

CREDIT DIVERTS PRODUCTION

Government "encouragement" to business is sometimes as much to be feared as government hostility. This supposed encouragement often takes the form of a direct grant of government credit or a guarantee of private loans.

The question of government credit can often be complicated, because it involves the possibility of inflation. We shall defer analysis of the effects of inflation of various kinds until a later chapter. Here, for the sake of simplicity, we shall assume that the credit we are discussing is non-inflationary. Inflation, as we shall later see, while it complicates the analysis, does not at bottom change the consequences of the policies discussed.

The most frequent proposal of this sort in Congress is for more credit to farmers. In the eyes of most Congressmen the farmers simply cannot get enough credit. The credit supplied by private mortgage companies, insurance companies or country banks is never "adequate." Congress is always finding new gaps that are not filled by the existing lending institutions, no matter how many of these it has itself already brought into existence. The farmers may have enough long-term credit or enough short-term credit, but, it turns out, they have not enough "intermediate" credit; or the interest rate is too high; or the complaint is that private loans are made only to rich and well-established farmers. So new lending insti-

tutions and new types of farm loans are piled on top of each other by the legislature.

The faith in all these policies, it will be found, springs from two acts of shortsightedness. One is to look at the matter only from the standpoint of the farmers that borrow. The other is to think only of the first half of the transaction.

Now all loans, in the eyes of honest borrowers, must eventually be repaid. All credit is debt. Proposals for an increased volume of credit, therefore, are merely another name for proposals for an increased burden of debt. They would seem considerably less inviting if they were habitually referred to by the second name instead of by the first.

We need not discuss here the normal loans that are made to farmers through private sources. They consist of mortgages; of installment credits for the purchase of automobiles, refrigerators, radios, tractors and other farm machinery, and of bank loans made to carry the farmer along until he is able to harvest and market his crop and get paid for it. Here we need concern ourselves only with loans to farmers either made directly by some government bureau or guaranteed by it.

These loans are of two main types. One is a loan to enable the farmer to hold his crop off the market. This is an especially harmful type; but it will be more convenient to consider it later when we come to the question of government commodity controls. The other is a loan to provide capital—often to set the farmer up in business by enabling him to buy the farm itself, or a mule or tractor, or all three.

At first glance the case for this type of loan may seem a strong one. Here is a poor family, it will be said, with no means of livelihood. It is cruel and wasteful to put them on relief. Buy a farm for them; set them up in

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business; make productive and self-respecting citizens of them; let them add to the total national product and pay the loan off out of what they produce. Or here is a farmer struggling along with primitive methods of production because he has not the capital to buy himself a tractor. Lend him the money for one; let him increase his productivity; he can repay the loan out of the proceeds of his increased crops. In that way you not only enrich him and put him on his feet; you enrich the whole community by that much added output. And the loan, concludes the argument, costs the government and the taxpayers less than nothing, because it is "self-liquidating."

Now as a matter of fact this is what happens every day under the institution of private credit. If a man wishes to buy a farm, and has, let us say, only half or a third as much money as the farm costs, a neighbor or a savings bank will lend him the rest in the form of a mortgage on the farm. If he wishes to buy a tractor, the tractor company itself, or a finance company, will allow him to buy it for one-third of the purchase price with the rest to be paid off in installments out of earnings that the tractor itself will help to provide.

But there is a decisive difference between the loans supplied by private lenders and the loans supplied by a government agency. Each private lender risks his own funds. (A banker, it is true, risks the funds of others that have been entrusted to him; but if money is lost he must either make good out of his own funds or be forced out of business.) When people risk their own funds they are usually careful in their investigations to determine the adequacy of the assets pledged and the business acumen and honesty of the borrower.

If the government operated by the same strict standards, there would be no good argument for its entering the

field at all. Why do precisely what private agencies already do? But the government almost invariably operates by different standards. The whole argument for its entering the lending business, in fact, is that it will make loans to people who could not get them from private lenders. This is only another way of saying that the government lenders will take risks with other people's money (the taxpayers') that private lenders will not take with their own money. Sometimes, in fact, apologists will freely acknowledge that the percentage of losses will be higher on these government loans than on private loans. But they contend that this will be more than offset by the added production brought into existence by the borrowers who pay back, and even by most of the borrowers who do not pay back.

This argument will seem plausible only as long as we concentrate our attention on the particular borrowers whom the government supplies with funds, and overlook the people whom its plan deprives of funds. For what is really being lent is not money, which is merely the medium of exchange, but capital. (I have already put the reader on notice that we shall postpone to a later point the complications introduced by an inflationary expansion of credit.) What is really being lent, say, is the farm or the tractor itself. Now the number of farms in existence is limited, and so is the production of tractors (assuming, especially, that an economic surplus of tractors is not produced simply at the expense of other things). The farm or tractor that is lent to A cannot be lent to B. The real question is, therefore, whether A or B shall get the farm.

This brings us to the respective merits of A and B, and what each contributes, or is capable of contributing, to production. A, let us say, is the man who would get the

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farm if the government did not intervene. The local banker or his neighbors know him and know his record. They want to find employment for their funds. They know that he is a good farmer and an honest man who keeps his word. They consider him a good risk. He has already, perhaps, through industry, frugality and foresight, accumulated enough cash to pay a fourth of the price of the farm. They lend him the other three-fourths; and he gets the farm.

