INTERVIEW WITH F.A. HAYEK

POLICY REPORT

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The Future of Small Business in America

By Bruce Bartlett

Having your own business has always been part of the "American Dream." Historically, this has been the ticket to great wealth in this country, as the experiences of men like Henry Ford, John D. Rockefeller, and Andrew Carnegie show. However, the steady encroachment of the government on the economy over the last 75 years has all but destroyed the dream of starting one's own business, let alone striking it rich with one. Today, one is far more likely to join the ranks of the millionaires by being a rock singer or a basketball player than by "building a better mousetrap," as Emerson put it.

For the most part, only large companies that were established before the New Deal consistently make money today. In 1977, for example, corporations with gross income of over $1 million earned 92% of the new income earned by all corporations, though they account for only 14% of the total number of corporations. At the same time, the chances of a small business surviving today have never been worse. According to Dun and Bradstreet, the number of business failures increased 42% between 1980 and 1981, with the bulk of these failures concentrated in industries largely dominated by small firms, such as construction, services, retail trade, and wholesale trade. The Small Business Administration now estimates that a firm with 21 to 50 employees has only a 54% chance of surviving four years; a firm with less than 20 employees has only a 37% chance of survival.

The inability of small businesses to survive and prosper has enormous implications. There will be increasing concentration of industry into a few large firms that are removed from effective competition. In addition, the control of these large firms is likely to become further and further removed from their owners. It is becoming more common every year for the chief executive officers of major corporations to have little, if any, significant share in the ownership of that company. As a result of these two factors, large firms are becoming increasingly removed from market discipline. They are more unwilling to take risks — especially of a long-term nature — and seem unable to satisfy the demands of consumers, who are turning more to imported goods, particularly imported autos.

"Government policy is largely geared toward suppressing invention, innovation, and entrepreneurship rather than stimulating it."

The Entrepreneur

What is needed is a renewed understanding and appreciation of the role of the entrepreneur in the economic system. The entrepreneur is the "sparkplug" of the economic system, the one who gives it vitality and dynamism. Such a task is a difficult one. Resistance to change is a natural aspect of human nature and the entrepreneurial function is, above all, one of bringing about change. Moreover, there are invariably institutional barriers to the new and different. Governments and financiers are reluctant to approve or finance a new project and tend to make life difficult for the entrepreneur, regardless of his potential. To act nevertheless in the face of such obstacles and overcome resistance requires exceptional traits and attitudes present only in a tiny fraction of the population.

With entrepreneurs such a scarce commodity, we can ill-afford to discourage them. Instead, they must be nurtured and encouraged. Unfortunately, government policy is largely geared toward suppressing invention, innovation, and entrepreneurship rather than stimulating it. Too often, new burdens are placed on business which — though their impact on large, well-established firms may be negligible — have a devastating effect on small, recently established ones. At the same time, government enacts incentives that tend to further enhance the profitability of the former while little, if any, stimulus is given to the latter. The result is a stifling of creativity, stagnation, reduced competition, loss of market share to foreign companies, and declining productivity. It also gives rise to a belief that capitalism itself is the culprit, leading to renewed pressure for government intervention.

Small Business and the Economy

Only recently have people become more aware of the significant contribution of the small businessman to the nation's economy. According to the SBA, there are 10,000 large companies in the United States with 500 or more employees each. The remaining 99.8% of businesses may be called small. These small firms employ 47% of the nongovernment work force and produce 38% of the nation's private domestic product. Moreover, recent studies have shown that small- and medium-sized businesses are responsible for a major portion of new inventions and contribute enormously to the innovation process. Ac-

(Cont. on p. 3)

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EDITORIAL

How High Is the Stock Market?

"Dow Soars to 1,070.92, A Record," headlined the *New York Times* early in January. The Dow-Jones Industrial Average had previously set all-time records in November and December of 1982. The new 1983 high was not confined to the stocks in the DJIA. The New York Stock Exchange's composite index of 1,500 stocks and Standard & Poor's 500-stock index also reached new highs.

Apparently, the stock market is in all-time good health even if the economy in general isn't. But just how high is the market these days? A little investigation reveals an entirely different story.

The DJIA and other stock-market averages are not adjusted for inflation. Thus, it is enormously misleading to compare today's average to past numbers. Given the unremitting inflation of the past 15 years, the Dow could have risen slightly every single day in nominal terms while falling every day in real terms. Millions of people rely on the Dow to tell them the value of the stock market. Unfortunately, they have been getting wrong signals.

In real, inflation-adjusted terms the Dow reached its all-time high in 1965 at just over 900, or about 960 in the standard measurement of 1967 dollars. In November 1972, when the Dow first closed above 1,000, its real value was only 790. And the real value of the Dow at its record high on January 5, 1983, was not 1,070.92 but 364 (in 1967 dollars).

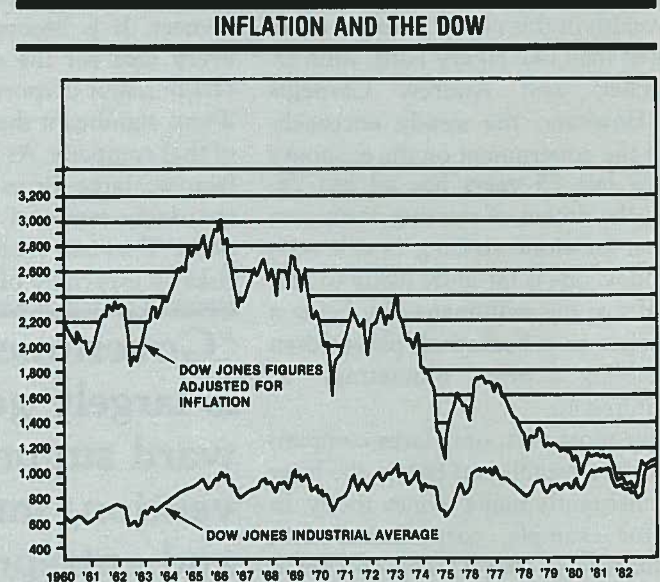
In other words, the stock market, as measured by the Dow, has lost some 62% of its value since 1965. A person who invested $1,000 in the market in 1965 would appear to have about $1,100 now — not much of a return, but at least some positive appreciation. In fact, his $1,100 would be worth about $380 in real terms.

