

## THE POLITICAL ECONOMY OF TAXES FROM A FREE-MARKET PERSPECTIVE\*

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Gene Epstein\*

If I am invited by an organization named after Murray Rothbard, then I always say “yes!” Unfortunately, this was the first time in my life I was invited by an organization named after Murray Rothbard. He is an economist who should be better known and better appreciated. I have the privilege of having contributed an introduction to a huge collection of Rothbard’s writings, called *Economic Controversies*, and my introduction begins with the sentence: “It was nearly 40 years ago that Murray Rothbard changed my life.” So thank you to the Romanian-American University, and also especially thank you to Alexandru Butiseacă and the Rothbard Center, who invited me to speak before you.

Any successful lecture is ultimately a dialogue between you and the lecturer. I was inspired – and I’m going to mention a left-wing name that maybe some of you aren’t familiar with, Noam Chomsky – who actually influenced me very much. I also noticed that some of my deeper, darker secrets were advertised around this university, since I have revealed them: my mother was a member of the Communist Party, and I was raised to worship Joseph Stalin – maybe you’ve heard of him! – so I evolved a little bit in a certain direction, that is why I hope to be able to tell you on Thursday how to talk to a socialist, since I spent much of my

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life talking to a socialist who happened to be my dear mom, and that started around the age of seven. So I have a lot of experience in that regard.

I want to introduce the topic a little bit by just revealing, by taking five minutes to tell you everything I know about the Romanian economy, because unfortunately it is not a whole lot, but it is a couple of things that I can share with you. First of all, I love and admire Romanian movies, and I do think of Romania as the film capital of Europe. I consider it is an extraordinary achievement, and I don't know where all that talent came from, but I imagine there are some filmmakers in the audience, and I hope you do films as good as the some of those that I have already seen.

What else about Romania that to my mind as an American, as a New Yorker, is extraordinary - and looking around the room maybe none of you were living through these events as I did: in 1988 and 1989, those of you who know something about history know that certain extraordinary events were happening, in and around Romania, extraordinary especially for me, who grew up at the age of seven thinking of the world as divided into socialist and communist, and capitalist. The one thing that we, as New Yorkers, were told that even though the Berlin Wall had fallen, even though the Soviet Union was unraveling, there was one country where the government had the people in its grip. And that was Romania. The next day - as I remember, virtually the next day - the headlines were: The government is overthrown. And if that doesn't teach you, as it taught me, that experts can often be absolutely wrong about the future, if it doesn't teach you, as it taught me, that radical change can happen, then nothing will. Radical change does happen. And of course, the example that I choose usually when I'm arguing with those who resist even the possibility of radical change is to point out what happened in countries like Romania, what happened to the Soviet Union, events that nobody anticipated in 1986 or 1987.

In 1986, the neo-conservatives were calling Ronald Reagan a sellout - and perhaps you know who he was, the president who was supposed to end communism, who was supposed to spell death to the evil empire – they were saying that the way he was cozying up to the communists was bad, and that we will have another thousand years of the evil empire. And then of course, they quickly changed their tune (I'm talking about the neo-conservatives), once these amazing events did happen, and suddenly they were deciding that Ronald Reagan was their hero. Well, that's a story for another day, but that is something else I know about Romania that sticks in my mind, something that I will never forget, the history that you have which is extraordinary and I admire you for it.

Now, let me finally end with the last thing I know about Romania, because unfortunately most of my talk is going to draw on something I do know something about, the U.S. economy: that is Romania's Economic Freedom Index, that's kept by the Fraser Institute and also by the Cato Institute.