There is a strange idea abroad, held by all monetary cranks, that credit is something a banker gives to a man. Credit, on the contrary, is something a man already has. He has it, perhaps, because he already has marketable assets of a greater cash value than the loan for which he is asking. Or he has it because his character and past record have earned it. He brings it into the bank with him. That is why the banker makes him the loan. The banker is not giving something for nothing. He feels assured of repayment. He is merely exchanging a more liquid form of asset or credit for a less liquid form. Sometimes he makes a mistake, and then it is not only the banker who suffers, but the whole community; for values which were supposed to be produced by the lender are not produced and resources are wasted.

Now it is to A, let us say, who has credit, that the banker would make his loan. But the government goes into the lending business in a charitable frame of mind because, as we saw, it is worried about B. B cannot get a mortgage or other loans from private lenders because he does not have credit with them. He has no savings; he has no impressive record as a good farmer; he is perhaps at the moment on relief. Why not, say the advocates of government credit, make him a useful and productive

member of society by lending him enough for a farm and a mule or tractor and setting him up in business?

Perhaps in an individual case it may work out all right. But it is obvious that in general the people selected by these government standards will be poorer risks than the people selected by private standards. More money will be lost by loans to them. There will be a much higher percentage of failures among them. They will be less efficient. More resources will be wasted by them. Yet the recipients of government credit will get their farms and tractors at the expense of what otherwise would have been the recipients of private credit. Because B has a farm, A will be deprived of a farm. A may be squeezed out either because interest rates have gone up as a result of the government operations, or because farm prices have been forced up as a result of them, or because there is no other farm to be had in his neighborhood. In any case the net result of government credit has not been to increase the amount of wealth produced by the community but to reduce it, because the available real capital (consisting of actual farms, tractors, etc.) has been placed in the hands of the less efficient borrowers rather than in the hands of the more efficient and trustworthy.

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The case becomes even clearer if we turn from farming to other forms of business. The proposal is frequently made that the government ought to assume the risks that are "too great for private industry." This means that bureaucrats should be permitted to take risks with the taxpayers' money that no one is willing to take with his own.

Such a policy would lead to evils of many different kinds. It would lead to favoritism: to the making of loans

to friends, or in return for bribes. It would inevitably lead to scandals. It would lead to recriminations whenever the taxpayers' money was thrown away on enterprises that failed. It would increase the demand for socialism: for, it would properly be asked, if the government is going to bear the risks, why should it not also get the profits? What justification could there possibly be, in fact, for asking the taxpayers to take the risks while permitting private capitalists to keep the profits? (This is precisely, however, as we shall later see, what we already do in the case of "non-recourse" government loans to farmers.)

But we shall pass over all these evils for the moment, and concentrate on just one consequence of loans of this type. This is that they will waste capital and reduce production. They will throw the available capital into bad or at best dubious projects. They will throw it into the hands of persons who are less competent or less trustworthy than those who would otherwise have got it. For the amount of real capital at any moment (as distinguished from monetary tokens run off on a printing press) is limited. What is put into the hands of B cannot be put into the hands of A.

People want to invest their own capital. But they are cautious. They want to get it back. Most lenders, therefore, investigate any proposal carefully before they risk their own money in it. They weigh the prospect of profits against the chances of loss. They may sometimes make mistakes. But for several reasons they are likely to make fewer mistakes than government lenders. In the first place, the money is either their own or has been voluntarily entrusted to them. In the case of government-lending the money is that of other people, and it has been taken from them, regardless of their personal wish, in taxes.

The private money will be invested only where repayment with interest or profit is definitely expected. This is a sign that the persons to whom the money has been lent will be expected to produce things for the market that people actually want. The government money, on the other hand, is likely to be lent for some vague general purpose like "creating employment;" and the more inefficient the work—that is, the greater the volume of employment it requires in relation to the value of product—the more highly thought of the investment is likely to be.

The private lenders, moreover, are selected by a cruel market test. If they make bad mistakes they lose their money and have no more money to lend. It is only if they have been successful in the past that they have more money to lend in the future. Thus private lenders (except the relatively small proportion that have got their funds through inheritance) are rigidly selected by a process of survival of the fittest. The government lenders, on the other hand, are either those who have passed civil service examinations, and know how to answer hypothetical questions hypothetically, or they are those who can give the most plausible reasons for making loans and the most plausible explanations of why it wasn't their fault that the loans failed. But the net result remains: private loans will utilize existing resources and capital far better than government loans. Government loans will waste far more capital and resources than private loans. Government loans, in short, as compared with private loans, will reduce production, not increase it.

The proposal for government loans to private individuals or projects, in brief, sees B and forgets A. It sees the people in whose hands the capital is put; it forgets those who would otherwise have had it. It sees the project to which capital is granted; it forgets the projects from

which capital is thereby withheld. It sees the immediate benefit to one group; it overlooks the losses to other groups, and the net loss to the community as a whole.

