Chapter 4

The Evolution of Private Income: A Few Sketches and Approximations

In the Fifth Book of *The Wealth of Nations*, Adam Smith builds up a stunning paradox:

> The private revenue of individuals, it has been shewn in the first book of this Inquiry, arises ultimately from three different sources: Rent, Profit, and Wages. (...)
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> The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation, is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate. (...)
>
> The tax which individual is bound to pay out to be certain, and not arbitrary. (...) The certainty of what each individual ought to pay is, in taxation, a matter of so great importance, that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty.[1]

Unless we are mistaken, Adam Smith is saying that (1) the basis of *private income* rests upon a foundation of well-defined public income directed to the provision of certain specific services. And (2) this public income amounts to the *private income* of the government. This conceptual equivalence means that the government, in effects, resembles a private enterprise-like entity, and that taxation is akin to a private contract between the government and the citizenry, in which citizens pay specific (and preferably low) taxes in exchanges for services rendered. Chapter 4 examines this seeming paradox.

The Origin of Private Income

In addition to orderly taxation, Adam Smith propounds several other important related insights. He always equates privacy of revenue with its certainty, in the sense of rules as opposed to discretion and arbitrariness.

[1]Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Washington, D.C.: Regnery Publishing, Inc., 1998), pp. 945-946.

He maintains that rents in a prosperous economy are certain,[2] that wages as return on labor effort and the ability to command all output surplus are certain,[3] and, that even in the absence of property rights and contractual lease, the common law secures private returns on land improvement as investment.[4]

> Those laws and customs so favourable to the yeomanry, have perhaps contributed more to the present grandeur of England, than all their boasted regulations of commerce taken together.[5]

The principle "no arbitrary taxation," so prominent in the writing of Adam Smith, was formulated by the English Parliament in the Petition of Right of 1628 and imposed on King Charles I. The Petition of Right of 1628 was itself based on well-established common law, which allowed individuals to sue the Crown for breaches of authority and financial distress. The Petition of Right of 1628, among other clauses, prohibited arbitrary search and seizures, which later was included in the U.S. Constitution in the Bill of Rights.

It is instructive that the rule of no arbitrary taxation, which effectively formulated the principle of private income, preceded in the Petition of Right of 1628 the rule of no arbitrary search and seizures, which underpinned the principle of private property. "A man's home is his castle" is a famous English expression, reflecting this principle. Turning back the pages of history still further, private ownership of land existed in England before the Norman conquest in 1066. Several decades later, in 1086, the new Norman king ordered his agents to conduct an incredibly detailed survey of his nation's wealth, visiting every household to count and register each unit of land, animals, tools, and every other quantifiable asset. The purpose was to determine the nation's potential tax base. This survey has come down to us through history as the famous *Doomsday Book*. Even though some 170 Norman barons took control of most large Anglo-Saxon estates, their land and other holdings were accurately registered in the king's records. The recognition and registration of private property provided the Crown with a basis for collecting taxes from the holders of wealth and the surrounding communities that served each feudal estate. The point of this historical expedition is that free transactions and private property have existed for millennia in settled or even nomadic agriculture. But the two well-recognized features of markets—free exchange and private property—were not sufficient, by themselves, to propel these ancient communities beyond a subsistence level of output and consumption.[6]

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[2]Ibid., pp. 439-440, 441.

[3]Ibid., p. 15, 143.

[4]Ibid., p. 442.

[5]Ibid. See also Douglass C. North, *Structure and Change in Economic History* (New York: W.W. Norton, 1981), pp. 124-136.

[6]Douglass C. North, *Structure and Change in Economic History*, pp. 78-94, 100-102.

For our purposes, it is important to note that the authors of the Petition of Right of 1628 placed private income ahead of private property. They probably understood that private property was of little use unless its owners could secure the private income generated by the property. By 1628, the unique English common law had settled rents, wages, and profits in a manner praised by Adam Smith—what, using modern language, we now call internalization of income. The heretofore missing element in the system of private income was the origin of a reasonable level of orderly public income, which would represent contractual payment for government services, especially for protection of life and property, thereby minimizing the confiscation and redistribution that results from the arbitrary and uncertain taxation Smith decried. This clarity of taxation, the source of public income, became the ultimate link to the stability and growth of private income. It laid the foundation for the great prosperity that was to a century later.

Douglass C. North describes a secular effort in England, which culminated after the Glorious Revolution of 1688, to set up a system of orderly taxation in place of traditional fiscal confiscations and redistribution of income. He argues that this development distinguished England from France and Spain and laid the foundation for the rise of large-scale private investment, which financed the Industrial Revolution.[7] Orderly taxation, in addition to its being certain and specific, was also low, taking from private households less than 10 percent of GDP.[8] Orderly and low taxation enabled investors to secure a high private rate of return on investment, invention, and innovation.[9]

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[7]Douglass C. North, *Structure and Change in Economic History*, pp. 145-168; Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990), pp. 114-116; Douglass C. North, "Institutions," *Journal of Economic Perspectives* 5, no. 1 (Winter 1991): 97-112; and, Douglass C. North, "Economic Performance Through Time," *American Economic Review* 84, no. 3 (June 1994): 359-368. See also an important discussion along similar lines in John Hicks, *A Theory of Economic History* (Oxford: Clarendon Press, 1969), pp. 81-86, 94-95. For a detailed analysis of the policies after the Glorious Revolution and the role of multi-layer federalism, see Barry R. Weingast, "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Growth," *Journal of Law, Economics and Organization* 11, no. 1 (April 1995): 1-31. For a broad discussion, see John Brewer, *The Sinews of Power: War, Money, and the English State, 1688-1783* (London and Boston: Unwin Hyman, 1989). For a contrasting perspective of income redistribution in England and France, see Hilton L. Root, *The Fountain of Privilege: Political Foundations of Economic Markets in Old Regime France and England* (Berkeley, CA: University of California Press, 1994).

[8]Until the latter part of the eighteenth century, government expenditure and taxation in Britain remained low, generally less than 10 percent of GDP. The Napoleonic War drove up spending and debt service costs to 27.1 percent of GDP by 1811. When the war concluded in 1815, Britain embarked on several successive tax-cutting sprees and sharply reduced public expenditure. Including debt service, gross public expenditure fell to 7.4 percent of GDP by 1871, and remain at this low level until the late 1890s. This reduction in the tax burden freed-up substantial funds for private investment and transformed Britain into the world's wealthiest nation, until it was supplanted by the United States. For the details of the reduction in the scope and size of government in Britain during this period, see Alvin Rabushka, *From Adam Smith to the Wealth of America* (New Brunswick, N.J.: Transaction Books, 1985), pp. 24-81. It is important to note that it took several decades after the Industrial Revolution to transform Britain into a wealthy nation. Indeed, the sharp reduction in the scope and size of government in the nineteenth century greatly facilitated the expansion of the British economy.

[9]Douglass C. North, *Structure and Change in Economic History*, p. 147.

North and John Hicks contend that the spread of the fiscally-orderly state and the financial independence of private economic activities distinguished the West from the rest of the world.[10] Hicks also emphasizes the significance of the development of a private financial system, protected from government predation. Its development resulted in the financial revolution that fostered strong capital formation and preconditioned the Industrial Revolution.[11] Peter G.M. Dickson, on whose work John Hicks draws in this respect, documents and details that the growth of a strong system of private finance in England was based on orderly, well-developed public finance. At the same time, private debts became convertible into equity.[12]

Orderly public debt replaced the practice of forced government loans and repudiations, which was standard in Europe and, before the eighteenth century, important, even if sporadic, in England.[13] Orderly public debt capitalized banks and reduced interest rates, which enabled banks to conduct two new, crucial activities:

1. Finance large-scale projects and make risky lump-sum investments in fixed capital, including those in new industrial ventures.

2. Attract deposits and channel private savings into private investment.

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[10]John Hicks, *A Theory of Economic History*, pp. 33-40, 53-61 and Douglass North, "The Paradox of the West," in R.W. Davis, ed., *The Origins of Modern Freedom in the West* (Stanford: Stanford University Press, 1995), pp. 7-34. On these and subsequent developments, see a broad analysis in David S. Landes, *The Unbound Prometheus: Technological Change and Industrial Development in Western Europe from 1750 to the Present* (London: Cambridge University Press, 1969); David S. Landes, *The Wealth and Poverty of Nations: Why Some are So Rich and Some So Poor* (New York: W.W. Norton, 1998); Jeffrey G. Williamson, *Industrialization, Inequality, and Economic Growth* (Cheltenham, U.K. and Brookfield, Vt.: Edward Elgar, 1997); and, Oliver E. Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (New York: Free Press, and London: Collier Macmillan, 1985).