### **Romania's Economic Freedom Index**

| <u>1995</u>               | <u>2005</u>              | <u>2011</u>              |
|---------------------------|--------------------------|--------------------------|
| 3.81 (117 <sup>th</sup> ) | 7.08 (54 <sup>th</sup> ) | 7.18 (53 <sup>rd</sup> ) |

The higher the number, the freer you are. I am starting in 1995, when the rating of 3.81 – that's 117<sup>th</sup> in rank – pretty low. Ten years later, there was a huge increase in economic freedom - I could go into how this index is calculated, but we won't have time for that, so I urge to read up on it, to understand it better, because I think it is very revealing of what goes on in countries around the world – the economic freedom index vaulted to 7.08, that is 54<sup>th</sup> out of approximately 140 countries, still below the U.S. And it inched up the most recent number to 7.18, 53<sup>rd</sup> in ranking, because other countries have also improved. And that's a huge

achievement as well, for any country. The U.S. economic freedom index has actually declined. It's still higher than that of Romania, but it rose through the decades of 70s, 80s, and 90s, and then in the year 2000 it peaked, and it is still in decline.

That is what I know about Romania, and now I am going to tell you a few things I know about taxes. I want to start with one underlying theme in line with the radical position I am going to take. This is credo from Google, a company which you may have heard of: *the difficult we can do by this afternoon, the impossible will take a little longer*. That, of course, is a credo for a creative company, but I don't expect that to happen to a country, because a country consists of political forces that are less adaptive to change. But as radicals, we want to believe something like that is possible, we want to believe at least that entrepreneurial companies are capable of that.

I am going now to cone in a couple of other themes before I get into the meat of the talk: another underlying theme about government, as I believe as a free market economist, is that *whatever government can do for us is in direct proportion to what government can do to us*. So there is always danger in that regard. And finally, the underlying theme, a line from Will Rogers, who was a famous American humorist: *be thankful we're not getting all the government we're paying for*. There is a certain virtue in that, in the inefficiency of government. In fact, the idea that the government should be efficient in its purposes has been pushed by many economists, but those of us who wonder about whether government should be arresting people for smoking marijuana, or for snorting cocaine, hope that it gets less efficient in pursuit of those purposes, until, of course, we allow the possibility that all drugs should be legal. To quote Milton Friedman, my friend Camil [Petrescu]'s favorite economist, just as government has no right to tell me what comes out of my mouth, it has no right to tell me what I put in my mouth or my veins. Every man has a right to go to Hell in his own fashion. That's a quote from David Friedman, Milton Friedman's son. I will be quoting a lot of people tonight,

because I don't want to pretend that I am an original thinker. All I want to do is arrange the thoughts of great thinkers and try to gain perspective from them. Now, there's going to be only one mention of Murray Rothbard this evening, even though he is my mentor. When you talk about taxes, then Rothbard's position is so extreme, we can spend the evening wrestling with it. I am going to quote something that is a bit out of context, just to tell you about where he is going and pluck out a phrase.

"The object ... is not to leave the income distribution the same as if a tax had not been imposed. The object is to affect the income "distribution" and all other aspects of the economy in the same way as if the tax were really a free-market price.... No market price leaves relative income "distribution" the same as before. If the market really behaved in this way, there would be no advantage in earning money..." (Rothbard, *Power and Market*)

He is talking about a tax being something like a free market price, and if you follow him in his book, *Power and Market*, he leads you gently to the conclusion that there should be no government at all. That the government's taxation, if it is supposed to replicate the fairness of the free market, is so impossible, that the only alternative is Rothbard's credo, which was anarcho-capitalism. Now, anarcho-capitalism is a tough topic, and we are not going to, but I want at least to pluck out one notion about the tax being something like a free market price. And the person I am going to go with, and then abandon, as you will see in a moment, will be Milton Friedman. Milton Friedman, in relation to Rothbard, was a moderate. As much as he might be called a radical, he was a moderate compared to Murray Rothbard, whose economics were sounder than Friedman's. But in this particular case, I am not going to ask for the impossible; I am going to ask only for the difficult. And the difficult will be difficult enough with Milton Friedman.

First of all, what would Friedman would say about taxes and spending? He says:

“The real cost of government is measured by what government spends, not by the receipts labeled taxes. The goods and services it buys are not available for other use.”