It is one more illustration of the fallacy of seeing only a special interest in the short run and forgetting the general interest in the long run.

3

We remarked at the beginning of this chapter that government "aid" to business is sometimes as much to be feared as government hostility. This applies as much to government subsidies as to government loans. The government never lends or gives anything to business that it does not take away from business. One often hears New Dealers and other statisticians boast about the way government "bailed business out" with the Reconstruction Finance Corporation, the Home Owners Loan Corporation and other government agencies in 1932 and later. But the government can give no financial help to business that it does not first or finally take from business. The government's funds all come from taxes. Even the much vaunted "government credit" rests on the assumption that its loans will ultimately be repaid out of the proceeds of taxes. When the government makes loans or subsidies to business, what it does is to tax successful private business in order to support unsuccessful private business. Under certain emergency circumstances there may be a plausible argument for this, the merits of which we need not examine here. But in the long run it does not sound like a paying proposition from the standpoint of the country as a whole. And experience has shown that it isn't.

None of this means, I repeat, that it is unwise to make foreign loans, but simply that we cannot get rich by making bad ones.

For the same reasons that it is stupid to give a false stimulation to export trade by making bad loans or outright gifts to foreign countries, it is stupid to give a false stimulation to export trade through export subsidies. Rather than repeat most of the previous argument, I leave it to the reader to trace the effects of export subsidies as I have traced the effects of bad loans. An export subsidy is a clear case of giving the foreigner something for nothing, by selling him goods for less than it costs us to make them. It is another case of trying to get rich by giving things away.

Bad loans and export subsidies are additional examples of the error of looking only at the immediate effect of a policy on special groups, and of not having the patience or intelligence to trace the long-run effects of the policy on everyone.

Chapter Thirteen

“PARITY” PRICES

Special interests, as the history of tariffs reminds us, can think of the most ingenious reasons why they should be the objects of special solicitude. Their spokesmen present a plan in their favor; and it seems at first so absurd that disinterested writers do not trouble to expose it.

But the special interests keep on insisting on the scheme. Its enactment would make so much difference to their own immediate welfare that they can afford to hire trained economists and “public relations experts” to propagate it in their behalf. The public hears the argument so often repeated, and accompanied by such a wealth of imposing statistics, charts, curves and pie-slices, that it is soon taken in. When at last disinterested writers recognize that the danger of the scheme’s enactment is real, they are usually too late. They cannot in a few weeks acquaint themselves with the subject as thoroughly as the hired brains who have been devoting their full time to it for years; they are accused of being uninformed, and they have the air of men who presume to dispute axioms.

This general history will do as a history of the idea of “parity” prices for agricultural products. I forget the first day when it made its appearance in a legislative bill; but with the advent of the New Deal in 1933 it had become a definitely established principle, enacted into law; and as year succeeded year, and its absurd corollaries made themselves manifest, they were enacted too.

The argument for “parity” prices ran roughly like this. Agriculture is the most basic and important of all industries. It must be preserved at all costs. Moreover, the prosperity of everybody else depends upon the prosperity of the farmer. If he does not have the purchasing power to buy the products of industry, industry languishes. This was the cause of the 1929 collapse, or at least of our failure to recover from it. For the prices of farm products dropped violently, while the prices of industrial products dropped very little. The result was that the farmer could not buy industrial products; the city workers were laid off and could not buy farm products, and the depression spread in ever-widening vicious circles. There was only

one cure, and it was simple. Bring back the prices of the farmer's products to a "parity" with the prices of the things the farmer buys. This parity existed in the period from 1909 to 1914, when farmers were prosperous. That price relationship must be restored and preserved perpetually.

It would take too long, and carry us too far from our main point, to examine every absurdity concealed in this plausible statement. There is no sound reason for taking the particular price relationships that prevailed in a particular year or period and regarding them as sacrosanct, or even as necessarily more "normal" than those of any other period. Even if they were "normal" at the time, what reason is there to suppose that these same relationships should be preserved a generation later in spite of the enormous changes in the conditions of production and demand that have taken place in the meantime? The period of 1909 to 1914, as the basis of "parity," was not selected at random. In terms of relative prices it was one of the most favorable periods to agriculture in our entire history.

If there had been any sincerity or logic in the idea, it would have been universally extended. If the price relationships between agricultural and industrial products that prevailed from August, 1909 to July, 1914 ought to be preserved perpetually, why not preserve perpetually the price relationship of every commodity at that time to every other? A Chevrolet six-cylinder touring car cost \$2,150 in 1912; an incomparably improved six-cylinder Chevrolet sedan cost \$907 in 1942: adjusted for "parity" on the same basis as farm products, however, it would have cost \$3,270 in 1942. A pound of aluminum from 1909 to 1913 inclusive averaged 22½ cents; its price

early in 1946 was 14 cents; but at "parity" it would then have cost, instead, 41 cents.