[11]John Hicks, *A Theory of Economic History*, pp. 79-99, 144-151. Recall that the Bank of England was established in 1694 as a private central bank and remained private until 1946. Hicks also contrasts English financial development with France, which saw a financial and fiscal debacle in the 1720s, thanks, ironically, to the English (or rather Scottish) economist and banker, John Law, creator of the infamous "Mississippi Bubble." That was a momentous setback for France. See Ibid., pp. 87-88, 145. An overview on the importance of the financial system in economic development around the world can be found in Ross Levine, "Financial Development and Economic Growth: Views and Agenda," *Journal of Economic Literature* 35, no. 2 (June 1997): 688-726.

[12]Peter G.M. Dickson, *The Financial Revolution in England: A Study in the Development of Public Credit, 1688-1756* (London: Macmillan and New York: St. Martin's Press, 1967).

[13]An interesting detail: Between 1473 and 1545 and again between 1614 and 1622, the English kings did not bother to return forced loans but did not want, unlike Spanish kings, to openly repudiate Crown debt. So they reclassified forced loans as gifts and called them benevolence; however, those who were late in delivering benevolence were declared to be in arrears and subject to legal recourse. One recalls this story reading how the Russian government blamed the IMF for welching on its obligations when the latter delayed the non-returnable (that is, rolling over) credit tranches. Benevolence is back.

Before the development of orderly public finance, private savings were generally directed into public investment in such infrastructure as roads, aqueducts, canals, fortresses, palaces, and cathedrals.[14] Dickson pinpoints the timing of the Financial Revolution before the Industrial Revolution:

> The proposals of the later Stuart period were realized during the sixty years after the political revolution of 1688.[15]

It is instructive to contrast the development of private finance in England after 1688, and the enormous industrial and economic changes that followed, with the growth and decline of the Netherlands during its Golden Age. During the seventeenth and eighteenth centuries, Holland was the most prosperous country on the globe. There was, in the 1600s, a high level of private income. One can readily envisage Holland's prosperity displayed in the splendid paintings of the great Dutch masters, such as Rembrandt, Vermeer, Hals, and Steen, and in the great merchant houses that line Amsterdam's canals. The Netherlands prospered from both domestic commerce and its expansive international trade. Dutch shipping was truly global. The country developed diversified cottage industries from cash crops and livestock to value-added handicrafts, an embryonic firm (the system of putting-out contracting), a stable currency (the gulden was literally as good as gold), big cities, well-developed ports, sophisticated banking and finance, a stock market (the Amsterdam Bourse), contract law and enforcement, joint-stock companies, the best models of cargo ships, shipbuilding wharfs, small textile factories, fossil fuel (peat) manufacturing, good science, a trained labor force, and many other prerequisites of modern industrial development.[16]

There was, however, one blight on this shining portrait: the economy of the Netherlands was victimized by a relatively high redistribution of income. The ruling authorities incurred enormous public debt

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[14]"I wonder whether undue attention has not been given to the magnitude of the savings ratio at the expense of the form that savings take. Savings may well have been at least as large a fraction of income in the Middle Ages as in modern times; they then in considerable measure, perhaps in major part, took the form of cathedrals, which, however productive of ultimate satisfaction and of social security in more than one sense of that term, were not productive of worldly goods. I understand that budget studies for India, which at first sight seem to give very different results from corresponding studies for the United States, are found largely to duplicate the latter if the category 'ornaments' is interpreted as savings or, in the jargon of budget studies, as 'net changes in assets and liabilities.' The East was for long regarded as a 'sink' for the precious metals, surely evidence both of substantial savings and of the particular form that it took. Perhaps the crucial role that has been assigned to the savings ratio in economic development should be assigned instead to the factors determining the form in which wealth is accumulated: to the investment rather than savings process, as it were." Milton Friedman, *A Theory of the Consumption Function* (Princeton, N.J.: Princeton University Press, 1957), p. 236.

[15]Peter G.M. Dickson, *The Financial Revolution in England*, p. 6. See also Barry R. Weingast, "The Economic Role of Political Institutions."

[16]See Violet Barbour, *Capitalism in Amsterdam in the 17th Century* (Baltimore: Johns Hopkins Press, 1950); Charles R. Boxer, *The Dutch Seaborne Empire, 1600-1800* (New York: Alfred Knopf, 1965); and, Pieter Geyl, *The Netherlands in the Seventeenth Century,* 2 volumes (London: Ernest Benn, 1961-64).

in order to finance Holland's defense against Spain, England, and others, but especially to underwrite the growth of its overseas empire. High taxes that were imposed, often levied ad hoc in direct violation of Smith's maxim, thwarting the growth of large-scale private capital formation.[17]

Let's be clear. For more than a century, the Dutch enjoyed the world's highest living standards. Dutch shipping ruled the seas. But the foundation of private income on which this great prosperity rested was at chronic risk due to the absence of an orderly system of public finance, and which would be its ultimate undoing when England chose to challenge Holland in a battle for global preeminence.

One of the main obstacles to orderly Dutch public finance and a severe disincentive to economic development was the hidden subsidization of the Dutch East India Company. Vereenigde Oost-Indische Compagnie (the United East India Company) was a huge private central planning agency, a joint-stock franchise monopoly. It operated forced production plantations across the Dutch Empire, from Indonesia to Ceylon to Malaya.[18] It acquired monopoly rights on trading in spices, rice, coffee, sugar, tea, silk, porcelain, and cotton. Its monopoly right on cotton was crucial for Holland's failure **not** to develop the most important industry of the day, textiles. Through convoluted arrangements, the company shipped high-tariff goods duty-free and thus shared (or rather **did not** share) tax revenues with the government. High commodity prices, due to high tariffs which were privatized by the company, reduced the demand for finished goods, which forestalled viable textile and other industries.

In one breath, the Dutch East India Company gave its owners an enormous private gain, but inflicted an even larger public loss on the Dutch economy as a whole. Individuals of wealth and moderate means invested in the firm, rather than in industrial innovation. The Dutch East India Company attracted

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[17]For an excellent analysis, see Jan de Vries and Ad van der Woude, *The First Modern Economy: Success, Failure, and Perseverance of the Dutch Economy, 1500-1815* (Cambridge and New York: Cambridge University Press, 1997). The brilliance of the Italian Renaissance, the Netherlands of the Golden Age, and other pre-industrial European communities does not overshadow the fact that people were still poor, not much higher in income per head than in ancient Rome, malnourished, physically stunted, and lived very short and unhealthy lives. See Robert W. Fogel, "Economic Growth, Population Theory, and Physiology: The Bearing of Long-Term Processes on the Making of Economic Policy," *American Economic Review* 84, no. 3 (June 1994): 369-396; Angus Maddison, *Monitoring the World Economy, 1820-1992* (Paris: Development Center of the OECD, 1995); Angus Maddison, "Poor Until 1820," *The Wall Street Journal*, January 11, 1999, p. R54; and, J. Bradford DeLong, "Estimating World GDP, One Million B.C.- Present," http://econ161.Berkeley.EDU/TCEH/1998_Draft/World_GDP/Estimating_World_GDP.html.

[18]See Thomas Stamford Raffles, *The History of Java,* vols. 1 and 2 (London: Black, Parbury, and Allen, 1817) and J.W.B. Money, *Java, or How to Manage a Colony,* vols. 1 and 2 (London: Hurst and Blackett, Publishers, 1861); J. S. Furnivall, *Burma En Ned.-Indie Vergeleken en Tegenover Elkaar Gesteld* (Weltvreden: G. Kolff, 1933); J. S. Furnivall, *Colonial Policy and Practice* (New York: New York University Press, 1956); and, J. S. Furnivall, *Netherlands India* (Cambridge, U.K.: Cambridge University Press, 1944). One can find a lucid account in "Dutch East India Company" in *Encyclopaedia Britannica*, article "Indonesia, History of."

a large measure of Dutch human resources[19] and Dutch financial resources.[20] This was among the greatest misallocations of investment before Soviet central planning. In our view, it became an Invisible Handcuff on the ability of the Netherlands to sustain its prosperity. In the end, Holland yielded both its naval and economic pre-eminence to England, and, most importantly, it fell behind in economic development. It retained the Spice Islands (Indonesia), several small Caribbean islands, and a sliver of land in South America, but was otherwise unimportant in global affairs until the second half of the twentieth century. In the language of Chapter 1, the Dutch East India Company was a precursor to the enterprise network socialism that emerged in Russia in the early 1990s. It took over fiscal and monetary policy by securing for itself, through monopoly rights and subsidies, revenue that precluded the establishment of orderly, separable public income. As J.S. Furnivall wrote in his great work, *Netherlands India*:

> *Fall of the Company*....From the beginning the accountancy [of the Company] had been defective; books were kept in India and also in Europe, but the two sets were never balanced. Then, when tribute took the place of trade as the main source of income, no distinction was drawn between the revenue of the Company as sovereign and its profits as trader, and no adequate provision was made for its expenditure as a sovereign power in war charges and administration.[21]

England exhibited some parallels to Holland with regard to overseas trade. From the late sixteenth century, most overseas trade was restricted to members of specific overseas trading companies to which the Crown granted monopoly rights in specific regions.[22] Among the famous companies were the Merchant Adventurers (active in northern and eastern Europe), the Levant Company (founded in 1581), the East India Company (1600), which was not entirely abolished until 1858, the Royal African Company (rechartered in 1660), the several North American colonization companies—Virginia, Plymouth, Hudson Bay—and the South Sea Company. At the time it was widely believed that commercial development would occur only if reasonable guarantees were given that those who took great risks would enjoy the profits. Some trading companies even became colonial powers in their own right when they established

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[19]Despite large migrations from poorer Flanders, Germany, and Scandinavia, the Dutch population declined in the second half of the seventeenth century and the eighteenth century, due both to a secular rise in mortality and to emigration to the Dutch East India Company's empire of one million young men, most of whom died at sea or in Java. Jan de Vries, "The Population and Economy of the Preindustrial Netherlands," in Roger S. Schofiled and E. Anthony Wrigley, eds., *Population and Economy: Population and History from the Traditional to the Modern World* (Cambridge and New York: Cambridge University Press, 1986), pp. 108-109, 116-117.

