeled, The Law of Deliberately Ignored Consequences.

Why, though, would policymakers wish to ignore the consequences of their actions? The answer to that query is simple. More often than not, this behavior supports an even more fundamental agenda of the public policy elites, the expansion of the role of government in social and economic affairs. Think of how convenient

¹¹ Ibid., table B-27, p. 331.

¹² Based on data reported in *Current Population Reports*, Series P-60, Income and Statistics Branch/HHES Division

it is. Define a problem. Propose a solution that has the effect of expanding the role of government. In the goodness of time, the solution makes the problem worse, which permits the policy advocates to claim that the problem is more serious than originally thought, and that the initial government response was inadequate to deal with it. The obvious solution is to have the government devote even more resources to solving the problem. There is a parallel here with the bloodletting practices of medieval "doctors." They would "bleed" the ill, which would have the "unintended consequence" of weakening them, making them become more ill, which would then become the rationale for bleeding them again, and again, and again, until they died. At that point, the doctors would note that the patient was sicker than they had thought.

But what about data such as those I have just cited? How do the policy elites deal with this? Simply ignore them. There is a delicious bit of irony here. In the past, I have heard Austrian economists caricatured as being people who say if the numbers don't agree with the theory, so much the worse for the numbers, implying that they are "non-scientific" ideologues. However, that is exactly how the policy elites, and much of the mainstream of the economics profession, behave. They often fit almost perfectly that very caricature. Take the earlier aside about the Nobel laureates introduced toward the beginning of this paper. There are a number of empirical studies that say there is a significant dynamic effect associated with income tax-rate changes that mutes the static impacts on revenue. Yet, these people, in effect, take the stance that since these numbers do not agree with their conceptual paradigm, so much the worse for the numbers. Or, take the case of the statement from the *Economic Report of the President* about the effect of government on the distribution of income. This was released under the signature of Joseph Stiglitz, a distinctly mainstream economist.

Further, I simply can't resist reporting two more classic instances of the mainstream types blatantly ignoring numbers that contradicted their basic theoretical notions. The first takes place in 1947.

Lawrence Klein, future Nobel laureate and pioneer in the construction of macroeconometric models, has just had published his book, *The Keynesian Revolution*.¹³ In dealing with two empirical studies, one by Lorie Tarshis and the other by John Dunlop,¹⁴ that challenged a casual empirical observation made by John Maynard Keynes in *The General Theory*,¹⁵ Klein blithely dismisses them with the remark, "Our main concern is not with the empirical problem, but with the theoretical."¹⁶

My second example is taken from some private correspondence with another Nobel laureate, Kenneth Arrow.¹⁷ The beginning sentence of one of his letters starts, "I have not had time to consider the empirical issues in determining what relation, if any, exists between inflation, GDP growth, and excess capacity." Having said that, he then proceeds to pontificate for almost two pages as to what the relationships are. Just as with Lawrence Klein, the attitude seemed to be, "Don't bother me with the data."

There is an unfortunate aspect to all this: numbers have a certain power about them. They often dominate the rhetorical playing fields of both intellectual and policy debate. If the Austrian community abjures this rhetorical device, it concedes a good deal to those who will use numbers selectively to pursue an agenda that is at odds with the conclusions derived from the Austrian deducto-logical frame-

¹³ Lawrence R. Klein, *The Keynesian Revolution* (New York: Macmillan, 1947).

¹⁴ Lorie Tarshis, "Changes in Real and Money Wages," *Economic Journal* 49 (1939): 150–54, and John Dunlop, "The Movement of Real and Money-Wage Rates," *Economic Journal* 48 (1938): 413–34.

¹⁵ Keynes's remark may be found in chapter 2 of his *The General Theory of Employment, Interest, and Money* (New York: Harcourt Brace, 1935). Specifically, on page 10, he offers the following opinion, "I think that the change in real wages associated with a change in money-wages, so far from being usually in the same direction, is almost always in the opposite direction." Tarshis and Dunlop, "The Movement of Real and Money Rates," found that in both the United States (Tarshis) and Britain (Dunlop), real and money-wage rates were significantly positively correlated.

¹⁶ Keynes, *The General Theory*.

¹⁷ Letter, dated December 29, 1992, from Kenneth Arrow to Lowell Gallaway [sic].

work. In the process, they will allow these purveyors of misinformation a significant advantage as they pursue their statist agenda. In short, it might be well for Austrians to heed the advice of Robert Higgs, given at the conclusion of a piece assessing the New Economic History, namely¹⁸

these findings can serve as valuable material for Austrians practicing their own distinctive style of interpretive economic history.

It may seem that I am delivering something of a schizophrenic message. On the one hand, I have suggested that, from the methodological standpoint, Austrians have a good deal of company among the mainstream economists who often, especially in the instances described by the rubric The Law of Unintended Consequences, deny the validity of numbers that do not accord with their analytical perspective. On the other hand, I suggest that Austrians place themselves at a decided disadvantage in public policy debates if they ignore the rhetorical power of numbers.

This suggests a dilemma. What to do? All I can offer as a solution is an anecdote. In the summer of 1983, Professor Vedder and I had an extended conversation with Murray Rothbard in Palo Alto, California, concerning our paper that was published in the first issue of the *Review of Austrian Economics*. At one juncture, I pointed out to Murray that there were regression equations in the paper and asked whether that would be a problem. His response, as nearly as I remember was, "No! You guys do econometrics right." What did Murray mean by that? While I can't be sure, I suspect he was suggesting the inverse of the logical-positivist approach to knowledge, that is, rather than testing the validity of theories by consulting the evidence, you test the validity of the evidence by observing how well it fits the theory.

¹⁸Robert Higgs, "Austrian Economics and the New Economic History," *Austrian Economics Newsletter* (Summer 1995): 2-3.