I hear immediate cries that such comparisons are absurd, because everybody knows not only that the present-day automobile is incomparably superior in every way to the car of 1912, but that it costs only a fraction as much to produce, and that the same is true also of aluminum. Exactly. But why doesn't somebody say something about the amazing increase in productivity per acre in agriculture? In the five-year period 1939 to 1943 an average of 260 pounds of cotton was raised per acre in the United States as compared with an average of 188 pounds in the five-year period 1909 to 1913. Costs of production have been substantially lowered for farm products by better applications of chemical fertilizer, improved strains of seed and increasing mechanization—by the gasoline tractor, the corn husker, the cotton picker. "On some large farms which have been completely mechanized and are operated along mass production lines, it requires only one-third to one-fifth the amount of labor to produce the same yields as it did a few years back."¹ Yet all this is ignored by the apostles of "parity" prices.

The refusal to universalize the principle is not the only evidence that it is not a public-spirited economic plan but merely a device for subsidizing a special interest. Another evidence is that when agricultural prices go *above* "parity," or are forced there by government policies, there is no demand on the part of the farm bloc in Congress that such prices be brought *down* to parity, or that the subsidy be to that extent repaid. It is a rule that works only one way.

¹ *New York Times*, Jan. 2, 1946.

Dismissing all these considerations, let us return to the central fallacy that specially concerns us here. This is the argument that if the farmer gets higher prices for his products he can buy more goods from industry and so make industry prosperous and bring full employment. It does not matter to this argument, of course, whether or not the farmer gets specifically so-called "parity" prices.

Everything, however, depends on how these higher prices are brought about. If they are the result of a general revival, if they follow from increased prosperity of business, increased industrial production and increased purchasing power of city workers (not brought about by inflation), then they can indeed mean increased prosperity and production not only for the farmers, but for everyone. But what we are discussing is a rise in farm prices brought about by government intervention. This can be done in several ways. The higher price can be forced by mere edict, which is the least workable method. It can be brought about by the government's standing ready to buy all the farm products offered to it at the "parity" price. It can be brought about by the government's lending to farmers enough money on their crops to enable them to hold the crops off the market until "parity" or a higher price is realized. It can be brought about by the government's enforcing restrictions in the size of crops. It can be brought about, as it often is in practice, by a combination of these methods. For the moment we shall simply assume that, by whatever method, it is in any case brought about.

What is the result? The farmers get higher prices for their crops. Their "purchasing power" is thereby in-

creased. They are for the time being more prosperous themselves, and they buy more of the products of industry. All this is what is seen by those who look merely at the immediate consequences of policies to the groups directly involved.

But there is another consequence, no less inevitable. Suppose the wheat which would otherwise sell at \$1 a bushel is pushed up by this policy to \$1.50. The farmer gets 50 cents a bushel more for wheat. But the city worker, by precisely the same change, *pays* 50 cents a bushel more for wheat in an increased price of bread. The same thing is true of any other farm product. If the farmer then has 50 cents more purchasing power to buy industrial products, the city worker has precisely that much less purchasing power to buy industrial products. On net balance industry in general has gained nothing. It loses in city sales precisely as much as it gains in rural sales.

There is of course a change in the incidence of these sales. No doubt the agricultural-implement makers and the mail-order houses do a better business. But the city department stores do a smaller business.

The matter, however, does not end here. The policy results not merely in no net gain, but in a net loss. For it does not mean merely a transfer of purchasing power to the farmer from city consumers, or from the general taxpayer, or from both. It also means a forced cut in the production of farm commodities to bring up the price. This means a destruction of wealth. It means that there is less food to be consumed. How this destruction of wealth is brought about will depend upon the particular method pursued to bring prices up. It may mean the actual physical destruction of what has already been produced, as in the burning of coffee in Brazil. It may mean a forced restriction of acreage, as in the American AAA plan. We

shall examine the effect of some of these methods when we come to the broader discussion of government commodity controls.

But here it may be pointed out that when the farmer reduces the production of wheat to get "parity," he may indeed get a higher price for each bushel, but he produces and sells fewer bushels. The result is that his income does not go up in proportion to his prices. Even some of the advocates of "parity prices" recognize this, and use it as an argument to go on to insist upon "parity *income*" for farmers. But this can only be achieved by a subsidy at the direct expense of taxpayers. To help the farmers, in other words, it merely reduces the purchasing power of city workers and other groups still more.

3

There is one argument for "parity" prices that should be dealt with before we leave the subject. It is put forward by some of the more sophisticated defenders. "Yes," they will freely admit, "the economic arguments for parity prices are unsound. Such prices are a special privilege. They are an imposition on the consumer. But isn't the tariff an imposition on the farmer? Doesn't he have to pay higher prices on industrial products because of it? It would do no good to place a compensating tariff on farm products, because America is a net exporter of farm products. Now the parity-price system is the farmer's equivalent of the tariff. It is the only fair way to even things up."

The farmers that asked for parity prices did have a legitimate complaint. The protective tariff injured them more than they knew. By reducing industrial imports it also reduced American farm exports, because it prevented

foreign nations from getting the dollar exchange needed for taking our agricultural products. And it provoked retaliatory tariffs in other countries. None the less, the argument we have just quoted will not stand examination. It is wrong even in its implied statement of the facts. There is no *general* tariff on all "industrial" products or on all non-farm products. There are scores of domestic industries or of exporting industries that have no tariff protection. If the city worker has to pay a higher price for woolen blankets or overcoats because of a tariff, is he "compensated" by having to pay a higher price also for cotton clothing and for foodstuffs? Or is he merely being robbed twice?