[20]In addition to subsidies, the Dutch East India Company built up large debt in order to pay high dividends to shareholders (18 percent per year for 197 years), high salaries to managers, and high bribes to custom and other officials. One author suggested that the company's logo, VOC, standing for Vereenigde Oost-Indische Compgnie, came to be read as Vergaan onder Corruptie (Perished by Corruption). See J.S. Furnivall, *Netherlands India*, p. 49.

[21]Ibid., p. 48.

[22]J. Walker, *British Economic and Social History* (London: Macdonald & Evans, 1968), pp. 88-92.

and governed settlements in North America, Africa, and India.[23] Although several companies persisted into the nineteenth century, most, especially those in North America, financed as they were by joint-stock companies with unlimited liabilities, not by subsidies, were small, short-lived, and mainly defunct in the early seventeenth century. Those which persisted into the nineteenth century ultimately were taken over by the Crown, most notably the East India Company, and ceased to overtake the government in control over taxes derived from foreign trading.

In contrast with the lesser impact of royally chartered English trading companies on the developing, industrialized British economy, the Dutch East India Company, perhaps the most powerful agent in the Dutch economy, lasted for almost 200 years and only collapsed in the late 18th century. The government shut it down exactly when England industrialized. Only thereafter could Holland reallocate financial and human resources and started gradually to catch up with England, but still industrialized later than Germany.

The story of the Dutch Golden Age illustrates the difference between the two perspectives on the market economy, viz., free exchange and private income. From the standpoint of free exchange, Holland was a nascent market economy; from that of private income, Holland was largely a mercantile economy with segments of private income, but one heavily burdened with socialism. From the first standpoint, Holland might have been on the cusp of the Industrial Revolution; from the second, it had a long way to go and first had to break up its redistributive chains—chains in more than one sense of the word.[24]

Holland was the most advanced of the pre-industrial economies, but it was not alone as an economy exhibiting the features of markets. Centuries before the Industrial Revolution started in England, markets emerged in such civilizations as ancient Athens, Rhodes, Phoenicia, Rome, and Ptolemaic Alexandria, in parts of medieval Africa North and South of Sahara, in Indonesia in the tenth and eleventh centuries, in Southeast Asia and throughout the Indian ocean in the thirteenth century, throughout the Hanseatic League cities, in Italian city-states, in Flanders, culminating in the great prosperity of Antwerp,

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[23] Alvin Rabushka, *From Adam Smith to the Wealth of America* (New Brunswick, N.J. and Oxford, U.K.: Transaction Books, 1985), p. 9. The Navigation Acts, which were finally repealed in 1849, were based on a series of laws dating back to 1381, but which were significantly expanded in scope in 1650 for the express purpose of injuring Dutch commerce and merchant marine strength. The Act of 1650 banned the carrying of goods from any English colony in foreign ships. The Navigation Act of 1660 defined English ships as those built in England, Ireland (excluded after 1670), or the colonies, which were manned by an English captain and had a minimum of three-quarters English crew. England specifically prohibited the import of certain staples from the Netherlands on any vessel. Nor could any foreign-built ship become English by purchase. Historians do not universally agree that the anti-Dutch effects of these laws were successful. J.R. McCulloch, in his essay on the commerce of Holland published in his *Treatise on Economic Policy*, argues, instead, that the decline of Dutch maritime power was not due to English navigation laws, but to excessive taxation within Holland itself. Cited in Sidney Buxton, *Finance and Politics: An Historical Study, 1783-1885*, vol. I (London: Murray, 1888), p. 113.

[24] John Hicks notes that a mercantile economy and free exchange by themselves are not sufficient for creating incentives for economic growth and industrial innovation. See John Hicks, *A Theory of Economic History*, pp. 37-38.

in the Dutch Republic, and other places.[25] In the terminology of Adam Smith, these were the mercantile economies. They had significant segments of private, internalized income: (1) between producers and consumers; (2) between producers along the value-added chains; (3) between producers and traders; (4) between lenders and borrowers; (5) between landlords and tenants; and, (6) between employers and wage workers. On these foundations, the mercantile economies made a limited number of technological advances, created financial arrangements for trade, built impressive infrastructure, and developed pockets of factory-scale handicraft manufacturing. But they did not make a breakthrough from these foundations to **investment in mechanized production**.[26] The absence of orderly public income did not allow people to sufficiently internalize profits as private returns on capital. This, in turn, thwarted incentives to substitute capital for labor, to invest in plant, equipment, and technology. The absence of orderly public income also prevented capital formation and financial intermediation for this investment.[27]

We can combine the insights of Peter Dickson, John Hicks, Douglass North, and David Landes, among others, and the evidence on the emergence of public and private finance. The development of a well-defined separation between public and private income solidified each of them on their own. Neither can exist jointly, that is, if private and public income are fused, but, at the same time, neither can exist on a substantial aggregate scale without the other. This relationship constituted the foundation of private income as the two separable systems of public and private finance. Public finance is non-confiscatory, private finance is non-trespassable. Both are private systems, internal to the government and to the private sector, respectively. They secure internalization of income on the part of asset owners and

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[25]For an enlightening discussion, see Carlo M. Cipolla, *Before the Industrial Revolution: European Society and Economy, 1000-1700* (New York: W.W. Norton, 1980); Jack A. Goldstone, "The Problem of the Early Modern World," *Journal of the Economic and Social History of the Orient* 41, no. 3 (1998): 249-284; and, David S. Landes, *The Wealth and Poverty of Nations.* For a list of historical instances of economic freedom, which includes those mentioned in the text and others, see Alvin Rabushka, *Hong Kong: A Study in Economic Freedom* (Chicago: Graduate School of Business, University of Chicago, 1979), pp. 102-121

[26]David S. Landes defines the Industrial Revolution as a shift to large-scale mechanized production. See David C. Landes, *The Wealth and Poverty of Nations*, p. 192ff.

[27]Ancient Rome during the late Republic and early Empire seemed to have come close. Its infrastructure and standard of living remained unsurpassed in Europe, and probably in the world for a thousand years (some historians of medieval China may dispute this). But the Roman fiscal system grew confiscatory and redistributive. See John Hicks, *A Theory of Economic History*, pp. 87-88 and Charles Adams, *For Good and Evil. The Impact of Taxes on the Course of Civilization* (London, New York, and Lanham: Madison Books, 1993), pp. 71-120. In addition, slavery minimized the role of profit in the narrow sense of return on additional capital substituting for labor. It is illuminating that the Romans, who built sophisticated bridges and aqueducts, did not know the wheelbarrow, the horseshoe, and the horse collar, all invented in eleventh century Europe (the Chinese invented wheelbarrows and discovered coal fuel in the fifth century A.D.). The Romans, in contrast, had draft people and did not need hauling equipment and draft animals. The Romans did not have widespread wages and thus profits. In contrast, and more than any other country in Europe, England had wages very early throughout the economy, thanks in particular to its unique system of life-cycle service, wherein peasant youth (of both sexes) served as farmhands in other peasant households. See Peter Laslett and Richard Wall, *Household and Family in Past Time* (Cambridge, U.K.: Cambridge University Press, 1972). Wages thus existed not only between landlords and peasants and between employers and day laborers but also between peasant households, resulting in a comprehensive labor market.

workers—private profit and private wages, respectively. To depict this relationship:

Private income		
1. Private wages and profit	2. Public finance	3. Private finance

The stylized historical origination seems to have run like this:

Private Wage —> Private Profit —> Public Finance —> Private Finance

When the real wage rates increased in England (as in Holland before it), substitution of additional capital for labor became profitable. But this risky investment required privateness, internalization of returns—in short, private profit. This, of course, meant after-tax profit, free of confiscation and separable from public income. Subsequent political developments produced separable public finance, which begot private finance, which realized private investment in mass production and technological innovation. In a complementary development, Britain's great industrial development and rise to global prominence took place against a backdrop of declining taxes and government spending. Similarly, the emergence of the United States as a great economic power occurred as spending and taxes by all levels of government—federal, state, and local—consumed less than a tenth of GDP, leaving the bulk of resources in private hands for investment, which were fully internalized as profits to those who undertook the great economic investments of the day.[28]

The key angle of this story, and its paradox, laid out by Adam Smith is that orderly public finance was a necessary condition for private finance and private profit and thus for the existence of private income in its entirety. Indeed, how else could private income be established and sustained if not by making public income separable, non-confiscatory, internalized by the government, and thus private-like? The desire of individuals to internalize their income for themselves and their offspring is natural. But predation is also natural, and, all other things being equal, predation and redistribution tend to prevail. Either predatory private interests or the predatory government, or a combination of the two, take over, as they have done throughout history. Common law contributed its part in establishing private income to people's desires, but the ultimate step belongs to the government, specifically to the Parliament, in setting orderly, non-confiscatory and non-redistributive public finance.[29] This measure enabled people to internalize returns on

[28]As recently as 1929, spending and taxes at all levels of government in the U.S. only consumed about 10 percent of GDP. The rapid expansion of American government began during the Great Depression and continued into and after World War II.