This has rarely been noted by the media. "Dow Soars to New Record" is, after all, a better story than "Dow Continues to Flounder at Historic Lows." The *Los Angeles Times* and the *Washington Post*, however, have run one story each explaining the issue.

Once we understand that the stock market is still quite depressed despite its recent "surges," we are led to wonder why this has happened. Why is the stock market, the basic measure of the value of America's industrial corporations, so low?

The most obvious reason for depressed stock values is the double taxation of corporate dividends. Corporate earnings are taxed once as income to the corporation and again if they are paid out as dividends. Clearly, double taxation of any investment would strongly discourage investors. We have heard quite a bit recently about the low rates of taxation paid by large companies who (quite legitimately) take advantage of deductions, credits, and other "loopholes" in the corporate tax laws. Even if that is true, however, dividends have recently been taxed at historically high marginal rates because inflation has moved most Americans into ever-higher

INFLATION AND THE DOW



tax brackets. So whatever the figures on corporate tax rates, the total tax burden on the stockholder has undoubtedly increased.

There are other reasons for the depressed market. Saving is discouraged by our tax laws and by Social Security, which creates the illusion of saving for retirement, thus reducing real savings by individuals. Also, there has been a decline in the value of ownership in the United States. Regulations restrict the way one can run one's business. Real profits (as opposed to paper profits created by inflation) have declined or even disappeared in many industries. Since a share of stock represents a share of ownership in a company, the value of such shares declines along with the value of ownership.

The Dow-Jones Average would have to reach about 2,850 for a real all-time high. That would be a real signal that the United States was back on the road to prosperity. But we won't see that day until we significantly reduce the tax burden on Americans (especially double taxation of dividends), deregulate the economy, and stop discouraging savings and investment. Then maybe someday we will see a headline that reads "After 20 Years, Dow Passes 1965 High." ■

Small Business (Cont. from p. 1)

cording to a study by the Office of Management and Budget, during the period 1953 to 1973, firms with less than 1,000 workers accounted for half of all major U.S. innovations per employee in research and development. A National Science Foundation study found that small firms produced 24 times the number of major innovations per R&D dollar of large firms.

Small business's contribution to the economy has been declining in recent years, however. This is basically because of a significant increase in government regulations, tax policies that are biased against entrepreneurs and small business, and a generally unhealthy economic climate created by government macroeconomic policies, especially those which cause inflation.

Regulation

Increased regulation is undoubtedly the most significant factor in the recent decline in productivity and small-business innovation. Since regulation is largely an "overhead" cost, the larger a firm's output the more the cost can be spread out, lowering the burden of the regulation on a per-unit basis. Thus, government regulation impacts most heavily on small firms.

Another way in which regulations are biased in favor of large firms is in the manner in which they are imposed. Large firms can afford to employ Washington lobbyists who hear about new regulations as soon as they are proposed, and are often able to effect changes in such regulations before they are finalized in ways which reduce the impact for their firms. Moreover, since the rise of significant federal regulation is relatively recent — dating from about 1968 — the activities of many long-established firms were "grandfathered in." For example, the Clean Air Act makes it very difficult to build a new manufacturing facility in many parts of the country if it adds even the smallest amount of new pollution to the atmosphere. But existing plants may continue to operate as they always have. The effect, again, is to protect established firms at the expense of new ones.

Of course, in many instances the reduction in competition is not just a side-effect of regulation, but its intended effect. New firms were effectively barred from such important industries as communications, broadcasting, finance, trucking, and airlines when the federal agencies were created to regulated competition in these industries. For example, until the recent deregulation efforts begun under President Carter, no new companies had been allowed into the interstate airline business for over 40 years. Those few interstate airlines in existence when the CAB was created had, in effect, been granted a government monopoly.

Other federal regulations which impact disproportionately on newly established firms and small businesses include the minimum wage law and occupational safety and health regulations. This is because small companies tend to be more labor-intensive than large firms, meaning that anything that increases their labor costs will have a much more significant impact on them than on a large firm. In this respect, one might also mention that labor unions have the same effect. This is why the "Right to Work" states have been so much more successful in attracting new firms in recent years than the heavily unionized states of the Northeast and upper Midwest. The unions know this, but their attitude is that it is much better to have a few large firms to bargain with than many small ones, which may just go out of business rather than face unreasonable union demands.

Tax Policy

Tax policy is another important factor in discouraging competition and innovation. This is because marginal tax rates — the tax on each additional dollar earned — are still very high, while business tax incentives are generally available only to large corporations.

When one thinks about business taxes it is common to think only of the corporate tax. But the reality is that the vast majority of businesses in the United States are either sole proprietorships or partnerships, not corporations. In 1977, for example, there were 11.3 million proprietorships in the U.S. and 1.2 mil-

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lion partnerships which filed tax returns, compared to only 2.2 million corporations. This means that the individual income tax law is of vastly greater importance for most businesses than the corporate income tax. The significant fact about this is that the personal income tax is steeply progressive, and the highest individual income tax has always greatly exceeded the maximum corporate tax rate. Consequently, taxes take from the individual entrepreneur or small businessman a much higher percentage of any profit that might be made from a new invention or major innovation than it does from a corporation.