Let us even it all out, say some, by giving equal "protection" to everybody. But that is insoluble and impossible. Even if we assume that the problem could be solved technically—a tariff for A, an industrialist subject to foreign competition; a subsidy for B, an industrialist who exports his product—it would be impossible to protect or to subsidize everybody "fairly" or equally. We should have to give everyone the same percentage (or would it be the same dollar amount?) of tariff protection or subsidy, and we could never be sure when we were duplicating payments to some groups or leaving gaps with others.

But suppose we could solve this fantastic problem? What would be the point? Who gains when everyone equally subsidizes everyone else? What is the profit when everyone loses in added taxes precisely what he gains by his subsidy or his protection? We should merely have added an army of needless bureaucrats to carry out the program, with all of them lost to production.

We could solve the matter simply, on the other hand, by ending both the parity-price system and the protective-tariff system. Meanwhile they do not, in combination,

even out anything. The joint system means merely that Farmer A and Industrialist B both profit at the expense of Forgotten Man C.

So the alleged benefits of still another scheme evaporate as soon as we trace not only its immediate effects on a special group but its long-run effects on everyone.

Chapter Fourteen

SAVING THE X INDUSTRY

The lobbies of Congress are crowded with representatives of the X industry. The X industry is sick. The X industry is dying. It must be saved. It can be saved only by a tariff, by higher prices, or by a subsidy. If it is allowed to die, workers will be thrown on the streets. Their landlords, grocers, butchers, clothing stores and local motion picture theaters will lose business, and depression will spread in ever-widening circles. But if the X industry, by prompt action of Congress, is *saved*—ah then! it will buy equipment from other industries; more men will be employed; they will give more business to the butchers, bakers and neon-light makers, and then it is prosperity that will spread in ever-widening circles.

It is obvious that this is merely a generalized form of the case we have just been considering. There the X industry was agriculture. But there are an endless number of X industries. Two of the most notable examples in recent years have been the coal and silver industries. To "save silver" Congress did immense harm. One of the

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cooperation with the idea of increased State domination and control over economic life, the international controls of the future seem only too likely to follow the pattern of the past, in which case the plain man's living standards will decline with his liberties.

Chapter Seventeen

GOVERNMENT PRICE-FIXING

We have seen what some of the effects are of governmental efforts to fix the prices of commodities *above* the levels to which free markets would otherwise have carried them. Let us now look at some of the results of government attempts to hold the prices of commodities *below* their natural market levels.

The latter attempt is made in our day by nearly all governments in wartime. We shall not examine here the wisdom of wartime price-fixing. The whole economy, in total war, is necessarily dominated by the State, and the complications that would have to be considered would carry us too far beyond the main question with which this book is concerned. But wartime price-fixing, wise or not, is in almost all countries continued for at least long periods after the war is over, when the original excuse for starting it has disappeared.

Let us first see what happens when the government tries to keep the price of a single commodity, or a small group of commodities, below the price that would be set in a free competitive market.

When the government tries to fix maximum prices for only a few items, it usually chooses certain basic necessities, on the ground that it is most essential that the poor be able to obtain these at a "reasonable" cost. Let us say that the items chosen for this purpose are bread, milk and meat.

The argument for holding down the price of these goods will run something like this. If we leave beef (let us say) to the mercies of the free market, the price will be pushed up by competitive bidding so that only the rich will get it. People will get beef not in proportion to their need, but only in proportion to their purchasing power. If we keep the price down, everyone will get his fair share.

The first thing to be noticed about this argument is that if it is valid the policy adopted is inconsistent and timorous. For if purchasing power rather than need determines the distribution of beef at a market price of 65 cents a pound, it would also determine it, though perhaps to a slightly smaller degree, at, say, a legal "ceiling" price of 50 cents a pound. The purchasing-power-rather-than-need argument, in fact, holds as long as we charge anything for beef whatever. It would cease to apply only if beef were given away.

But schemes for maximum price-fixing usually begin as efforts to "keep the cost of living from rising." And so their sponsors unconsciously assume that there is something peculiarly "normal" or sacrosanct about the market price at the moment from which their control starts. That starting price is regarded as "reasonable," and any price above that as "unreasonable," regardless of changes in the conditions of production or demand since that starting price was first established.

In discussing this subject, there is no point in assuming a price control that would fix prices exactly where a free market would place them in any case. That would be the same as having no price control at all. We must assume that the purchasing power in the hands of the public is greater than the supply of goods available, and that prices are being held down by the government *below* the levels to which a free market would put them.

Now we cannot hold the price of any commodity below its market level without in time bringing about two consequences. The first is to increase the demand for that commodity. Because the commodity is cheaper, people are both tempted to buy, and can afford to buy, more of it. The second consequence is to reduce the supply of that commodity. Because people buy more, the accumulated supply is more quickly taken from the shelves of merchants. But in addition to this, production of that commodity is discouraged. Profit margins are reduced or wiped out. The marginal producers are driven out of business. Even the most efficient producers may be called upon to turn out their product at a loss. This happened in the war when slaughter houses were required by the Office of Price Administration to slaughter and process meat for less than the cost to them of cattle on the hoof and the labor of slaughter and processing.

