Episode 1,118: Austrians Against the Mainstream: A Case Study

Guest: Jeff Herbener

WOODS: We are going to do our best here to cover a topic that you hit on in your recent article over at the Mises Institute. It's an article on taxation, on the ways the mainstream looks at taxation and Austrians look at it, but it relies heavily on a discussion on indifference curve analysis, and the Austrians also have a methodological difference over that. Now, somehow I want to accomplish two things here. I want to convey this stuff without having to use graphs, because this is an audio podcast, and secondly, I want to convey it so that even the beginner who's not heard of indifference curves can walk away with, Okay, I think I have the basic gist of this and I think I see what some of the flaws and shortcomings of the mainstream view might be. So are these reasonable goals that I'm setting?

HERBENER: Well, we'll find out.

WOODS: Yeah, we'll find out. That's right. I love your comment before we went on: "Well, if it's no good, we can always throw it in the trash." [laughing] Now, with that attitude, where are we going to be? So all right, in particular what you're doing in the article is showing how the mainstream might compare, for example, the income tax with an excise tax and come up with the conclusion that people would prefer an income tax of the same amount as opposed to an excise tax. And you're arguing that the method that's used to draw this conclusion is not legitimate. And then also — but you start the article with a discussion of Austrian method, which by implication you're going to be contrasting with the method employed by the mainstream. Do you think to situate the argument we need to start with that here, or is that dispensable?

HERBENER: Well, it might be actually better to start with the context of where my article came from and how I came up with this particular —

WOODS: Great, yeah.

HERBENER: And then we can go in I think to the method point. This argument I learned in graduate school, this is part of Milton Friedman's collection of articles in his essay on positive economics, and we read quite a few and studied quite a few of these articles of Friedman in grad school. And so I was trained as a mainstream economist. I didn't think much about this. It seemed like a proper way to go about doing it in this indifference curve framework and so on, and it seemed that the conclusion that Friedman came to was unexceptionable.

And again, to give a kind of basic point that Friedman is trying to convey with this argument, what he's saying is that his excise tax is imposed upon people, it will have an additional

detrimental effect that an income tax will not. So his idea in the construct is to give two alternative taxes, one an excise tax on some good and then one then a general income tax. And in the two alternatives, the government collects the exact same tax revenue.

And then he says, if that's the case, the person being taxed would always prefer the income tax to the excise tax because the excise tax does one additional bad thing that the income tax does not do. They both do the bad thing of taking income coercively from the person, but the excise tax skews the relative prices of things in the economy in the way that the income tax does not. So the excise tax would be imposed on, let's say, electricity, and then the price of electricity would rise relative to other prices, and these would, he claims, cause a further detriment to the person beyond just the income tax or the tax revenue that's extracted by either the income tax or the excise tax.

WOODS: Isn't that analogous to people who say that the introduction of tax breaks of various kinds likewise distorts decision making? Like for instance, the very popular mortgage interest deduction, that wouldn't it be better if we just had a uniform tax instead of having a tax rate but then also the mortgage interest deduction because that skews resource allocation? And there is a certain — I don't think that's a stupid argument. There seems to be a certain plausibility to that, even without getting into indifference curve analysis or any of that stuff. Is there a way for us to navigate the rights and wrongs of that claim?

HERBENER: Yeah, I completely agree with what you said, and the way in which I found out how to navigate this was after my graduate work, I studied in the Austrian literature and read Murray Rothbard's Man, Economy, and State and then Power and Market. And he explains it in Power and Market. And it turns out Rothbard himself was relying on the prior work of J.B. Say in this area of taxation, and what Say said about taxation is that the detrimental effect of taxation on economic activity depends first and primarily so in the main on the amount of tax revenue that's taken by the state. And this is because, as Rothbard would put it, the command over resources moved out of the arena of entrepreneurial economic calculation where it can be used efficiently and placed in the arena of government politicians and bureaucratic decision-making where the resources will necessarily be used inefficiently.

And so when we compare two tax systems, the main point of comparison is which one would generate the most tax revenue, and then there's the secondary question of how do people react to the taxation system and how does that then introduce further inefficiencies. And you're right then; that would be where this ancillary point comes in. So this is why Rothbard always insisted that loopholes were good on net because they reduce the overall tax burden, even though they would introduce these kind of secondary inefficiencies.

WOODS: But suppose the two options were ones in which the government earns the same revenue, as in your case of the excise tax and the income tax. Then in that case, why would we not prefer a general, simple, everybody-knows-what-it-is tax to, Well, here's a tax but we've got 12 different ways to get out of it, but the government still earns the same amount of revenue?

HERBENER: Yeah, so that's exactly what my article was pinpointing. I was trying to ascertain whether or not in Friedman's presentation if it's actually the case that the government could conduct this equal tax alternative even as a mental experiment problem. The article wasn't about whether this could be done in the real world, which would add other difficulties, but

whether even in the logic of the apparatus that Friedman's using it's possible to generate and equal tax. That was really the sort of gist of what I was trying to get at in the paper.