[29]The historical role of the Parliament in setting England and, later, the U.S., apart in economic development is crucial. Douglass C. North relentlessly makes this point. The Parliament, representative of numerous local interests, converged with federalism, which also played a key role in limiting the economic power of the central executive. See Barry R. Weingast, "The Economic Role of Political Institutions." Peter Dickson sees the historic divide between England and France in that the latter did not have an effective Parliament. See Peter G.M. Dickson, *The Financial*

their labor, capital, and land, permitting private finance to function effectively. The foundation of private income as an element in the great prosperity of first Britain and then the West in general was public income in the sense of internal and separable income of the government.

Is the Government with Separable Public Income a Private Enterprise?

How would the government function under pure private income, including its own separable public income? We will show shortly that pure private income and the total separation of public income are not feasible in the real world. But many market economies in the past, and some still, exhibit a sufficient degree of private income to make the above question pertinent.

The paradox of government is that it was invented by individuals to protect their income and wealth from predators, but the government itself can become the predator that was its purpose to prevent.[30] Therefore, the problem of government was how to make it protect private income comprehensively, including from the government itself. This has been an inherent, perennial problem. What other solution can there be but a fiscal straightjacket, the financial isolation of the government, which rigidly separates public and private income from each other? The English found this unique solution in the development of orderly public finance. In so doing, they largely solved the problem of government, and, thereby, the problem of ultimate protection of private income. This was arguably the most important human invention in the social sphere since the invention of money and government itself. But this was only the first part of the solution, even if necessary for the also important second part.

The doctrine of limited government reflected this invention. In the particular context of the time, it joined together two dimensions: that of the government, ranging from small to big, and that of income, on a continuum from private to common. The correct form and amount of government is embodied in the combination of private income and small, or limited, government. But the founding thinkers, such as John

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Revolution, p. 14. However, France started to catch up in the second quarter of the nineteenth century. The famous caricature by Honore Daumier depicts King Louis Philippe as a beggar with his finance minister Adolphe Thiers as a monkey carrying a collection plate before the members of the National Assembly. This was the new order of things, which at the time appeared farcical to the French but would have looked nondescript—certainly not worthy a caricature—to the English. In this light, it is ironic that Western policy makers strongly supported in the 1990s the concerted efforts of the Russian executive branch to destroy the Parliament as an institution and to monopolize economic policy—of course, in the name of market reform. The cause is always good. It is the consequences that fail.

[30]Invention of the government for protection does not contradict the fact that most governments in history have been imposed by force. It is the government as an organization that was invented, so that, using the terms of Mancur Olson, a stationary bandit replaced roving bandits, which, in many cases, was an improvement. See Mancur Olson, *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (New York, N.Y.: Basic Books, 2000).

Locke, Francis Bacon, John Milton, Adam Smith, and others, had explored each dimension separately.[31] The doctrine of limited government did not mean just a small government; it meant first and foremost a separable government.[32] Only later was this context of separation of public income from income of the firms and household lost. The doctrine of limited government was reduced to one dimension, a mere size, regardless of the extent of socialism in the economy. The object of this chapter is to restore the notion of the government in the economy with its own private income to its initial sense.

The government as an organization with its own, separable income, which it has to earn from the public as payment for services, and with its own expense (which it has to match with income and with the ability to raise returnable debt) functions in the financial sense like a separable, private enterprise. It is not private in the sense of ownership—indeed, it is a public enterprise, and the enterprise of the public. But it is private in the sense of income because it internalizes revenues and expenses. That this enterprise does not make profit does not change the nature of internalization. The absence of profit results from the fact that the public is both the owner of the enterprise and the user of its services, and does not want it to make profit. This is similar to the case of a publicly-owned private corporation which is also a public utility, a concession, a franchise, with fully overlapping ownership and service. Representative government acting as such a concession charges agreed-upon payments and user fees for public services rendered.[33]

Although the government is a public institution and everyone uses the term public finance, its income is private when it is both non-confiscatory and impregnable to confiscation and redistribution by other private parties. As in the case of a publicly-owned private corporation, households and firms do not enjoy open access to its revenues. The veritable label "Private property. No trespassing" applies. The signs posted on fenced-off government sites in Hong Kong, for example, read "Government Property. Keep Out," even though the property was acquired with taxpayers' funds. Public finance, or government finance, is, in effect, the private, exclusive finance of the government. The taxes and fees collected by the government belong exclusively to it as a corporate-like entity. It is not a treasure chest to be raided by private individuals and enterprises, as we observed in the case of Russia and similar countries. In this vein, the income that accrues to the government, even though it is a public entity, has the same properties as private income. It is specific in the sense of being earned for services, exclusive from intruders, and internal. But there is also a big difference in outcomes, as we argue throughout this book, between an economy in which the government's internal income reaches or exceeds half of GDP and one that collects a far smaller

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[31] Chapter 8 continues this discussion.

[32] This approach further developed in American constitutionalism. On the crucial role of constitutional rules, as opposed to discretion, to build the wall against redistribution, see James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor: University of Michigan Press, 1962) and James M. Buchanan, *The Limits of Liberty: Between Anarchy and Leviathan* (Chicago: The University of Chicago Press, 1975).

[33] For a pioneering treatment, see Frederick C. Lane, *Profits from Power: Readings in Protection Rent and Violence-Controlling Enterprises* (Albany: State University of New York Press, 1979).

share.

Viewing the government as a publicly-owned, corporate public utility is another way of expressing Adam Smith's notion of the government as the manager of a private estate serving joint tenants. Similar to a corporation, investors (taxpayers) have placed their funds (taxes) in exchange for shares, although the shares are not tradeable as taxpayers cannot sell their citizenship to foreigners. Shareholders (taxpayers) are the owners of the corporation (government). In exchange for their funds, shareholders expect to receive a return (public services) on their investment (taxes). As with a public utility, its technical monopoly naturally rests on decreasing costs of providing public services. The government can enforce a natural monopoly in the business of enforcement. But democratic elections make this public utility competitive and make the fees it charges the public, contractual and limited by users (taxpayers). The famous formula by Edwin Chadwick about the concession applies: If competition within the field of service is impossible, competition for the field solves the problem of monopoly and price.[34]

Paradoxically, this view of the government as a publicly-owned private franchise (public utility) converges with the line of thought which sees the government as an obsolete and offensive organization and invents various ingenious schemes for private providers of public services to replace the government. From the perspective of the government as private enterprise with private income, it is the term "government," not its function, that is obsolete and offensive.[35] People of separable, private means are not governed; rather, they own a public utility concession and are served for a price, on contract. The government need not be either deified or demonized, only franchised and audited. If the private nature of public income and the competitive assignment of the concession are the rules, the government and the private contractor (concessioner) converge.[36]

This is not, by far, what public income is today in Western market economies. This is not what it has typically been in practice. This is what it was meant to be when it originated at the time of John Locke, Adam Smith, and the Founders of the American Republic. But the invisible private core of orderly public

[34]Edwin Chadwick, "Results of Different Principles of Legislation and Administration in Europe: Of Competition for the Field as Compared with Competition within the Field of Service," *Journal of the Royal Statistical Society*, Series A22 (1859): 381-420.

[35]It is fitting that in the U.S., historically, ministers are called secretaries and the chief executive officer, president. Even the word governor does not have its cockney connotation because it emphasizes the precedence of the states.

[36]Actually, they can converge not only in the sense of providing contractual services at an orderly price on a competitive basis, but also in the sense of predation, redistribution, monopoly pricing, cheating, overcharging, contract welching, bureaucratic overspending on wasteful projects and on itself, and abuse of power. The opportunities for predation are the same for the representative government and a private contractor. The classic example of the latter is the Vereenigde Oost-Indische Compagnie, the Dutch United East India Company, mentioned earlier. It ruled the Indies (today's Indonesia, Sri Lanka, Malaysia, and other countries) in 1602-1799 on the charter of the Dutch Republic and established central planning there.

income remains intact today. Without this invisible core, Western market economies would not have survived the socialist tides of the twentieth century.