In other words, I was having a debate with my friend Camil [Petrescu (ed.)] just twenty minutes ago, and I was trying to argue that they were resetting debt chairs on the Titanic when talking about taxes. The government taxes us to the extent that it spends, and that is a simple bit of wisdom of Friedman’s.

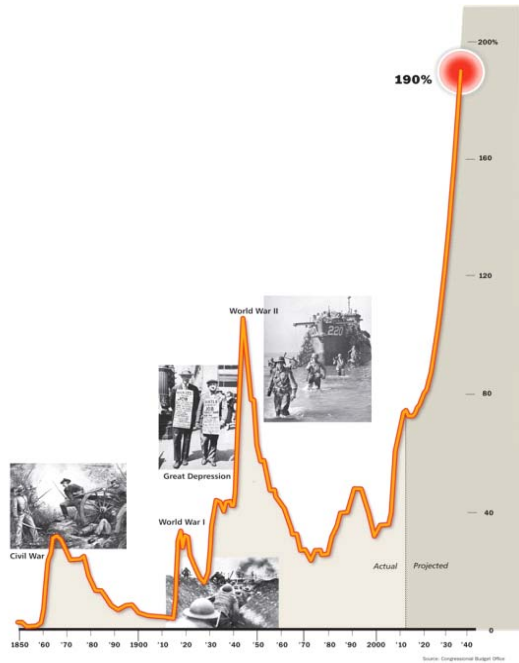
“Suppose government spends \$400 billion and raises \$350 billion in funds labeled taxes. Who do you suppose pays for the \$50 billion difference? The tooth fairy? Hardly. You do.”

So we know to look at the spending side of the ledger. Now I will start abandoning Friedman for particular reasons. Now, Friedman posited what I have done, that is the *teenager model of government spending*. None of you are teenagers, I can tell, so you won’t be offended by this analogy, but some of you were teenagers no so long ago, so you will understand the analogy:

“Contrary to the myth that government arranges its finances by first determining how much it needs to spend, it’s basically the other way around. Just as your average teenager will spend whatever he can lay his hands on, so, too, will government. And the solution is the same: Cut the allowance.”

And indeed, Friedman believed in what has been dubbed by others as *starve-the-beast theorem*:

“My view has always been: Cut taxes on any occasion, for any reason, and in any way that’s politically feasible.”



Starve the beast. That is Friedman talking. I am going to abandon that idea for a particular reason, and this is one empirical reason why: This is the ratio, in the U.S. of treasury debt held by the public, to nominal GDP. It starts in 1850 and takes us up to 2038, which is in the future. The nominal GDP is a proxy for the ability of the economy to support that type of debt, and that is just Treasury debt- the obligation of the U.S. Treasury to the Federal Government. With the Civil War it rose, with WWI and WWII it rose, and then it fell, but then it started to rise. The grey area takes us up to the present. Without a war, suddenly the government's debt is rising, and now there is a line that goes up to 190% into the stratosphere.

That comes not from me, but from the non-partisan, very middle-of-the-road Congressional Budget Office of the U.S. And that is, again, a government organization very establishment, but

they have argued – and I have written something about this in Barron’s – that the U.S. could go the way of Greece, that it runs the risk that the debt will get so out of control, up to 190%, that there will be a financial crisis in the U.S., similar to that of Greece.

When I wrote this article, I got a lot of response, and the response usually took the following form: it was that I was being myopic to compare the U.S. with Greece. Of course, I pointed out to people that actually I didn’t originate that analogy; it came from the Congressional Budget Office. But that was less important. Their point was that Greece owned its debt in Euros, in money it cannot print, and it doesn’t have control over those Euros. The U.S. on the other hand owns its debt in dollars, and we won’t have to default on our debt. All we have to do is print the money. That’s the solution. The 190% is not going to be a problem, let’s just print it and pay for it that way.