Of course, taxes may also take a significant portion of a large company's "windfall" profits as well. But large companies need those profits a lot less than a small company does because they have already accumulated their capital. Indeed, in the case of many large corporations like Ford Motor Company, General Motors, Exxon, and U.S. Steel, their capital was accumulated before the income tax even came into existence. But more important, for a large corporation, many features of the tax code are available to help reduce its effective tax liability that are generally unavailable to the small businessman or entrepreneur. As a consequence, the tax code actually imposes higher average tax rates on small businesses. For instance, in 1979 firms with assets of less than $5 million had an effective tax rate of 41% on average, compared to a 29% effective rate on firms with assets of over $1 billion.

The reason for this is that large corporations tend to be more capital-intensive, and most of the important incentives in the tax code are designed to encourage capital investment. These include the investment tax credit, which allows a credit against tax liability of 10% of the purchase price of capital equipment, and the accelerated cost recovery system, which allows firms to depreciate capital assets at a rapid rate. Also, large corporations are more likely to have legal specialists who are knowledgable about these and other special tax measures which are either unknown to small businesses or too complex for them to bother with. A recent report by the House Small Business Committee noted that although the foreign tax credit and investment tax credit are available to all businesses, the major portion of their benefits go to only 1,300 firms — less than one-tenth of one percent of all U.S. corporations.

Other tax measures which discriminate against small businesses and entrepreneurs include the Social Security tax, which raises labor costs; estate and gift taxes, which often make it impossible to keep small businesses and farms in the family; the deductibility of interest payments, which helps large companies that are able to borrow capital, rather than small firms that must raise their capital through equity; the capital gains tax, which discourages investment in new enterprises, where the profit is more likely to show up in asset appreciation rather than earnings; and tax policies which discourage saving, thereby making it difficult for an entrepreneur to raise equity through his own means. Consequently, the House Small Business Committee recently concluded that "the practical effect of Federal tax policy has been the tendency to encourage the growth of large firms at the expense of the small."

"Government regulation impacts most heavily on small firms and least heavily on large ones."

Macroeconomic Policy

The federal government's macroeconomic policies have also discouraged and hurt small businesses at the expense of large firms in recent years. The constant ups and downs in the economy created by erratic monetary and fiscal policies inevitably impact disproportionately on small businesses, because they have less capital to carry them through bad times and because they tend to be marginal suppliers to large firms. Thus, when the auto industry suffers, the major impact is on the small firms that supply parts and services to the Fords and General Motors. Inflation also affects small firms disproportionately because large, well-established firms are more likely to be able to pass through increased costs than small firms whose products are less well-known.

In addition, the federal government hurts small firms by running budget deficits, which crowds them out of capital markets; constantly changing the "rules of the game" by switching tax, spending, and regulatory policies before its previous policies have even been absorbed; by propping up large firms with political pull, like Chrysler, while making no similar efforts to aid smaller firms which may have the same problems; by making it difficult for small firms to do business with the government, due to redtape requirements and being slow to pay its bills; and by gearing most of its nontax business incentives largely toward big business, as in the case of the Export-Import Bank. In 1980, for example, 27% of the Ex-Im Bank's loans went to just one big company — Boeing — and another 40% was divided among only six firms.

Economic Consequences

The result of all this has been the increasing concentration of American industry, a decline in inventiveness and innovation, and declining productivity, which ultimately means a declining standard of living. People are well aware of these facts, but they tend not to blame the federal government for them. Instead, they tend to blame the big corporations themselves, OPEC, the Japanese, or a decline in the work ethic. Consequently, most of the solutions that are advanced propose *more* government intervention in the economy rather than *less*.

Much in vogue these days is the idea that government should promote an industrial policy or "reindustrialization." The idea behind an industrial policy is that government planners can somehow pick winners and losers in the marketplace. The winners would be helped by government, in the form of low-interest loans, protection from foreign competi-

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An Interview With F.A. Hayek

December 1, 1982

In December the Cato Institute launched its Distinguished Lecturer Series with an address by F. A. Hayek, 1974 Nobel laureate in economics and author of numerous books, including The Road to Serfdom; The Constitution of Liberty; Prices and Production; Monetary Theory and the Trade Cycle; *and* Law, Legislation, and Liberty, *Professor Hayek is now working on a book entitled* The Fatal Conceit, *which will deal with socialism and central planning in all its forms. Before his lecture, Professor Hayek granted the following exclusive interview to* Policy Report.

Policy Report: What role can a public policy institute, like the Cato Institute, play to limit the size of government and increase individual freedom?

Hayek: Well, I can't speak about particular institutes, but the one institution of that sort which I have watched from the beginning and for the existence of which I am in some sense responsible, is the Institute of Economic Affairs of London, which was created by Antony Fisher. He thought you could sway mass opinion. What I insisted and what was strictly followed by the Institute was not to appeal to the large numbers, but to the intellectuals. My conviction is that, in the long run, political opinion is determined by the intellectuals, by which I mean, as I once defined it, the secondhand dealers in ideas — the journalists, schoolmasters, and so on. In fact, socialism is very largely an affair of the intellectuals and not the working class.

So the Institute began publishing little brochures or pamphlets dealing with a few political issues on a level intelligible to the intelligent, but not technically educated, person. They are not writing for the economist, nor for the general public, but for the educated man, represented by schoolmasters and journalists and so on.

It has taken a long time to prove its success. And for a time I did wonder whether or not I was thinking correctly. I now think it has become the most powerful maker of opinion in England. By now, book shops usually have a special rack of Institute of Economic Affairs pamphlets. Even people on the left feel compelled to keep informed of the Institute's publications. And I think that if you are looking for a program here in the United States, you can do no better than to study the Institute's publications catalogue.

PR: Do you think monetarism has failed? And what would be wrong with enforcing a monetary rule that limited the growth of high-powered money?