Self-Limitation and Self-Preservation of Private Income

In the real world of Western market economies, every government is bigger than warranted by its initial contractual functions. More importantly, every government is redistributive to one or another degree and every public income takes a bite out of private income. This does not mean that identification of government with socialism stands. This rather means that socialist segments, segments of common income, are present in every Western market economy. Their development may work through the government, embodied in excessive taxation and a panoply of subsidies and bailouts, and through private predation not sufficiently repelled by the government. Thus the real Western market countries exist along the dimension of private and common income with the private core and common segments.[37] Market economies lie on a continuum.

In addition, as we mentioned in the previous chapter, the market has natural limitations. It does not cover the total area of economic activity. Not all costs can be internalized, especially those associated with information gaps, excessive risks, uncertainty, and insurance, like the so-called moral hazard in banking and other spillover effects.[38] These circumstances often lead to government bailouts and other soft subsidies. Not all benefits can be internalized, as in the case of scientific discoveries, technological improvements, and contributions of educated people to society, because ideas become available in the public domain. This leads to under-production of these goods and, paradoxically, does require a remedial social subsidy. The literature employs such fitting terms as externality and public goods effects to describe this class of phenomena (as opposed to internalization and privateness of payoffs and costs) and also an unfortunate term "market failure," as if the market has failed, whereas it simply fails to encompass actions whose gains and costs cannot be internalized.[39] This confirms our chosen narrow definition of the market

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[37]We will pursue the discussion of these issues in Chapter 5.

[38]For an excellent overview of moral hazard in banking, see Ronald I. McKinnon, *The Order of Economic Liberalization. Financial Control in the Transition to a Market Economy* (Baltimore and London: The Johns Hopkins University Press, 1993), pp. 84-91.

[39]As a rule, markets automatically create only those institutions whose gains can be sufficiently (even if not fully) internalized by private agents. Examples include money, trade credit, the bill of exchange, credit and banking, etc. Markets call upon the government to create institutions with large social and relatively small private gains, like markets call upon scientists and engineers to create new technologies. So the market creates institutions indirectly, through the demand transmitted to the government. If one does not view market and government as the dichotomy, the problem disappears. When the limited liability corporation was established by an act of the state of New York in 1811, contemporaries, notably *The Economist* of London, objected to this as government intrusion. They argued that if the market wanted limited liability it would have created it automatically. A counter-argument is, if markets did not want limited liability, they could have easily negated government action: Creditors would simply not lend to limited liability

as free, voluntary exchange with private, internalized income only—not **any** free exchange. In the cases of externalities people face natural socialization. Excessive taxation and subsidies in Western market economies constitute man-made socialization and a true failure of public income to stay private and separable.

This raises another paradox of private income, namely, its self-limitation. The self-limitation derives from the fact that private income requires for its existence a foundation of public income. But the growth of public income acquires momentum of its own and leads, ineluctably, to a partial undoing of private income. The downside of private income is the natural continuation of its upside, a catch-22-like circle. This stems from two different, but overlapping, developments:

1. Representative democracy solidified numerous local and sectoral interests. It converged federalism with Parliamentarism.[40] These forces established public income, which separated public and private finance. This engendered private income and the market economy. The resulting economic growth and prosperity increased both the scope and power of sectoral and local interests. These interests promoted various redistributive legislation to benefit themselves. Segments of common income spread across the entire body of the market economy. Successful rent-seeking amounts to appropriation of income from households beyond those contractually-implied payments for public services. It is, in short, socialization beyond the social contract. It undermines the private capacity of public income. The failure of representative government to fully sustain separability of public and private income and full separability of all private incomes is natural. It results from inefficiencies in the democratic process of aggregating individual preferences into a public choice. Gary S. Becker dissected the mechanism of concentrated benefits and diffused costs: Benefits from income redistribution are large for pressure groups and are worth fighting for, while fiscal and other costs spread across the society and are small for the average taxpayer and consumer, are not worth opposing.[41] Public income becomes redistributed and private income partially socialized.

2. Growth and prosperity enlarge the middle class. It becomes the majority in society. It uses its political power to enact and expand an array of redistributive programs of which it is the principal beneficiary at the expense of higher and lower income groups. This phenomenon is known as

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corporations and thus defeat the whole purpose of the new institution. However, the limited liability company was one of the greatest inventions in human history. It advanced private income by separating private liabilities of the firm from private assets of the household. It limited the rights of creditors in their claims on shareholders. By doing so, it facilitated capital formation through equity because the risk for shareholders of assuming company debts declined. This expanded broad ownership and mass-based investment. This example shows the difference between private income and free exchange perspectives on the market economy.

[40]See Barry R. Weingast, "The Economic Role of Political Institutions."

[41]Gary S. Becker, "A Theory of Competition Among Pressure Groups for Political Influence," *Quarterly Journal of Economics* 98, no. 3 (August 1983): 371-400.

Director's Law of Public Income Redistribution.[42] This created a system of income transfers, which has been mislabeled the Welfare State. The latter includes numerous sectoral subsidies and preferential regulations, popularly known as corporate welfare. They represent a form of stealth confiscation and may absorb significant amounts of GDP, as in the Scandinavian countries and many other Western European democracies, where the governments routinely tax and spend half, and sometimes more than half, of the national income. Given the scope of the political interests behind the Welfare State it is not surprising that income redistribution in many Western market countries reached such exorbitant levels.

Thus public income in its private, separable capacity proves to be an inherently weak institution. It is vulnerable to politics. This sets an evolutionary limit on private income and prevents its complete permeation of Western market economies.[43] However, the same developments create a self-preservation mechanism of private income. At some point, segments of common income and the Welfare State are stalled and even rolled back.

1. Diffuse costs become sufficiently large for the majority to fight against sectoral subsidies. The expected benefits of globalization and universal free markets add opportunity costs and strengthen the fight.

2. The further growth of the middle class turns the Welfare State into a perpetual motion of redistribution among an essentially homogeneous population—a self-defeating proposition. People realize that their net benefits are nil whereas their opportunity costs, in terms of foregone economic growth and prosperity, due to economic distortions, are considerable.

In the U.S., Great Britain, Continental Europe, and even Scandinavian countries, the growth of socialization of income has been significantly reduced in the last two decades and rolled back in some cases. The emergence of the new, information-based economy both makes people more independent of the government and uproots some entrenched vested interests. This may give further momentum to the rollback of segments of common income in Western market economies. Although public income as a private institution is weak, private income as a system is viable, enduring, and indeed interminable.

But there are no stable laws of disequilibrium dynamics. By that we mean that forces can emerge which enlarge the scope and size of government for a considerable length of time; or, which shrink government. The former occurred during the twentieth century, when the level of government spending in the U.S. rose from a tenth of GDP in 1929 to a third of GDP after World War II, and in Europe when the

[42]George J. Stigler, "Director's Law of Public Income Redistribution," *Journal of Law and Economics* 13, no. 1 (April 1970): 1-10. The law is named after its inventor, Aaron Director.

[43]This is why James M. Buchanan's quest for constitutional rule is so crucial. See James M. Buchanan, *The Limits of Liberty: Between Anarchy and Leviathan*.

postwar size of government grew to half or more of GDP. There is nothing intrinsically stable about government taxing at 10 percent, 33 percent, 50 percent, or indeed 70 percent of GDP. But the trends described in the above paragraphs have, for the moment, produced a relative measure of stability in the size of government in the Western industrial democracies.

A Reference on the Role of Public Finance and Private Finance in Economic Development

The experience of countries that recently became successful market economies seems to conform, for all the variety of specific policies, to the pattern found in eighteenth century England. Our understanding of extensive work by Ronald I. McKinnon on the order of building market economies in East Asian and Latin American countries in the 1960s-80s is that creating viable public finance was the key to establishing private finance. McKinnon points to ending financial repression and other predatory practices of the government as a key to subsequent economic growth.[44] Financial repression amply summarizes the predatory activities of the government. It suppressed returns on private savings by depleting the value of money balances through inflation, by putting caps on lending interest rates and thus on deposit interest rates, and by diverting investment from more productive to less productive uses.[45] Ross Levine in a detailed overview of studies and evidence on broad cross-country experience in recent decades emphasizes the crucial role of developing private financial markets.[46]

The Paradox of Private Income after Central Planning

Successful post-Communist countries discovered, by design, chance, or evolutionary logic, that public income must be separated from enterprises. In China, Vietnam, Myanmar, and, to a lesser extent, Poland, Slovenia, Slovakia, Hungary, and the Czech Republic, the government broke up the inherited enterprise network and established a measure of private income. We observed this development in Chapter 2. We can now discuss the principal policies applied to this end.