Well, those of us who have read a little bit of economics, free market economics from people like Milton Friedman or Murray Rothbard understand that doing it that way means that it is analogous to pouring gasoline on a fire. That could truly lead to a financial crisis, and financial unraveling, a collapse of the dollar, a takeoff of inflation, price inflation, double digits and possible triple digits. But that is their solution, and of course, that’s what happened to the Weimar Republic. That is no solution at all, it’s only a solution that the government knows how to resort to. And indeed, Alan Greenspan who perhaps you are familiar with, former Fed chairman, wrote that this was indeed a fear, that when the debt does take off to that extent, the U.S. will face a financial crisis.

There is a lesson in this with respect to Milton Friedman’s teenager model, the starve-the-beast theorem. The lesson, unfortunately, is that this government is not a teenager at all, what this government is a teenager that has unlimited credit at a bank, and has unlimited ability to print his or her own money. That is the teenager you are talking about, and that kind of teenager is dangerous. The starve-the-beast model unfortunately doesn’t



work, because when you do starve the beast, it only encourages it to incur deficits and debt, and debt takes off and financial crisis ensues. The starve-the-beast model unfortunately does not work.

One other thing I think I know about Romania is the debt-to-GDP ratio. On one side, the ratio comes from the chart above for the U.S.: it was 38% in 1999, it's 73% in 2013, and the Congressional Budget Office projects that it is a danger it could go to 190%. For Romania, the debt-to-GDP ratio was 38% in 2013. It is just that Romania is where the U.S. was in 1999. I don't know whether you are going to go the way of the U.S., but you have less to worry about than the U.S. does.

**United States**

**Romania**

**1999: 38%**

**2013: 73%**

**2038: 190%\***

**2013: 38%**

\*forecast of Congressional Budget Office

Let us consolidate a little bit. Taxes and spending are associated with each other. Spending is the problem, not taxes, and in addition, you can't really starve the beast very easily, because the beast is going to borrow. So what do we do on the spending side? I will quote briefly Douglas Elmendorf, of the Congressional Budget Office. He wrote in the study that they published:

“We as a society have a fundamental choice of whether to cut back on those programs or to raise taxes to pay for them. So far, we've chosen to do very little of either.”

Those programs that are taking off are taking off, that are engulfing the U.S. economy, are mainly entitlements for the elderly, entitlements for the baby boomers, - of whom I am one - for example: Medicaid, Medicare especially, and social security. Entitlement spending that is taking off and over which there is no

control. But bear in mind, Douglas Elmendorf is saying that we have a choice whether to cut back on those programs or to raise taxes to pay for them, and that so far, we've chosen to do very little of either. The Obama Administration did was to raise taxes on the top, basically one percent of incomers, it is very clear that the only way to pay for all of these promises is with draconian taxes across the board, on everyone. But this is bad news that no government seems to have the courage to bring to the people, and for that reason the debt is out of control.

Those are the facts, and we're talking about a choice. Let me run you through something else I think it's also worth understanding, and that it is known as *public choice theory*. It has been called by one of its inventors, James Buchanan, Nobel Prize winner, "politics without romance". And clearly, the socialist, the progressives, so many of whom are my friends, so many of whom I grew up with, they believe in politics *with* romance. They believe that when somebody runs a business, he is crass, self-interested and materialistic. But when you turn that person into a politician, he becomes selfless, and idealistic, and he regards the public interest as his ideal. Well, politics without romance of the public choice theory tells us that political actors design policy-making institutions and processes to advance their self-interest, normally that is what they do; they want to bring in votes and don't want to bring bad news to the people. Politics without romance tells us something else: ordinary citizens have little or no rational incentive to participate at given political activity, or be fully informed about politics. Why? Because your ability to effect the outcome in terms of your own position in the world is so limited. Yes, we tend to be interested in politics, many of us do. But the vast majority of people, by and large, recognize that it is too difficult, and that there isn't enough time in a day to keep up with an activist progressive government that does so many things, that you can barely keep track of them. By contrast, people have huge incentives to inform themselves about how to purchase a good car or washing machine. That is where self-interest and politics really do meet, and conjoin in a coordinated way.