Hayek: I don't know what monetarism is. If monetarism just means a good old-

fashioned quantity theory, of course it has not failed. If it means the particular version of Milton Friedman, I think it has because he imagines that he can achieve — ascertain — a clear quantity relationship between a measurable quantity of money and the price level. I don't think that is possible. In fact, just about 40 years ago in the opening sentences of my book, *Prices and Production,* I wrote that it would be a great misfortune if people ever cease to believe in the quantity theory of money. It would be even worse ever to believe it literally. And that's exactly what Milton Friedman does. He imagines that it is possible to prescribe to the monetary authorities a definite rate at which "the " quantity of money must be allowed to increase. I must say that I don't know what "the" quantity of money in a measurable sense is. It has become so complex. There is a distinction between M1, M2, and so on. I don't think there is such a simple relationship.

When you mean by monetarism that you can instruct the monetary authorities — the Federal Reserve System — to adjust the quantity of money to keep the price level stable, I believe that is correct. But they have to find out by experimentation what they have to do to keep the price level stable. If you understand correctly what Milton Friedman believes, that you can tell them to increase some particular observable quantity by 3% a year, I think it is nonsense. I say this although Friedman is a great friend of mine, and I admire most of his views, but his quantitative approach to economics seems to me to involve a gross oversimplification of what things really are like.

PR: What steps would you recommend to return the United States to stable economic growth and prosperity?

Hayek: What I can say about the United States is exactly the same that I've been preaching in England since Mrs. Thatcher has been in power. It is politically possible to cause, by braking inflation, 20% unemployment for six months. It is not politically possible to create 10% unemployment for three years. If you do it quickly even a very high rate of unemployment can be tolerated. If you try to do it slowly and gently, you are bound to fail, because people in the long run will not put up with it. But they will accept it if it comes quickly.

I think every termination of inflation, which is without doubt the most important thing to do, has to be done much more quickly than it has been done in England. It wasn't Mrs. Thatcher's fault; she knew she couldn't get her cabinet to follow her view. She admits as much. In fact, I heard her say, "My one mistake was to go on much too slowly. I ought to have done it much more quickly."

I think the same thing is in a measure true of the United States. You have done

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F.A. Hayek (Cont. from p. 5)

much better. You have, since Reagan came into power, reduced inflation very considerably. But one thing I might add is that reducing inflation is of little use unless you bring it down to zero inflation. Anybody who argues that a little inflation is all right, is completely wrong because inflation stimulates things only as it accelerates. If you rely on a little inflation, you are bound to increase it. You are driven into increasing inflation. So the aim must be not to reduce inflation, but as rapidly as possible to get back to a stable price level.

PR: One thing that some of the Reagan advisors have talked about is applying a cost/benefit test to regulations. Is it possible to measure costs and benefits and is cost/benefit analysis a sufficient program for deregulation?

Hayek: If you take "measure" literally, certainly not. But so far as you can estimate them roughly, they must be your guide. I think what you soon arrive at is that for practically all regulations the costs are greater than the benefits. It is simpler to argue against regulations as such than to pretend that you can single out those where clearly the costs are greater than the benefits. There is good sense behind the cost/benefit argument, but I don't think it's of great practical value.

PR: What reforms would you propose in our monetary system?

Hayek: Well, I have despaired of ever again finding a way of restraining government abuse of any money which it issues. My proposal to denationalize money was always in a sense utopian because governments will never freely allow competition in this business. I believe there are ways around this, and my present view — which I hope before long to state in detail — is that there is probably a possibility of not issuing currency but starting with credit accounts under some other name — say, call the unit a "stable" and promise to redeem it with enough of whatever current monies are required to buy a certain list of raw materials. So it doesn't involve issuing any circulating money, but it enables the holder to keep a stable unit in the form of a credit. Once you've succeeded in this, the next step would be issuing credit cards on these accounts. And then you have circumvented the whole monopoly of government.

Since it is politically impractical to deprive the government of its monopoly, you have to circumvent it.

PR: Other than monetary reform, what sort of limits or constraints do you think it is feasible to put on government in a Western democratic society?

Hayek: I think it requires a change in the constitutional arrangement. We have really to redo in a different manner what the world tried to do in the 18th century when they hoped that the principle of the separation of powers was *intended* as a restriction on democracy. It hasn't done so. I think we have to invent a new way.

PR: Professor Hayek, when did you realize the important incentive and information functions played by market prices?

Hayek: Well, it's a very curious story, in a way, that I was led to put the emphasis on prices as a signal of what to do. It was an essay I wrote in 1936 called "Economics and Knowledge." That was originally written to persuade my great friend and master, Ludwig von Mises, why I couldn't accept all of his teaching. The main topic of the essay was to show that while it was perfectly true that what I called the logic of choice — analysis of individual action — was, like all logic, an *a priori* subject, Mises' contention that all the analysis of the market was an *a priori* thing was *wrong,* because it depended on empirical knowledge. It depends on the problem of knowledge being conveyed from one person to another.

Federal Reserve Board Governor Henry Wallich talks with Hayek at Cato Institute reception.

Now, curiously, Mises, who was so very resentful generally of critiques by his pupils, even praised my article, but he never seemed to recognize to what extent it meant a diversion from his own fundamental conception. And I never got him to admit what I really imagined to be the case, that I refuted his contention that the analysis of the market economy was an *a priori* function, that it was a fully empirical matter. What was *a priori* was a logic behind it — a logic of individual action — that when you pass from the action of one individual, there occurs a causal process of one person acting upon another and learning. And this could never be *a priori.* This must be empirical. And pursuing this thought is how it started. This led me to investigate how important the prices forming on the market were as guides to individual action. And it is since that date, since what originally was a criticism of my master, Mises, that I have developed this idea of the guide function of prices which I regard as more and more important, which I have applied in its effect on price fixing, on rent restriction, on capital investment.