The methods of creating private, separable public income were stunning, if not damning, from the conventional perspective. Countries built market economies by applying apparently anti-market policies. They were stalling liberalization and privatization and even—in Eastern Europe, of all places—started with

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[44]Ronald I. McKinnon, *The Order of Economic Liberalization.*

[45]See Ibid. and also Ronald I. McKinnon, *Money and Capital in Economic Development* (Washington, D.C.: Brookings Institution, 1973), and Edward S. Shaw, *Financial Deepening in Economic Development* (New York: Oxford University Press, 1973).

[46]Ross Levine, "Financial Development and Economic Growth."

de-liberalization and de facto de-nationalization, thereby rolling back the partial liberal reforms of the 1980s. This is a muted subject, although the documentation is in the public domain, and serious literature exists.[47] The principal task was **not to open up** free markets—that was relatively trivial—but rather to accomplish this in such a way as to **close down** common access to public income after the abolition of central planning. The latter task was non-trivial, indeed Herculean, due to the power of the enterprise network and lack of precedents and learning. This task required impious and blasphemous measures.[48] What follows is a set of policies that were relatively successful in unleashing the productive potential of real market forces.[49]

1. *Split the economy apart*. Instead of blanket reform, instead of opening up a unified, free market, the government promoted the new-entrant private sector (as well as the old private sector if it existed); at the same time, it set aside the preexisting sector and kept it under stringent financial and ownership controls. This broke up the enterprise network before it could emerge. Instead of reforming, liberalizing, and privatizing the old sector, the government rather phased it out and

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[47]For a detailed institutional and policy overview by countries, see Ian Jeffries, *Socialist Economies and the Transition to the Market: A Guide* (London and New York: Routledge, 1993). This indispensable compendium also provides a comparison of policies before and after 1989, which helps see both innovations and reversals in the early 1990s. For the analysis of specific policies see Timothy D. Lane, "Wage Controls and Employment in Economies in Transition," *Journal of Comparative Economics* 19, no. 2 (October 1994): 171-187; Grzegorz W. Kolodko, *From Shock to Therapy: The Political Economy of Postsocialist Transformation* (New Haven: Yale University Press, 2000); and Gregory C. Chow, "Challenges of China's Economic System for Economic Theory," *American Economic Review* 87, no. 2 (May 1987): 321-327. For important country studies, see Fabrizio Corichelli and R.R. Rocha, "A Comparative Analysis of the Polish and Yugoslav Programmes of 1990," in P. Marer and S. Zecchini, eds., *The Transition to a Market Economy* (Paris: OECD, 1991), pp. 189-243; Erzsebet Viszt and Judit Vanyai, "Employment and the Labor Market in Hungary," *Eastern European Economics* 32, no. 4 (July-August 1994): 13-18, 30-33; Kazimierz Z. Poznanski, *Poland's Protracted Transition: Institutional Change and Economic Growth, 1970-1994* (Cambridge, U.K.: Cambridge University Press, 1996), pp. 169-207; Stefan Bojnec, "Macroeconomic Stabilization and the Reform Process in Slovenia," *Eastern European Economies* 34, no. 1 (January-February 1996): 21-40; Barry Naughton, *Growing out of the Plan: Chinese Economic Reform, 1978-1993* (New York: Cambridge University Press, 1994); Alvin Rabushka, *The New China: Comparative Economic Development in Mainland China, Taiwan, and Hong Kong* (Boulder: Westview Press, 1987), pp. 71-99; and, Markus Diehl, "Structural Change in the Economic Transformation Process: Vietnam 1986-1993," *Economic Systems* 19, no. 2 (June 1995): 147-182.

[48]How could Eastern European countries get away with this? Forty years of subjugated experience begot skill. They treated the U.S. Treasury and the IMF the same way they treated the Soviet government and the Comintern in the past: said one thing and did the other. Because of their publicly sworn allegiance to the orthodoxy, the IMF now can (and does) take credit for their partial success. In fairness, the IMF and other parties and research groups involved were intellectually flexible and adopted as their own some of the policies introduced in China, Poland, and elsewhere, such as the emphasis on the new-entrant private sector, which we discussed in Chapter 2.

[49]Hereinafter we draw heavily on a marvelous compendium of policies across post-Communist economies in Europe and Asia presented in Ian Jeffries, *Socialist Economies and the Transition to the Market*.

phased in the new sector with private income.[50]

2. *Retain and reinforce state banking for the preexisting major enterprises*. It is hard, indeed impossible, for enterprises to practice tax non-remittance when the state banking system automatically seizes and remits profits and tax liabilities of state-owned enterprises. This puts a powerful constraint on the ability of liberated enterprises, even after price decontrol, to enforce the tax subsidy, which, in turn, makes excess invoices a self-defeating proposition. Note that reinforcement of state banking in Eastern Europe in 1990 and thereafter for the purposes of automatic remittance of profits and taxes represented in some countries a rollback of liberal reforms of the 1980s. The government in the 1980s allowed enterprises to retain profits in expectation of creating productive incentives. But the government continued to subsidize the purchase of inputs through the soft budget constraint. This combination, instead of stimulating production, led enterprises to maximize subsidies for converting them into wages and managerial bonuses. Before this liberalization, enterprises could use subsidies only for inputs, not for consumption, because the government, through the state banking system, automatically remitted profits and taxes. In addition, wage controls secured government profits. Liberalization of the 1980s ruined public finance and ended up in extreme inflations. It is a widespread illusion that money and banking under central planning played a minor role and served accounting and payment purposes only. On the contrary, they played a major role, although quite different from that in market economies. Money monitored and enforced production[51] and the state banking system monitored and enforced the fiscal rights of the government as both the tax authority and the residual claimant of profits as the owner of assets. Reinforcement of state banking in the early 1990s allowed the government to minimize subsidies after the abolition of central planning and to repel the tax subsidy, thus establishing a relative degree of orderly and separable public finance.

3. *Impose credit ceilings*. These were quantitative credit quotas specific to banks and enterprises. They did not allow commercial banks and even private banks to lend above the cap. This precluded the transmission of central bank credit to enterprises as part of the tax subsidy to fully match their excess invoices. Recall that central bank credit is issued and transmitted to enterprises through the banking system to substitute for tax non-remittance (that is, to ensure tax remittance) in critical fiscal situations. Thereby, even though the central bank continued to print excessive money and provide inflationary credit to the banking system for the enterprise sector, as well as monetize government budget deficits, enterprises could not enforce the tax subsidy. In combination

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[50]Ironically, although this story immediately associates with China and, to a lesser extent, Poland, the most consistent protagonist was Germany after unification, with respect to enterprises in its Neue Landers. For an excellent discussion see Diane Glikmanas. "East German Economic Transition: A Challenge to the Economics of Transition?" Unpublished manuscript (Stanford, Ca. and Paris, France, Fall 1997). Estonia accomplished the same policy by default, due to the split along ethnic lines, as we mentioned in Chapter 2.

[51]See Michael S. Bernstam and Alvin Rabushka, *Fixing Russia's Banks: A Proposal for Growth* (Stanford, Ca.: Hoover Institution Press, 1998), pp. 23-25. We will discuss this matter in detail in Chapter 5.

with the above inability to confiscate tax collection, this thwarted the claims of excess invoices and defeated their purpose. This measure in some countries also comprised a rollback of earlier reforms, which allowed liberal commercial credit, originating, of course, in central bank money printing. Although in Eastern European countries the second and third policies on this list could not be fully enforced, because of the spread of commercial banks, especially private banks, and tax non-remittance was widespread, the government could nonetheless protect and not surrender its fiscal and monetary power. In China, the government simply periodically cracked down on unruly banks and shut many of them down. We never said these measures were subtle.

4. *Close down financial institutions if they pose any danger of passing their liabilities onto the government*. This is an extension of the previous measure. In most Western market and developing economies, the government socializes the debt of failing financial institutions when it bails them out. This happens when the expected spillover effect, such as the loss of deposits and investments, exceeds the bailout costs. Examples range from the savings and loan debacle of the 1980s to the Long-Term Capital Management hedge fund in 1998 to major Japanese banks and insurance companies in the 1990s. Globalization of this practice is exemplified by IMF bailouts during the Asian crisis of 1997 and Brazilian crisis in 1998, which were effectively bailouts of Western lenders. The Chinese government acted counter to this practice, to the annoyance of Western investors. In 1999, it refused to assume the liabilities of Guangdong International Trust and Investment Corporation (GITIC), a failed investment fund owned by the Guangdong provincial government, along with other bankrupt provincial ITICs. Furthermore, it abruptly shut down, without compensation of creditors, most other investment companies which borrowed from Western lenders to finance local ventures. This prevented the creation of a subsidy chain, which could have turned Township and Village Enterprises (TVEs), owned by provincial and local governments, into an enterprise network.