Public choice theory also tells us that officials have a powerful incentive to provide voters and interest groups with short-term benefits and to hide the long-term costs that must pay for those benefits. That's what's happening in the U.S. It tells us as well that much political activity consists of narrow-interest logrolling at the expense of taxpayers: I'll build your bridge to nowhere if you build my road to nowhere. We don't have enough time or energy to keep up with those things. And finally, it tells us the political dynamics of public policies depend on how it distributes benefits and costs among voters and groups; classically we have the agricultural lobbying in the U.S. that gets enormous subsidies of which a special interest group benefits greatly, but the cost is spread out so evenly among so many of us that we don't feel that cost very much. Of course, all of it mounts up, and of course we can't even affect the outcome. So we have a government out of control for that reason.

Pulling all of that together, I will summarize and then move on to summarize where I am going, to what I'm proposing. First, we have said that taxes and spending cannot be separated, that spending can take off and get out of control; when government is incurring enormous debt, they are taxing us as well, they are taking those resources from us. Thus, I will say that in order to have any hope in keeping government spending under control, we advocate the flat tax on consumption and income, which works best, and we'll get to that in a moment. Then borrowing must be restricted to capital investment: if a government builds something – I'm not necessarily advocating that the government should build anything, but in the real world sometimes it does build things - they charge us for that infrastructure and their borrowing could be tied to capital investment, but never to actual ongoing expenditures. Finally, the central bank money printing to fund government must be curtailed.

In regard to the flat tax, I'm quoting from Richard Epstein, a libertarian legal scholar, who writes:

“Classical liberal thinkers all gravitate to the flat, or proportionate, tax on either income or consumption... one that requires uniform rates for the taxable income individuals, regardless of their aggregate income in any given tax period” (Richard Epstein, *Why Progressive Institutions are Unsustainable*).

In other words, everyone pays, say, 20% on his income, everyone does. And there is no progressivity in the tax structure. Well, what it means is that of course, “I love rich people and want them to keep their money”. I have no particular love or hatred of rich people, but the key virtue of a flat tax is really political. Without it, benefits and costs are completely skewed:

“So long...as most voters know that they will pay no additional federal income taxes for any particular benefit program, they can vote for it with the confidence of receiving benefits without making any additional payments” (Richard Epstein, *Why Progressive Institutions are Unsustainable*).

That delusion can't persist, and indeed it's writ large, it has become a tragic-comedy in the United States. We have President Obama constantly saying: “let's tax those billionaires and millionaires”. It doesn't matter that people like me, columnists like me, point out that even if you tax almost every penny from those millionaires and billionaires - despite the inequality of income distribution and despite the fact that I reject some of that inequality since so much of it comes from crony capitalism, from the way the government subsidizes the rich; that's a big reason why there's inequality of income, subsidy of the government of rich people - there aren't enough dollars in those millionaires and billionaires to go around to pay for all of this. But when we pursue that delusion, and when everyone of the 99% of the other taxpayers think the government is a free lunch, they we have a problem.

But if we have a flat tax, and if every time government wants more funds to fight its wars, to further any aspect of the wealth or warfare state, if there is a proportionate tax, and all of us on all

levels feel the pinch, they we will have something like the market price that Murray Rothbard dreamt of. Something like all of us understanding that government takes from us, and government is taking from all of us when it appropriates resources to spend on what it wants. That is the key virtue of the flat tax. Not an economic reason, but really a reason from political economy, from human behavior.