All through, what it comes to is that we can achieve a condition of correspondence of separate effort only if we rely on prices as guides which tell people what to do.

I am personally convinced that the reason which led the intellectuals, particularly of the English-speaking world, to socialism was a man who is regarded as a great hero of classical liberalism, John Stuart Mill. In his famous textbook, *Principles of Political Economy,* which came out in 1848 and for some decades was a widely read text on the subject, he makes the following statement as he passes from the theory of production to the theory of distribution: "Once the product is there, mankind — socially or individually — can do with it whatever it pleases." Now, if that were true I would admit that it is a clear moral obligation to see that it is justly distributed. But it isn't true, because if we did do with that product whatever we pleased, it would never be there again. Because if you ever did it once, people would never produce those things again.

PR: Professor Hayek, we're hearing much today about the threat to world trade through new rounds of protectionism. What advice would you have to political leaders and also to the people of Western countries who might be concerned about new protectionist measures?

Hayek: Perhaps I am over-optimistic — but one thing has been understood, at least by the more responsible people, that nothing did more to intensify the depression of the 1930s than the return to protectionism. I have not yet found anybody who, once he was reminded of this fact, would still continue to believe that it might be necessary to reintroduce protection.

PR: In your recent interview with the *New York Times* you said, "Keynes was one of the most intelligent people I knew, but he understood very little economics." How do you account for his great influence in policy-making circles as well as in the academic community?

Hayek: Well, that is a very profound problem. He was in complete agreement with the philosophical movement which had invaded that generation, what I'd call intellectualist or constructivist ideas derived from many decades of French philosophers. These ideas taught: Don't believe anything which you cannot rationally justify. This was at first applied to science, but then was equally applied to morals. "Do not regard as binding upon you any morals which you cannot intellectually justify." Now that meant in the person of Keynes two things which he himself stated. He admitted publicly that he had always been an amoralist. And that involved the famous statement — in the long run we are all dead. Now the great merit of traditional morals is that they have evolved and developed by long-run effects which people never foresaw and understood. And the merits of the institution of private property and of saving are that in the long run those groups that adhered to them prospered.

Similarly, the function of the market system, the benefits of it, are effects beyond our vision — beyond our comprehension. Now, any philosopher who says, "I should admit only what I can rationally justify," must exclude effects which are not foreseeable, must refuse to acknowledge a moral code which has been evolved because of its de facto effect. The utilitarian theorists believed, and Mises strongly believed, that man had chosen his morals with an intelligent understanding of the good effects. But that is wrong. Most of the effects of the moral we can't foresee. They are beyond our vision.

The effect is that on the market especially we can serve people whom we do not know. We can profit from the services of people we do not know. In short, we can form an order of activities far exceeding our comprehension. The same is true in our action for the future. Our morals teach that saving is a good thing, because it will help future generations, but that is not a thing we know from experience. All we do know is that those social groups in which saving was a virtue have prospered, and they gradually displaced the others. We simply must realize that our traditional morals are not to be approved because we can show how they are beneficial to us, but only because they have been proved in a process of selection.

By selection I sometimes speak of the natural selection of religions: those religions which preached the right morals survived and enabled the group to multiply. It is not the intelligence of our ancestors that has left us with more efficient morals, but — as I like to express it to shock people — our ancestors were really the guinea pigs who experimented and chose the right ways which have been transmitted to us. It was not neces-

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F.A. Hayek (Cont. from p. 7)

sarily their superior intelligence. Rather, they happened to be right, so their successes multiplied, and they displaced the others who believed in the different morals.

So the difference between Keynes and me is really based on different beliefs about the foundation of ethics. Keynes believed — asserted — "I am only prepared to believed in such rules the effects of which I can see." But, in fact, civilization has formed by man learning to conform to rules of action, the effects of which were far beyond his vision. I've just come up with a new formulation which I rather like, that the invention or the development of the market amounts to the invention of a new sense organ in effect, similar to the evolution of sight in addition to the sense of touch. The sense of touch gives information only about the immediate environment as far as we can feel. The formation of the sense of sight in the evolution of animals enables us to take account of a much wider environment, but one still visible to our senses. Now, the market has become a sort of, as the biologists call it, extra-somatic or external sense organ, which informs us of things of which we are not aware physically. We cannot see the benefits of our action. We cannot see where our benefit come from, but we have developed a mechanism that serves as an organ of information operating very similarly to the sense organs, but enabling us to adjust our action to events which are beyond our sensory perception.

PR: What flaws do you see in current free-market economic thinking?

Hayek: I have two defaults in my activities which I frequently regret. The one is that when Keynes, after I had devoted so much time to criticism of his *Treatise on Money,* thought out his general theory and told me no one believed in what I spent so much time to criticize, I did not return to the charge and never systematically attacked the *General Theory.*

And the second thing which I regret is that when Milton Friedman, who was a close colleague and friend, preached positivist economics, I did not attack his positivist economics. Positivist economics is really based on the same idea that we can form appropriate policy on the assumption of complete knowledge of all the relevant facts. In fact, the achievement of the market system is that we can do much better than we would do if we relied only on what we positively know. We can make use of this signaling system, as I call the market, which informs us of things which we cannot directly perceive or which are only transmitted to us — and that applies both spatially and temporally. We learn to adjust ourselves to the events which are beyond our vision spatially, which happen on other continents, and we learn to adjust ourselves to things which will happen in the distant future which we cannot see. The mathematical economists in particular talk of the "given" knowledge, the "given" data. Note how the use is placed to cause reduplication: "Given data" means "given" "givens." If they suspect that things are not really given to them, they reassure themselves by calling them "given data"; in fact the data are hypothetical assumptions. Nobody knows all of the data. They only become operative and enable us to form an appropriate order by this transmission system of the market, where through many relays and changes what happened somewhere in New Zealand still affects my action by affecting wool prices or land prices and guiding me in what to do.