5. *Retain or reimpose wage control*. It restrains the tax subsidy and de-stimulates excess invoicing. Wage control can be direct or indirect, tax-based. If the government retains central planning in the preexisting industrial sector, which it splits from the rest of the economy, as happened in China, direct wage control will do. If central planning is abolished, as in Eastern Europe, it is difficult to enforce wage control by direct administrative means. Then the efficient mechanism is indirect, tax-based wage control. This is a prohibitive, say, 300 percent taxation of wage increases above the government-set baseline.[52] Direct or tax-based, wage control in both cases limits the ability of enterprises to pass the tax subsidy onto such specific beneficiaries as workers and managers. This is reinforced in the absence of legal privatization, when managers are not owners and their

[52]See Timothy D. Lane, "Wage Controls and Employment in Economies in Transition," pp. 171-187. For specific country studies, see, e.g., Fabrizio Corichelli and R.R. Rocha, "A Comparative Analysis of the Polish and Yugoslav Programmes of 1990," pp. 189-243; Erzsebet Viszt and Judit Vanyai, "Employment and the Labor Market in Hungary," pp. 13-18, 30-33; and, Kazimierz Z. Poznanski, *Poland's Protracted Transition: Institutional Change and Economic Growth, 1970-1994*, pp. 169-207.

compensation is also subject to wage control. In the case of direct wage control, the residual income which constitutes government profit, is enhanced. The government seizes it, and this nullifies the tax subsidy and renders excess invoicing impotent. The effect of indirect wage control is the same. If the government enforces the remittance of taxes levied on wage increases—and it does, or else wage control is meaningless—this remittance offsets the tax subsidy extracted from non-remittance of other taxes. The money is fungible, and through a prohibitive tax the government nullifies the tax subsidy and the benefits of inflated invoices. On top of that, indirect wage control affects enterprises as buyers. Despite the loss of the tax subsidy, managers and owners still increase wages, due to workers' pressure, because workers become partial de facto owners of state enterprises after the abolition of central planning. Then enterprises have to minimize non-labor costs in order to cope with additional labor costs of punitive taxation for wage increases. Buyers no longer accept inflated invoices from sellers. In all, wage control breaks up the network of counterfeit spending.[53] Under wage control, every enterprise is in business for itself, not as part of a network.

6. *Stall privatization until private income acquires critical mass in the economy, over 50 percent of GDP*. When the enterprise network exists, privatization opens more access for enterprises to common income, indeed opens direct enterprise access to public income. Under these conditions, the absence of private owners is a necessary, although not sufficient, condition for denying individuals the gains from the tax subsidy, from acquiring access to public income. Note that a de facto re-nationalization and a rollback of de facto privatization automatically occur when the government re-imposes and enforces remittance of profits on state-owned enterprises. Stalling or rolling back privatization is a direct corollary of the Coase Theorem, applied to common income. The Coase Theorem states that under market conditions (and provided that assets are easily transferrable), property always ends up in the hands of most productive users. This happens because the most productive users are willing to pay the highest price for a given asset, since it is they who can derive the highest return. Therefore, the initial allocation of property rights does not matter because the most productive users will be the ultimate owners.[54] It follows that even if there was an initial theft of property, the most productive owners will bid it away from thieves and create wealth for everyone. It also follows that under market conditions asset stripping on the part of legal owners is uneconomical: Why strip assets if they can gain more by selling the firm intact to the most productive (and thus highest paying) users? The corollary to the Coase Theorem states that the rationale changes diametrically if the market economy does not exist and income is common while property is private. Then the value of the asset derives not from its market return but from the

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[53]In 2000, after ten years of discouraging wage control wherever possible and de-emphasizing its success elsewhere, the IMF came to recognize its usefulness in view of mounting enterprise arrears and tax arrears and insisted on re-imposition of wage control in Romania. See *The Financial Times*, June 13, 2000. As we mentioned earlier, the IMF, like the Comintern before it, can be flexible.

[54]See Ronald H. Coase, "The Problem of Social Cost," *Journal of Law and Economics* 3, no. 3 (October 1960): 1-44.

share of redistribution it entails. After the abolition of central planning and in the presence of the inherited enterprise network, the true asset is access to public income, to the tax subsidy. Property rights, ownership of enterprises provide **privileged access** to common income. Property rights on productive assets become **fiscal property rights** on the tax subsidy. The corollary to the Coase Theorem states thus: Under enterprise network socialism, property always ends up in the hands of most capable predators on public income, masters of redistribution, subsidy extractors, because they are willing to pay the highest price (apply the greatest force and influence).[55] It follows that stripping productive assets by legal owners is most profitable under these conditions, because it is not from production but from access that they derive their gains. They want to keep the titles to continue to exploit their privileged access to common income and they add asset stripping as a dessert to the main course. It also follows that it matters little how privatization was conducted and what methods were used, which is the subject of a voluminous literature. The best (worst) predators always come on top in the end. China, Vietnam, and other post-Communist countries in Asia, and Poland and Slovenia in Eastern Europe eschewed privatization.[56] They escaped its worst predatory outcomes which befell Russia. To recapitulate, the issue is not the theft of property, because the end is the same even in the case of the cleanest initial assignment of legal rights on assets. The issue is not improper privatization, the issue is that privatization is improper under enterprise access to common income. The issue is predatory natural selection and self-selection of ultimate owners, the surrender of the country to worst predators.

7. *Scrap SLiP*. When a conventional market reform (a package of stabilization, liberalization, and privatization, which we discussed in Chapter 2) begets contraction, do not stay the course, change the policy. Countries that changed direction, as did Poland in 1993, performed much better than those that did not, such as the Czech Republic. It is one of the best-kept secrets of post-Communist experience that the relative success of Poland was due to a fundamental policy shift,

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[55]See the introduction of this corollary in Michael S. Bernstam and Alvin Rabushka, *Fixing Russia's Banks*, pp. 14-15. The initial theft of assets under common income may appear neutral from the standpoint of eventual efficiency (or inefficiency), but it most definitely is not neutral from the fiscal perspective. What happens when the government gives away assets to predators or allows them to seize assets, instead of, say, using these assets to capitalize retirement accounts, which would ease budgetary pressure in the future, or swap them in exchange for reducing government debt? Either the government has to raise payroll or other taxes to finance its expenditures, which were previously financed by the return on the lost assets, or reduce pensions and perhaps default on debt service. If the government sold these assets to Western investors at market prices and these assets eventually ended up in the hands of domestic predators, it is Western investors, not domestic taxpayers, who would have been robbed. The production (or contraction) effect may be the same, but the fiscal effect is far worse if the predatory seizure of assets takes place in the beginning, not at the end. The production (contraction) effect may actually worsen if a fiscally weakened government compensates its losses by raising taxes or defaulting earlier than it would have otherwise been forced to do.

[56]See Gregory C. Chow, "Challenges of China's Economic System for Economic Theory," pp. 321-327; Socialist Republic of Vietnam, General Statistical Office, *Nien Giam Thong Ke* [Statistical Yearbook] (Hanoi, 1994), pp. 17-21; Kazimierz Z. Poznanski, *Poland's Protracted Transition*, pp. 169-207; and, Stefan Bojnec, "Macroeconomic Stabilization and the Reform Process in Slovenia," pp. 21-40.

not to a lagged effect of initial policies; not to continual initial policies but to their discontinuation.[57] Do not sacrifice growth for reform. There is no such trade-off, given the extent of inherited value subtraction, discussed in Chapter 1. Contrary to the dominant literature, contraction is not an investment in future growth,[58] it is a pure loss in both the income and asset sense, never recovered. Advocating a second edition of reform, as voiced by the U.S. government and the IMF for Russia, is calling for an accelerated contraction. It is never too late to scrap SLiP, but the sooner the better.

8. *Let economic organizations and property types naturally evolve, self-select, and grow under restricted access to common income and public finance.*[59] This is probably the most important policy of all. Evolution will naturally select those types of property on productive assets that will adapt to conditions of private income. These will be optimal property types that are least conducive to redistribution of income, socialization, networking, and gaining access to public income. If a country can wipe out the enterprise network in one fell swoop,[60] private property may be the immediate natural outcome. What type of ownership is optimal under incomplete private income depends on the degree to which the enterprise network is broken up. In Poland, some 30 percent of GDP was produced outside the network even before the abolition of central planning. Such large industries as agriculture and services were already in the private income domain. Although the inherited enterprise network remained in the state sector, its financial claims were constrained by credit ceilings and wage control. New entrants naturally emerged as privately owned firms, filling up various market niches. Most of the new entrants could not join the inherited network and thus, neither by government design nor by deliberate intention, expanded the domain of private income. New entrants started to compete with the inherited enterprise network of the state sector, thereby reducing its share of GDP. This, in turn, strengthened the growth of private income for the next wave of new entrants. A virtuous circle developed. A different serendipity in Estonia led to similar results. Privatization into the hands of foreigners followed the breakup of the enterprise network, which consisted of Russian enterprises and which was razed for political reasons, not as an economic policy design. In other countries, the efficient approach selected itself in China and was reinvented in Vietnam, Myanmar, and elsewhere. Many property types emerged, including shareholding and individually-owned private firms and rural units.[61] But local government

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[57]For an insightful, insider account see Grzegorz W. Kolodko, *From Shock to Therapy*.