WOODS: Okay, so for that reason then let's get into the method, because then that will show whether or not this is doable. So I don't know — you've actually been on the show and talked about Austrian method to some degree before, but that was probably like Episode 211. Here we are 1,118. So the intrepid listeners have no doubt heard that one. And by the way, you can only get like the last few hundred of them on iTunes right now. There's a way podcasters cope with that. They have a whole bunch of different streams and each one is 300 long and just, I'm not going to do that. If you want the other episodes, they're at TomWoods.com/episodes, including a lot of these great Herbener ones. But let's talk about what we need to know about method in order to be able to critique what is about to be said to us with regard to indifference curves.

HERBENER: RIght, so the contrast is that the Austrians begin with this causal realist method. So they take the human person as he or she is and the logic of human action and then just work out their analysis from that beginning point. The neoclassical procedure is to rely upon the fictitious economic agent, and the economic agent is doing things logically that the human person would not do, and so this creates a different framework within which the analysis proceeds and then reaches its conclusion.

And in particular in this case, what Austrians insist on is when we think about marginal utility and choice between alternatives and so on, we always think of this with respect to the given circumstances of an action. So Menger's idea of marginal utility is that a person selects the unit of a good — let's say I want a gallon of water to drink each other — and then they value that unit as suitable for — I would value that unit as suitable for drinking. So I don't want to drink two gallons of water or half a gallon; I just want one gallon. And so I would place more value on that gallon than, if I had two gallons of water, the second gallon to which I would have to put to a less valuable use. So we get this idea of diminishing marginal utility that's a consequence of real human action.

Now, in the neoclassical view, that's not what's done. In the neoclassical view, the economic agent values bundles of goods. So he doesn't value each good as it's being used by the actor for a particular action and then judge the utility of that. They say, let's construct a bundle of goods — good X, good Y, good Z — and then configure different bundles of different amounts of X, Y, and Z and then see how the economic agent compares the value difference between those different bundles. So the economic agent could value bundle A over bundle B or B over A, or he could value them the same. And so that's their beginning point in how they proceed, and they have various reasons for doing this, mainly to create a kind of mathematically tractable logic that they use to draw conclusions.

WOODS: All right, so once that is laid out, have they already gone wrong? And if so, where?

HERBENER: That's right, so they've already gone wrong from the very first point, the beginning premises of their argument. They've already gone down the wrong path. And then this leads them to further mistakes as they move down this path. So just to again take a simple illustration of this, remember their alternatives. The way in which Friedman lays this out is a particular sequence of alternatives. So he says, suppose we have this economic agent and the economic agent is not taxed. The economic agent then chooses between these two

goods, X and Y, optimally, and the agent has a certain amount of money income to buy the two goods and so on.

Then the second step is an excise tax is imposed on good X. This raises the price of good X, and now we let this economic agent reoptimize, given that he now has less real income because of the higher price of X, and also he'll substitute away from Y and toward X because X is more expensive relative to Y. So that's the second step.

Then the third step is: now let's give the economic agent another alternative where he can choose between staying where he is with the excise tax, or he can choose an income tax that extracts from him the same amount of tax revenue. And so the income tax option lowers the price of X back where it was and extracts the same amount of tax revenue. Of course, in that circumstance, the agent is able to shift back to good Y that he prefers relative to good X at the original price ratio. That's the way the argument's laid out.

And what I show in my article is that if you change the sequence, you get a different answer. And so it doesn't really depend upon comparing income tax to excise tax. It depends upon this extra condition that is not made explicit in the argument. So the logic doesn't really flow out in the way that Friedman implies when he works through the argument.

WOODS: So walk us through then what happens if the sequence is changed.

HERBENER: Okay, so the other alternative sequence would be: let's let the economic agent again optimize with no tax. Then we'll impose an income tax, so that would be the second step, and let him reoptimize given the income tax. And then we would impose as an alternative an excise tax. And if you do that and you allow this economic agent to reoptimize, then the economic agent can actually lower his tax bill by moving toward X. So in order to keep his tax amount the same, what the analysis is really implying is that the economic agent cannot be allowed to move from his optimal income tax choice. He can't be allowed to reoptimize. So you're imposing really a second condition on this. And if you allow this sequence to proceed, then the government could never hold the tax revenue the same because you're giving the person in the third sequence always the choice to reoptimize. They do this in the income tax case. Well, if they do it in the excise tax case, then the income tax amount would change.

Now, that was probably pretty technical to follow, so let me give you a simpler example of how the sequence might go. Let's suppose we have a real human person and not an economic agent who's bound to act according to utility functions and so on. And he knows that the government is going to follow this sequence. He knows the government is going to say to him: we're going to impose an excise tax at some particular rate on your buying of this good, whatever it is, and then we're going to let you adjust to that, we're going to calculate the tax revenue, and then we're going to give the alternative between the same excise tax and an equivalent income tax.