So it's all a guide, as I put it before, an information system, something, which, incidentally, Adam Smith said over 200 years. In many respects I find more wisdom in Adam Smith than in most of the later classical economics (not to speak of the famous mathematical economics) which is very beautiful and very true if you assume all of the data are known, but becomes nonsense when you remember that these data are not known to anybody.

PR: Do you think that positivism as a methodology, as a way of thinking, tends to incline economists toward believing that they can fine-tune and intervene in the economy to achieve predictable results?

Hayek: Yes, very much. I started as a positivist myself, in the Ernst Mach group in Vienna. I gradually changed — and in spite of Mises' argument against positivism, I would say that even Mises was still at heart a positivist who had not completely freed himself from its assumptions, which in a way really go back to Rene Descartes. The whole basic idea of positivism — that our knowledge is based on given observations of the external world — goes back to Descartes.

PR: Professor Hayek, just one last question. What should be the role of the economist as a policy advisor?

Hayek: You can either be an economist or a policy advisor. Now, just let me in conclusion tell you another story of which I have only become recently aware. You know I have moved about a great deal from country to country, but certainly it drew my attention that in each case I've cleared out as soon as I was threatened to be used for government purposes. In Austria, at the end of the '20s or beginning of the '30s, I was just for the first time called to sit on a government committee. Within six months I was out of the country.

In England I took a little longer. At the age of 19 years I had been for the first time used on a mission of the colonial office and six months later had left the country. In the United States, where I was for 12 years in Chicago, it never got quite as far because by the time I was asked to sit on a government committee I had already committed myself to leave the country. By moving around the world I have avoided that corruption which government service regularly involves.

And more sadly, I have seen in some of my closest friends and sympathizers — I won't mention any names — who completely agreed with me, how a few years in government corrupted them intellectually and made them unable to think straight.

I suppose you all know the famous story of the one-handed economist. An American chief of one of the big corporations advertised for a one-handed economist. His associates were very puzzled as to what he meant. He replied, "Oh, I want a person who doesn't say, 'on the one hand and on the other.'" And I'm afraid that all the people who have been in government service have become two-handed economists who think in terms of one hand and the other. If one has kept out of government service, one remains a one-handed economist who believes there is a clear way in which we ought to proceed, but one maintains this conviction only so long as one stays out of government. All my friends who have gone into it and stayed for any length of time have, in my sense, been corrupted. ■

Small Business (Cont. from p. 4)

tion, and other measures, while the losers, in theory, would be killed off. The great unanswered question is how government planners will be able to do a better job of picking winners and losers than the market does. Is it really reasonable to believe that some government bureaucrat will be a better judge than those who risk their own money trying to do the same thing? Of course not. Consequently, the only likely result of a government industrial policy will be bailouts for losers with political pull.

It's not a coincidence that those politicians most interested in promoting an industrial policy are from the industrial Northeast and upper Midwest, where dying industries like autos, steel, and textiles are located. Politicians from the Sunbelt, on the other hand, where most of the high-growth electronics and aerospace firms are located, know that such firms have no need for government assistance, and fear that their states will end up being taxed to save the "white elephants" of the North.

What is most unfortunate is that the Reagan administration's economic policies were originally intended to redress the imbalance in our economic system by encouraging entrepreneurship, innovation, and risk-taking through reduced taxes and spending, regulatory reform, and a stable anti-inflationary macroeconomic policy. The administration's failure to implement its own policies correctly and to restore prosperity is leading us toward economic planning under the guise of reindustrialization. Even some conservatives, like Kevin Phillips, are now saying a free-market economic policy will not work and that an industrial policy is required.

A Renewed Understanding

What is needed is a renewed understanding of the importance of the entrepreneur and the small businessman in the economic system, and the adoption of policies to reduce the barriers to enterprise, risk-taking, innovation, and invention. This will require further reductions in marginal tax rates for individuals and revision of tax laws which now primarily benefit big corporations.

In the original Reagan package, the principal focus was on reducing marginal income tax rates for individuals, so that there would be an increased after-tax reward for work, saving, and investment. Instead, the individual income tax cuts were watered down, while the big corporations, with their high-powered lobbyists, managed to greatly enlarge their tax breaks.

The incentives for small business, by contrast, were so watered down that the major small business organization, the National Federation of Independent Business, almost opposed the tax bill at the last minute. Now, of course, even the limited effort to create an incentive-oriented tax policy has been abandoned by the Reagan administration, which now believes that tax *increases,* not tax reductions, encourage economic growth.

Also, a renewed commitment needs to be made to real reductions in government spending and regulations. Until now we have barely been able to hold the line on the growth of spending and new regulations. To be sure, the President cannot do this alone. He needs Congress to enact the necessary legislation. But first President Reagan needs to admit that we have not done enough to carry out the program he originally articulated.

No doubt many of the current problems facing business will evaporate when the business cycle moves up again and when interest rates decline from their recent high levels. But we should not allow this to blind us to the critical, long-term structural problems with our economy that are caused by policies which discourage competition and entrepreneurship. ■

Economic Freedom and the Third World

Development Without Aid: Growth, Poverty and Development, *by Melvyn B. Krauss. McGraw-Hill for the Manhattan Institute, New York, 1982. 208 pp. $17.95.*

Development Without Aid shatters one myth after another about less-developed countries (LDCs), deftly utilizing economic principles, rigorous argumentation, and a wealth of empirical data. Krauss compares the performances of those Third World economies that allow a significant degree of economic freedom and initiative (notably Hong Kong, South Korea, Taiwan, and Singapore) with those that restrict economic freedom and suffer from more state intervention and usurpation of the voluntary sector. He shows how economic prosperity and free markets, as well as statism and poverty, are closely related.