If we did nothing else, therefore, the consequence of fixing a maximum price for a particular commodity would be to bring about a shortage of that commodity. But this is precisely the opposite of what the government regulators originally wanted to do. For it is the very commodities selected for maximum price-fixing that the regulators most want to keep in abundant supply. But

when they limit the wages and the profits of those who make these commodities, without also limiting the wages and profits of those who make luxuries or semi-luxuries, they discourage the production of the price-controlled necessities while they relatively stimulate the production of less essential goods.

Some of these consequences in time become apparent to the regulators, who then adopt various other devices and controls in an attempt to avert them. Among these devices are rationing, cost-control, subsidies, and universal price-fixing. Let us look at each of these in turn.

When it becomes obvious that a shortage of some commodity is developing as a result of a price fixed below the market, rich consumers are accused of taking "more than their fair share"; or, if it is a raw material that enters into manufacture, individual firms are accused of "hoarding" it. The government then adopts a set of rules concerning who shall have priority in buying that commodity, or to whom and in what quantities it shall be allocated, or how it shall be rationed. If a rationing system is adopted, it means that each consumer can have only a certain maximum supply, no matter how much he is willing to pay for more.

If a rationing system is adopted, in brief, it means that the government adopts a double price system, or a dual currency system, in which each consumer must have a certain number of coupons or "points" in addition to a given amount of ordinary money. In other words, the government tries to do through rationing part of the job that a free market would have done through prices. I say only part of the job, because rationing merely limits the demand without also stimulating the supply, as a higher price would have done.

The government may try to assure supply through ex-

tending its control over the costs of production of a commodity. To hold down the retail price of beef, for example, it may fix the wholesale price of beef, the slaughter-house price of beef, the price of live cattle, the price of feed, the wages of farmhands. To hold down the delivered price of milk, it may try to fix the wages of milk-wagon drivers, the price of containers, the farm price of milk, the price of feedstuffs. To fix the price of bread, it may fix the wages in bakeries, the price of flour, the profits of millers, the price of wheat, and so on.

But as the government extends this price-fixing backwards, it extends at the same time the consequences that originally drove it to this course. Assuming that it has the courage to fix these costs, and is able to enforce its decisions, then it merely, in turn, creates shortages of the various factors—labor, feedstuffs, wheat, or whatever—that enter into the production of the final commodities. Thus the government is driven to controls in ever-widening circles, and the final consequence will be the same as that of universal price-fixing.

The government may try to meet this difficulty through subsidies. It recognizes, for example, that when it keeps the price of milk or butter below the level of the market, or below the relative level at which it fixes other prices, a shortage may result because of lower wages or profit margins for the production of milk or butter as compared with other commodities. Therefore the government attempts to compensate for this by paying a subsidy to the milk and butter producers. Passing over the administrative difficulties involved in this, and assuming that the subsidy is just enough to assure the desired relative production of milk and butter, it is clear that, though the subsidy is paid to producers, those who are really being subsidized are the consumers. For the producers

are on net balance getting no more for their milk and butter than if they had been allowed to charge the free market price in the first place; but the consumers are getting their milk and butter at a great deal below the free market price. They are being subsidized to the extent of the difference—that is, by the amount of subsidy paid ostensibly to the producers.

Now unless the subsidized commodity is also rationed, it is those with the most purchasing power that can buy most of it. This means that they are being subsidized more than those with less purchasing power. Who subsidizes the consumers will depend upon the incidence of taxation. But men in their role of taxpayers will be subsidizing themselves in their role of consumers. It becomes a little difficult to trace in this maze precisely who is subsidizing whom. What is forgotten is that subsidies are paid for by someone, and that no method has been discovered by which the community gets something for nothing.

3

Price-fixing may often appear for a short period to be successful. It can seem to work well for a while, particularly in wartime, when it is supported by patriotism and a sense of crisis. But the longer it is in effect the more its difficulties increase. When prices are arbitrarily held down by government compulsion, demand is *chronically* in excess of supply. We have seen that if the government attempts to prevent a shortage of a commodity by reducing also the prices of the labor, raw materials and other factors that go into its cost of production, it creates a shortage of these in turn. But not only will the government, if it pursues this course, find it necessary

to extend price control more and more downwards, or "vertically"; it will find it no less necessary to extend price control "horizontally." If we ration one commodity, and the public cannot get enough of it, though it still has excess purchasing power, it will turn to some substitute. The rationing of each commodity as it grows scarce, in other words, must put more and more pressure on the unrationed commodities that remain. If we assume that the government is successful in its efforts to prevent black markets (or at least prevents them from developing on a sufficient scale to nullify its legal prices), continued price control must drive it to the rationing of more and more commodities. This rationing cannot stop with consumers. In war it did not stop with consumers. It was applied first of all, in fact, in the allocation of raw materials to producers.