A flat tax is also better than the value-added tax due to its transparency. We want transparent prices, we don't want you to go to the store, and think that you can take any good from that store, and that somebody else is going to pay for it. We want to have a tax system where people understand in real terms, the only way any of us understand what things cost, by paying for them on our own, by ourselves. In practice, the flat tax does exist, as you know: since its introduction in Estonia in 1994, several countries followed suit, including Russia (2001), Slovakia (2004), Georgia and Romania (2005) – but Romania will soon have a progressive tax -, Macedonia and Albania (2007), the Czech Republic and Bulgaria (2008), Bosnia (2009) and Hungary (2011). Slovakia has abolished its flat tax rate, but other Eastern and Central European countries are likely to continue with the policy. From what I gather, not Romania anymore, unfortunately.

But then we have problems with the flat tax, and the problems have been recently written down: flat taxes seem to work pretty well when an economy is growing - but not so well when it is stagnant or shrinking. Across Central and Eastern Europe, "every country is in need of more revenue because of debt and public deficits," says Andreas Peichl, a senior research associate at the IZA think tank in Bonn, Germany.

"There is a feeling that the crisis has affected poorer people more than the rich and that the rich should contribute more. But that is not easy to do if you only have one tax rate."  
(*"Krugmenistan vs. Estonia"*, *Bloomberg Businessweek*)

I'm not arguing that the flat tax is easy, and I gather there are issues in this country about the progressivity of taxes, but

ultimately the solution is to address the public debt and deficits, try to understand, as difficult as it is, then whatever the government can do for us it can also do to us.

I will end with another large subject, so that we are aware of the real issues involving taxes and spending, and that is the role of public debt. Richard Epstein writes again:

“In a sound system of public finance, the government’s borrowing to meet the cost of capital improvements is acceptable, but borrowing to pay for short-term-consumption items is not. It is, in other words, proper to use borrowed funds to create long-term capital improvements but not to fund short-term government activity, like the payment of salaries for public employees.” (Richard Epstein, *Why Progressive Institutions are Unsustainable*)

He leaves something out, and I mentioned it above, that is money printing. The debt has one catch: the debt can be monetized by the central bank. We should be aware of that. We should be aware of what goes on, as I have said before, that the solution of the U.S. to the problem was to print its way out of it. So that too we have to deal with. Not a very positive picture that I have painted. I want to mention Alan Greenspan’s acquiescence in this, in his book, *The Age of Turbulence*:

“I have long since acquiesced in the fact that the gold standard does not readily accommodate the widely accepted ...view of the appropriate functions of government... the propensity of Congress to create benefits for constituents without specifying the means by which they are to be funded”.

Let me quote from another economist I admire, who wrote about this problem, of the ability of government to print money rather than tax:

“When the government need not obtain its funds from the people, but instead can supply the people with funds, it can no

longer easily be viewed as deriving its powers and rights from the people" (George Reisman, *Capitalism*).

I believe that is profoundly true, and that is the reason why we need the abolition of the central bank, which I advocate, or at least control over the central bank and its ability to print money. The history of money printing originates in the idea that that government needed to fight its wars, and did not want to just tax the people. Taxing the people when you want to fight a war is never a good idea, so the kings decided to print the money. That is the ultimate appropriation of the people's resources, without being answerable to the people. Profoundly true, not just for economic reasons – I think there are good economic reasons to abolish the Central Banks – but for political reasons, the power of the government to print money is a direct affront to the government being answerable to the people, and I think it must be abolished if we are truly going to have anything like a democracy in a country.

In sum, taxes and spending cannot be separated. In order to have any hope of keeping government spending under control, the flat tax, either on consumption or income, works best; borrowing must be restricted to capital investment, and central bank money-printing to fund government must be curtailed. That is an enormously tall order, very difficult, practically impossible. But let me end on one of my radical credos: to those who tell us radicals we have no sense of politics, we respond: you have no sense of history.

Radical change does happen, radical change does happen for the better. We had slavery in the world for thousands of years - slavery ended. We had communism, bolshevism, in so much of the world for so many years - that ended too. Good things, radical change, can happen. It's important as well, however, for us to keep those radical ideas on the table. Quoting Milton Friedman, those radical ideas must be lying around, you always have to keep aware of them, because you never know when or where you will have the opportunity to further and bring back those radical ideas.