[58]The World Bank, *From Plan to Market. World Development Report 1996* (New York: Oxford University Press for the World Bank, 1996), pp. 29-30.

[59]To mix metaphors, let a hundred flowers blossom (let a hundred schools of thought contend), not just *fleurs du mal*.

[60]We show in Part Three how to achieve this.

[61]For an elaborate classification, see People's Republic of China, State Statistical Bureau, *China Statistical Yearbook 1996* (Beijing: China Statistical Publishing House, 1997), pp. 377,401, 404, 410-411.

or community ownership prevailed, such as Township and Village Enterprises (TVEs), in China and Vietnam and Cantonment Municipal Enterprises in Myanmar.[62] Chinese TVEs by themselves set an economic record, turning in about 25 percent growth of output per year and 10 percent annual growth of productivity since the mid-1980s.[63]

What is their secret? The conventional literature dubs them as halfway houses between state and private property and advocates their convergence with standard private firms.[64] In our view, they are an organizational species *sui generis*. The secret of TVEs is twofold: Not only do they embody private income, they, of all property types, **inadvertently established separable public income from scratch**. Consider the effect of provincial and local government ownership when the inherited enterprise network is set aside and kept under central fiscal control:

(a) The central government could not confiscate income of TVEs because they raised revenues for the local governments that owned them. If the central government tried to seize these revenues, it would be stuck with the need to subsidize those local expenditures financed by TVE income. As ever, money is fungible.

(b) The central government could not subsidize TVEs because it did not want to subsidize local governments. It gave them economic freedom to set up TVEs in exchange for fiscal self-sufficiency. The central government closed budget subsidies to outsiders and newcomers such as TVEs, but also precluded allocating state bank credit to them.

(c) TVEs could not join the existing network of state-owned enterprises because the network is blocked from expansion by the central government through such tools as price control, credit ceilings, and wage control, and because, to repeat, the central government did not want to subsidize local government. In effect, a Chinese wall was built around the inherited network. Nor did the network of state enterprises have any incentive to let TVEs join the club. The network would not extend unpaid trade credit and free inputs to TVEs, because state enterprises already receive subsidies (the soft budget constraint) from the government and would rather sell resources

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[62]For an intellectually inspiring discussion see Gregory C. Chow, "Challenges of China's Economic System for Economic Theory," pp. 321-327 and Ronald I. McKinnon, "Financial Growth and Macroeconomic Stability in China, 1978-1992: Implications for Russia and Other Transitional Economies," *Journal of Comparative Economics* 18, no. 3 (1994): 438-470. A detailed analysis on China is in Barry Naughton, *Growing out of the*; and, Alvin Rabushka, *The New China,* pp. 71-99. On Vietnam, see data in Socialist Republic of Vietnam, General Statistical Office, *Nien Giam Thong Ke* [Statistical Yearbook] (Hanoi, 1994), pp. 17-21. An analytical treatment is in Markus Diehl, "Structural Change in the Economic Transformation Process," pp. 147-182. The data and policy details on Myanmar are in Ministry of National Planning and Economic Development [Myanmar], *Review of the Financial, Economic and Social Conditions for 1993/94*.

[63]The World Bank, *From Plan to Market*, p. 51.

[64]Ibid.

on the open market.

(d) Local governments could not confiscate income of TVEs because they already receive TVEs' profits as their owners. One does not confiscate one's own income. Confiscation of more income would amount to decapitalization of TVEs, which would deprive local governments of future revenues. This would amount to killing the goose that lays the golden eggs, and the Chinese much preferred a steady diet of eggs to a one-time feast on roast goose.

(e) Local governments could not subsidize TVEs because local governments derive their revenues from the profits of TVEs, and have no sufficient alternative sources of revenues. The reason that TVEs exist in the first place is to provide income to their local political jurisdictions, not to receive subsidies. If TVEs do not prosper, local governments will shut them down. Managers of TVEs face incentives to perform because, unlike privatized enterprises, there are no preexisting assets to loot. All parties are interested in creating new wealth.

(f) Local governments and TVEs could not establish a new network for extracting subsidies from the central government because they would not survive while they waited for the network to become sufficiently comprehensive to absorb them. As we discussed in Chapter 2, a network with enforcement powers over fiscal and monetary authority can only be inherited.

(g) Self-interest of local governments and TVEs beget competition among themselves for market profits, not collusion for the state subsidy. Local governments can raise capital from local savings and foreign investors, forming local or provincial-level investment funds and using their power to tax as a collateral. Market profits are feasible with relatively little risk. Attempting to secure tax subsidies is more risky. Indeed, in China's circumstances, TVEs made more sense as a form of ownership than genuinely privately-owned enterprises. Inasmuch as the latter have few assets and limited opportunity to raise capital, they would have greater incentive to make an extra effort to break in into the existing network of state enterprises, to attach themselves to subsidized state enterprises. TVEs rather thrive in the market in dividing production with state-owned enterprises, obtaining inputs from them, and selling some output to them (but mostly to consumers). Their complementarity creates wealth for the entire economy.

(h) It follows, then, that private finance develops after separable public finance. Local governments can raise capital for TVEs because their own income is non-trespassable and credible. This experience of China and similar countries demonstrates that a multi-layer federalism can play a crucial role in separating public income and establishing private finance—a role similar to that in merry old England.[65]

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[65]See Yuanzheng Cao, Yingui Qian, and Barry R. Weingast, "From Federalism, Chinese Style, to Privatization, Chinese Style," *Economics of Transition* 7, no. 1 (February 1999): 103-131.

The thrust of all these seemingly non-market policies, intentional or not, was (1) to prevent liberalization of the enterprise network and (2) to close access of private interests to public income. All these policies were applied in part and in one or another mix in specific countries. Only to the extent they were applied, did contractions stop or not occur, and growth followed or started instantly. The data presented in figures 2.1 and 2.2 summarize evidence to this effect.

This paradoxical road to the market economy can be viewed from the general perspective of the second best, formulated by Kelvin Lancaster and R.G. Lipsey. They show that in the absence of full markets and in the presence of distortions, market results in particular areas are impossible whatever market policies are applied. Non-market policies constitute the second best and can obtain the best results possible under the circumstances. Market policies, by contrast, can magnify distortions.[66] This is intuitively simple. As in any system, if a crucial link is missing or broken, many others cannot work right. They must be adjusted in a wrong way from the standpoint of the initial equilibrium and system purity, but this is necessary to enable the system to function at all. An alternative is a crash. Case in point: Russia during the 1990s.

The experience of all post-Communist economies shows that the issue is neither speed nor sequence of policies but their thrust. If policies are found for separating public income and establishing private income, they can be applied at once. If they are not found, the policies of liberalization and privatization should not be applied at all, not fast, not slow. Between these two extremes, every successful country found its own mix, its own second-best solutions, and its own speed. If we combine our discussion of the evolution of private income in history with the experience of post-Communist countries, four strategies stand out:

1. Break up the enterprise network and establish orderly, separable public finance.

2. Create a framework for separable, non-trespassable private finance.

3. Assign property rights based on private, internalized income.

4. Liberalize product, labor, and capital markets, but only on the condition of internalization of income.

We discuss in Part Three of our book the details of how to implement these strategies.

Economies Evolve with the Type of Income

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[66] Kelvin Lancaster and R. G. Lipsey, "The General Theory of Second Best," *The Review of Economic Studies* 24, no. 1 (63) (February 1957): 11-32.

Let us combine the facts discussed in the first four chapters. Economic species evolve and adapt. Economies can evolve from mostly common to mostly private income, as did England after 1688 and China after 1978. To achieve this result, they need to establish a separate fiscal system and separate, private incomes of firms and households. Everything else follows and adapts from these basic, fundamental steps. Going back to redistribution, as practiced by modern welfare states in the 1900s, defeats private income. Economies can also evolve from one species of common income to another. For this, they can increase or reduce the role of the government in the economy. The government can take total control and move from confiscation of relatively free production to forced production under central planning. Or the government can abolish central planning, liberalize, privatize, and surrender fiscal and monetary power to the inherited enterprise network. Reducing the role of the government in the economy under common income does not lead to the market economy. Rather, it creates a new socialist species.

In this chapter, we have sketched the evolution of private income, its origin, and its partial retreat. The next chapter explores various species of common income. We do not claim to present a complete taxonomy, but rather a first approximation. Chapter 6 examines how common income evolves from one species to another. This brings us back to our primary subject, the emergence of enterprise network socialism after central planning, this time from an evolutionary perspective. Chapter 7 tries to combine all previous findings about private and common income economies into a unified taxonomy. Chapter 8 places this story in the context of economic philosophical thought on predatory and productive societies.