The natural consequence of a thoroughgoing over-all price control which seeks to perpetuate a given historic price level, in brief, must ultimately be a completely regimented economy. Wages would have to be held down as rigidly as prices. Labor would have to be rationed as ruthlessly as raw materials. The end result would be that the government would not only tell each consumer precisely how much of each commodity he could have; it would tell each manufacturer precisely what quantity of each raw material he could have and what quantity of labor. Competitive bidding for workers could no more be tolerated than competitive bidding for materials. The result would be a petrified totalitarian economy, with every business firm and every worker at the mercy of the government, and with a final abandonment of all the traditional liberties we have known. For as Alexander Hamilton pointed out in the Federalist papers a century

and a half ago, "A power over a man's subsistence amounts to a power over his will."

4

These are the consequences of what might be described as "perfect," long-continued, and "non-political" price control. As was so amply demonstrated in one country after another, particularly in Europe during and after World War II, some of the more fantastic errors of the bureaucrats were mitigated by the black market. It was a common story from many European countries that people were able to get enough to stay alive only by patronizing the black market. In some countries the black market kept growing at the expense of the legally recognized fixed-price market until the former became, in effect, *the* market. By nominally keeping the price ceilings, however, the politicians in power tried to show that their hearts, if not their enforcement squads, were in the right place.

Because the black market, however, finally supplanted the legal price-ceiling market, it must not be supposed that no harm was done. The harm was both economic and moral. During the transition period the large, long-established firms, with a heavy capital investment and a great dependence upon the retention of public good-will, are forced to restrict or discontinue production. Their place is taken by fly-by-night concerns with little capital and little accumulated experience in production. These new firms are inefficient compared with those they displace; they turn out inferior and dishonest goods at much higher production costs than the older concerns would have required for continuing to turn out their former goods. A premium is put on dishonesty. The new firms

owe their very existence or growth to the fact that they are willing to violate the law; their customers conspire with them; and as a natural consequence demoralization spreads into all business practices.

It is seldom, moreover, that any honest effort is made by the price-fixing authorities merely to preserve the level of prices existing when their efforts began. They declare that their intention is to "hold the line." Soon, however, under the guise of "correcting inequities" or "social injustices," they begin a discriminatory price-fixing which gives most to those groups that are politically powerful and least to other groups.

As political power today is most commonly measured by votes, the groups that the authorities most often attempt to favor are workers and farmers. At first it is contended that wages and living costs are not connected; that wages can easily be lifted without lifting prices. When it becomes obvious that wages can be raised only at the expense of profits, the bureaucrats begin to argue that profits were already too high anyway, and that lifting wages and holding prices will still permit "a fair profit." As there is no such thing as a uniform *rate* of profit, as profits differ with each concern, the result of this policy is to drive the least profitable concerns out of business altogether, and to discourage or stop the production of certain items. This means unemployment, a shrinkage in production and a decline in living standards.

What lies at the base of the whole effort to fix maximum prices? There is first of all a misunderstanding of what it is that has been causing prices to rise. The real

cause is either a scarcity of goods or a surplus of money. Legal price ceilings cannot cure either. In fact, as we have just seen, they merely intensify the shortage of goods. What to do about the surplus of money will be discussed in a later chapter. But one of the errors that lie behind the drive for price-fixing is the chief subject of this book. Just as the endless plans for raising prices of favored commodities are the result of thinking of the interests only of the producers immediately concerned, and forgetting the interests of consumers, so the plans for holding down prices by legal edict are the result of thinking of the interests of people only as consumers and forgetting their interests as producers. And the political support for such policies springs from a similar confusion in the public mind. People do not want to pay more for milk, butter, shoes, furniture, rent, theater tickets or diamonds. Whenever any of these items rises above its previous level the consumer becomes indignant, and feels that he is being rooked.

The only exception is the item he makes himself: here he understands and appreciates the reason for the rise. But he is always likely to regard his own business as in some way an exception. "Now my own business," he will say, "is peculiar, and the public does not understand it. Labor costs have gone up; raw material prices have gone up; this or that raw material is no longer being imported, and must be made at a higher cost at home. Moreover, the demand for the product has increased, and the business should be allowed to charge the prices necessary to encourage its expansion to supply this demand." And so on. Everyone as consumer buys a hundred different products; as producer he makes, usually, only one. He can see the inequity in holding down the price of *that*. And just as each manufacturer wants a higher price for

his particular product, so each worker wants a higher wage or salary. Each can see as producer that price control is restricting production in his line. But nearly everyone refuses to generalize this observation, for it means that he will have to pay more for the products of *others*.

Each one of us, in brief, has a multiple economic personality. Each one of us is producer, taxpayer, consumer. The policies he advocates depend upon the particular aspect under which he thinks of himself at the moment. For he is sometimes Dr. Jekyll and sometimes Mr. Hyde. As a producer he wants inflation (thinking chiefly of his own services or product); as a consumer he wants price ceilings (thinking chiefly of what he has to pay for the products of others). As a consumer he may advocate or acquiesce in subsidies; as a taxpayer he will resent paying them. Each person is likely to think that he can so manage the political forces that he can benefit from the subsidy more than he loses from the tax, or benefit from a rise for his own product (while his raw material costs are legally held down) and at the same time benefit as a consumer from price control. But the overwhelming majority will be deceiving themselves. For not only must there be at least as much loss as gain from this political manipulation of prices; there must be a great deal more loss than gain, because price-fixing discourages and disrupts employment and production.

cluding the members of the very class for whose benefit we have been trying to run it. We must run the economy for everybody.