The first three chapters examine internal LDC policies affecting income redistribution, state direction of investment, protectionism, and taxes. In making his case for free trade, free markets, and low taxes, Krauss points up the class biases of many development economists and the exploitaive nature of state action, and describes the dynamic process by which nominally democractic welfare-state LDCs become tyrannical military regimes.

The rest of the book deals with the process of spreading prosperity, the role of multinational corporations in the LDCs and in the world economy, the impact on LDCs of the domestic welfare-state policies and income transfers of the industrialized nations, and LDCs and international monetary relations. Here Krauss goes beyond the insights of renowned development economist P.T. Bauer, known for his iconoclastic analyses and free-market conclusions, with his unique analysis of the role of the industrialized welfare states in stifling the development of LDC economies and in keeping their populations in poverty.

As Krauss concludes, "the biggest obstacle to the economic development of the Third World is big government, both in the Third World itself and elsewhere. Big government in the northern industrialized countries has damaged the LDCs by restricting international exchange. Big government in the South has constrained economic growth there by taxing the dynamic competitive sectors of the LDC economies." Krauss's book is not only a powerful antidote to those who would condemn the Third World to perpetual poverty through the growth of parasitic states, it also provides a model for economic development without foreign aid.

Balanced Budgets, Fiscal Responsibility, and the Constitution, *by Richard E. Wagner and Robert D. Tollison, Alvin Rabushka, and John T. Noonan, Jr., Cato Institute, Washington, D.C., 1982. 109 pp. $6.00.*

Policy Report Reviews

Thirty-one states have passed resolutions calling for a constitutional amendment to balance the federal budget, just three away from the number necessary to force Congress to pass an amendment or call a constitutional convention for the purpose. This volume presents several analyses of the issues surrounding this controversy.

Economists Richard Wagner and Robert Tollison examine the question of putting fiscal limitations in the Constitution. They argue that a political bias in favor of deficit financing is inherent in a democracy because there are incentives for politicians to spend and political costs associated with taxing. This deficit spending, which has accelerated tremendously over the last two decades, has created serious economic problems. Some critics of deficit spending would nevertheless object to a constitutional amendment, but Wagner and Tollison argue that fiscal responsibility is unlikely to be achieved without it. They also analyze some of the specific issues involved in writing an amendment and implementing it. Finally, they point out that a balanced budget is not the end point but the first step toward fiscal responsibility and suggest some of the remaining steps that would need to be taken.

Alvin Rabushka of the Hoover Institution extends the argument into the present political context, examining the failure of the Budget Act of 1974 and the impact of deficit spending over the last 20 years. Rabushka analyzes in detail S.J. Res. 58, the specific amendment that was considered in the 97th Congress and will likely be reintroduced in the 98th.

Legal scholar John T. Noonan, Jr., discusses the various methods for amending the Constitution. He convincingly argues that the Founders expected amendments to be proposed by the states and that there is nothing inappropriate about the procedure. In addition, he argues that constitutional conventions can be limited to one subject, preventing the threat of a "runaway" convention.

National Health Policy: What Role for Government?, *edited by Isaac Ehrlich. Hoover Institution Press, Stanford University, 1982. 424 pp.*

The 10 essays in this volume (plus comments and an epilogue) carefully analyze the success of socialized medicine — specifically in Great Britain, Australia, and Germany — and the present state of the health care industry in the United States. The book, with its often illuminating studies of intervention into medicine, is instrumental in demonstrating the flaws of collective medicine.

One of the best pieces is Cotton Lindsay's investigation of the British National Health Service. His hypothesis is that in nationalized services run by bureaucracies more resources will be allocated to those uses that are monitored by high-ranked officials than would normally be done in a competitive market. For instance, if the officials want a certain amount of a drug administered, the functionary administering that drug will have this goal in his mind — hence deemphasizing the question of its appropriateness. Lindsay convincingly demonstrates the applicability of this principle in Britain's case. He concludes, "As many of the characteristics of health output may not be economically monitored, and thus are invincible, the incentives of these organizations influence the diversion of resources from such invisible characteristics of output as patient comfort, information, and convenience toward visible (monitored) aspects as patient-days."

While the criticisms of socialization are often good, unfortunately the empirical work is supported with only a weak theoretical framework, and the volume's own free-market proposals are equally half-hearted. Throughout the book we find authors advocating guaranteed premium subsidies, transfer payments, voucher systems, community-rated subsidies to lower income individuals, tax credits for insurance, and sundry other measures designed to bring us closer to privatization. In general, the proposals have the flavor of stabilization.

A conclusion based on a solid understanding of the nature of market-provided or nationalized services, and on the empirical work presented in this volume, would be much more clearly oriented toward the removal of government from the health-care field. Nevertheless, the essays in this book offer a useful analysis of the effects of government intervention in medicine.

Meeting Human Needs: Toward a New Public Philosophy, *edited by Jack A. Meyer. American Enterprise Institute, Washington, D.C., 1982. 469 pp. $34.95/$13.95.*

The 17 articles making up this volume form the basis of an agenda for reform. As Meyer says in his introductory essay, "This study evaluates the potential of the private sector for delivering a wide range of human services to alleviate social problems. It also assesses the effect of government programs and policies on nongovernmental organizations." The goal of the book is to point out that most social problems actually occur on the local level and that therefore a policy that would encourage increased local government activity and the privatization of government services should be welcomed. The editor feels that as social needs change, the structure of government programs should change to meet them. Today's circumstances are especially conducive to this local/private movement because the federal bureaucracies that now perform the services have become extremely inefficient and inflexible. Also, the mounting deficit would be greatly relieved by the decrease in spending. However, the book fails to present a viable alternative to today's crisis.