Chapter Twenty-One

THE FUNCTION OF PROFITS

The indignation shown by many people today at the mention of the very word "profits" indicates how little understanding there is of the vital function that profits play in our economy. To increase our understanding, we shall go over again some of the ground already covered in Chapter XV on the price system, but we shall view the subject from a different angle.

Profits actually do not bulk large in our total economy. The net income of incorporated business in the fifteen years from 1929 to 1943, to take an illustrative figure, averaged less than 5 per cent of the total national income. Yet "profits" are the form of income toward which there is most hostility. It is significant that while there is a word "profiteer" to stigmatize those who make allegedly excessive profits, there is no such word as "wageer"—or "losseer." Yet the profits of the owner of a barber shop may average much less not merely than the salary of a motion picture star or the hired head of a steel corporation, but less even than the average wage for skilled labor.

The subject is clouded by all sorts of factual misconceptions. The total profits of General Motors, the greatest

industrial corporation in the world, are taken as if they were typical rather than exceptional. Few people are acquainted with the mortality rates for business concerns. They do not know (to quote from the TNEC studies) that "should conditions of business averaging the experience of the last fifty years prevail, about seven of each ten grocery stores opening today will survive into their second year; only four of the ten may expect to celebrate their fourth birthday." They do not know that in every year from 1930 to 1938, in the income tax statistics, the number of corporations that showed a loss exceeded the number that showed a profit.

How much do profits, on the average, amount to? No trustworthy estimate has been made that takes into account all kinds of activity, unincorporated as well as incorporated business, and a sufficient number of good and bad years. But some eminent economists believe that over a long period of years, after allowance is made for all losses, for a minimum "riskless" interest on invested capital, and for an imputed "reasonable" wage value of the services of people who run their own business, no net profit at all may be left over, and that there may even be a net loss. This is not at all because entrepreneurs (people who go into business for themselves) are intentional philanthropists, but because their optimism and self-confidence too often lead them into ventures that do not or cannot succeed.¹

It is clear, in any case, that any individual placing venture capital runs a risk not only of earning no return but of losing his whole principal. In the past it has been the lure of high profits in special firms or industries that has led him to take that great risk. But if profits are limited

¹ Cf. Frank H. Knight, *Risk, Uncertainty and Profit* (1921).

to a maximum of, say, 10 per cent or some similar figure, while the risk of losing one's entire capital still exists, what is likely to be the effect on the profit incentive, and hence on employment and production? The wartime excess-profits tax has already shown us what such a limit can do, even for a short period, in undermining efficiency.

Yet governmental policy almost everywhere today tends to assume that production will go on automatically, no matter what is done to discourage it. One of the greatest dangers to production today comes from government price-fixing policies. Not only do these policies put one item after another out of production by leaving no incentive to make it, but their long-run effect is to prevent a balance of production in accordance with the actual demands of consumers. If the economy were free, demand would so act that some branches of production would make what government officials would undoubtedly regard as "excessive" or "unreasonable" profits. But that very fact would not only cause every firm in that line to expand its production to the utmost, and to reinvest its profits in more machinery and more employment; it would also attract new investors and producers from everywhere, until production in that line was great enough to meet demand, and the profits in it again fell to the general average level.

In a free economy, in which wages, costs and prices are left to the free play of the competitive market, the prospect of profits decides what articles will be made, and in what quantities—and what articles will not be made at all. If there is no profit in making an article, it is a sign that the labor and capital devoted to its production are misdirected: the value of the resources that must be used up in making the article is greater than the value of the article itself.

THE FUNCTION OF PROFITS

One function of profits, in brief, is to guide and channel the factors of production so as to apportion the relative output of thousands of different commodities in accordance with demand. No bureaucrat, no matter how brilliant, can solve this problem arbitrarily. Free prices and free profits will maximize production and relieve shortages quicker than any other system. Arbitrarily-fixed prices and arbitrarily-limited profits can only prolong shortages and reduce production and employment.

The function of profits, finally, is to put constant and unremitting pressure on the head of every competitive business to introduce further economies and efficiencies, no matter to what stage these may already have been brought. In good times he does this to increase his profits further; in normal times he does it to keep ahead of his competitors; in bad times he may have to do it to survive at all. For profits may not only go to zero; they may quickly turn into losses; and a man will put forth greater efforts to save himself from ruin than he will merely to improve his position.

Profits, in short, resulting from the relationships of costs to prices, not only tell us which goods it is most economical to make, but which are the most economical ways to make them. These questions must be answered by a socialist system no less than by a capitalist one; they must be answered by any conceivable economic system; and for the overwhelming bulk of the commodities and services that are produced, the answers supplied by profit and loss under competitive free enterprise are incomparably superior to those that could be obtained by any other method.