The alternative this book offers can be called a localized partnership between public and private forces. To improve the youth employment situation, for instance, it is suggested that government agencies and private institutions work together to place individuals and develop programs. The public/private partnership is also proposed for education — setting up apprenticeships and on-the-job-training — and for health care, pharmaceutical development, youth crime prevention, child welfare, and other social issues.

The fatal flaw of the book is its failure to acknowledge that government power always tends to flow upward. This renders the idea of decentralization utopian. There simply are not sufficient public or private decision makers with an interest in restructuring government programs in the manner suggested.

The Gateway: U.S. Immigration Issues and Policies, *edited by Barry R. Chiswick. American Enterprise Institute, Washington, D.C., 1982. 476 pp. $22.95/12.95.*

This volume contains the proceedings of a 1980 conference entitled "U.S. Immigration Issues and Policies." The conference papers, the comments, and the transcribed discussions are all reprinted in this book. The contents represent several different points of view, with contributors from such fields as economics, history, political science, and sociology.

There are four sections: the supply and demand for immigrants, the progress of immigrants, the economic impact of immigrants, and alternative immigration policies. Sections two and three are particularly informative. Chiswick's "The Economic Progress of Immigrants: Some Apparently Universal Patterns" attacks the time-honored myth that immigrants create a permanent class of low-income citizens who live off welfare. Data from the 1970 census show that although economic migrants have an initial earnings disadvantage in comparison with native Americans, the immigrants reach earnings equality across demographic groups within 10 to 15 years. Furthermore, the sons of immigrants earn 5 to 10% more than the sons of native Americans with the same demographic characteristics.

The most interesting paper in the third section is Julian Simon's "The Overall Effects of Immigrants on Natives' Incomes." Simon concludes that the long-run productivity benefits accruing from immigrants as well as their contributions to Social Security far outweigh the costs of additional immigration.

While there is some excellent research in this volume, as a whole its quality is uneven. Too much attention is given to economic model-building and not enough to the free immigration alternative. For those interested in immigration policy, however, *The Gateway* should prove to be a useful source of information as well as a fairly balanced overview of many of the issues involved.

Coming up in Policy Report:

Bank Failures and Bank Regulation

Telecommunications and the 98th Congress

Privatizing the Infrastructure

Alvin Rabushka on the Flat-Rate Tax

"To be governed . . ."

Make the farms work like the KGB

Where Andropov and the Soviet intelligentsia come together is in wanting what this society and its stumbling economy most need — a stiff dose of discipline. . . .

There are elements in this country [Soviet Union] which perform effectively. The army, the KGB, and various professional academies do what they are supposed to do. In those institutions, morale is high and people work hard. There is a system of rewards and penalties, and a clear sense of discipline.

Much of the rest of this country, however, lacks tautness. . . . Managers knowingly produce shoddy goods. Workers are often drunk or absent. Except when allowed to produce for themselves, peasants turn out the bare minimum.

—Joseph Kraft in the *Washington Post*, Dec. 23, 1982

Good news on the home front

More than 30,000 top U.S. aides — lawmakers, astronauts, administrators, scientists, and cabinet officers among them — will get pay raises retroactive to last week as a result of the stopgap federal funding bill President Reagan signed into law yesterday.

Most people getting the raises live and work in metro Washington.

—*Washington Post*, Dec. 22, 1982

Calling Thomas Jefferson

Two outgoing members of the U.S. House of Representatives said yesterday that the high cost of running for public office is corrupting the nation's political system. . . .

Both blamed a Supreme Court ruling that there can be no constitutional limit on the amount of money spent on a congressional campaign for some of the problems.

"I think that's wrong; it overdoes freedom of speech," [Wisconsin Democrat Henry] Reuss said.

—*Washington Post*, Dec. 27, 1982

And keep the change

About 300 contributors to a political fund-raising group for Walter S. Orlinsky are getting refunds but have been told they can donate the money to a legal defense fund for the former [Baltimore] City Council president, who is serving a six-month prison term for extortion.

—*Washington Post*, Dec. 21, 1982

A rose by any other name

Mr. Chairman, there is an expression that says, "clothes make the man," or I guess these days we say, "clothes make the person." The relevance that that little expression has to this legislation today is, I think, worth noting.

On several occasions during the last 4 or 5 years, during the administrations of the last two Presidents, efforts were made to pass legislation very similar to that which we are considering today. Those efforts were not only unsuccessful but were overwhelmingly defeated. . . .

But we have now dressed the "person" in some different clothes. It is no longer a gasoline tax, it is a user fee. It is no longer a highway bill, it is an infrastructure improvement program. And no longer is it simply to build highways with a user fee; it is a jobs bill.

So we have taken essentially the same piece of legislation, which may have been needed for quite some time and because we have dressed it in some new clothes and made it no longer a tax but a user fee, no longer a highway bill but an infrastructure improvement program, and above all, a jobs bill, we are now going to see, in my judgment, many Members of this body support this legislation and pass it tonight.

—Rep. Elliott Levitas (D-Ga.) on the floor of the House of Representatives, Dec. 6, 1982

Grim tidings

Women and minorities in the federal work force again bore a disproportionate share of the layoffs and other job actions that have grown out of Reagan administration budget cuts. . . .

Rep. Michael D. Barnes (D-Md.), who is chairman of the task force, called on President Reagan yesterday to halt the layoffs with a moratorium, asserting that the federal government should not add unnecessarily to an unemployment rate that already stands at 10.8 percent. . . .

A total of 1,393 federal employees [out of 2.1 million civilian employees] were laid off nationwide in the three months ending in June 1982.

—*Washington Post*, Dec. 30, 1982

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