So now of course what the person would do is the following. The excise tax is imposed. The person chooses to buy none of the good at all, and so the revenue taken from the person is zero. And then the person given the income tax alternative chooses the income tax, which would be zero, and he goes back to his optimal point.

WOODS: [laughing] I like that guy.

HERBENER: Yeah, that guy's a human person, right? That guy's a real person. That's what real people would actually do. And you can see this stilted way in which the economic agent is forced to act in a particular way that is really not fully human.

WOODS: Yeah. Yeah, yeah. Okay, that is kind of interesting. Now, I hope I'm not totally missing the point if I ask you this just as a question of practicality when trying to design something like this in the real world. We're assuming in a case like this that the good on which they place the excise tax is something that the person values and would normally be buying and already is buying and now we're going to put an excise tax on. But in the real world, if they were to try the excise tax route as the main source of revenue, then I could simply — it could turn out that the goods they're targeting I don't like at all, I don't care about, and so I would prefer the excise tax version. Or for example, I would prefer the mortgage interest deduction because I prefer home ownership to other possible uses of my money.

So in other words, there is no uniform answer to the question because the possible preferences I could have are infinite and the possible ways government could tax me are very numerous as well, and maybe I would choose a bundle of taxes and tax breaks that I think benefit me and hurt other people and other people would favor different ones. I get that that's not the theoretical point, but it does seem to be a practical one.

HERBENER: I think it actually is both a theoretical and a practical point, because, again in the Austrian conception, we accept that there are different human persons that have different preferences and abilities and so on and so forth, but in this stilted neoclassical approach there really is just one person, one economic agent who represents sort of all persons. And you can't really incorporate this variation, or when you begin to incorporate this variation, you can't reach the conclusions that you reached before, which are that an income tax is always better than an excise tax for a given tax revenue.

By the way, this also has, when you're talking about the practical application of this, it has a practical application in American history to the original federal government's limitation of tax revenue to tariffs and excise taxes. Part of the reason for this was precisely to keep the tax revenue take of the government low.

WOODS: Right, right, exactly. So to see economists spinning these theoretical tales about how actually if we were disembodied spirits with no human attributes, we would prefer the following system that actually none of us would prefer unless we're parasites and misanthropes. It's extremely disturbing, especially coming from Friedman.

HERBENER: Yeah, right, right. That was the sort of extra added feature of this. This is coming from the pen of someone who is supposed to be an advocate of laissez faire. It's a strange —

WOODS: Well, so what is his point in doing this? Is he saying that, look, taxes are unavoidable, so we might as well make them as efficient as possible and also, to the extent possible, make them conform to people's preferences? Let's arrange them so they are the least-bad taxing option from the point of view of the taxpayers? That was his thinking?

HERBENER: Yeah, that's right; that's right. This is the quest for the, as Rothbard called it, the neutral tax. Can we design a tax system that is neutral to the production processes in the

market or at least less disruptive to the efficient production processes in the market? And the other element of — you know, Rothbard has this great article on the myth of neutral taxation, addressing all the ins and outs of this.

And the other point that Rothbard makes there is that the standard literature that tries to argue for a neutral tax or tries to say let's compare one tax scheme to another with respect to its imposition of inefficiency very rarely pushes the analysis to cover all of the indirect effects of the tax. So they don't treat the economy as an integrated whole, where once you impose an income tax then people's demands for particular products will change and their time preferences will change, so interest rates will change, and so saving and investing will change, and so on and so forth. None of that is in this standard analysis either.

WOODS: That's interesting. And yet, the standard analysis, so-called, is put forth by people who would criticize us for not being scientific enough, isn't it?

HERBENER: [laughing]

WOODS: Am I being unfair?

HERBENER: Oh, not at all. That's absolutely right.

WOODS: Yeah.

HERBENER: That's the common knock against our approach.

WOODS: So the reason that you spend time in your article on indifference curve analysis is the idea that they're using this analysis to try to imagine how somebody would think about different bundles of taxation, or is it different bundles of goods they might by and how the tax affects the way they value those goods?

HERBENER: Right, yeah, it's the latter. It's the indifference curve analysis, no matter how it's applied to whatever issue, would be based upon this bundle valuing of the economic agent, and then it's just applied to this particular case in the Friedman article.

WOODS: So what is the purpose of indifference curve analysis in general in mainstream economics? What purpose does it serve? I guess first of all we should say — I think you probably hit on this, but try to describe the idea of the indifference curve and why is it there? And could mainstream economics get by all right without this analysis, or it a linchpin of something?

HERBENER: Right, it's a linchpin in the following sense. Now, whether or not the mainstream can get along without it is perhaps debatable. I think there's some debate in the mainstream literature about this. But I would say conventionally it's a linchpin. And it works like this, the problem it attempts to solve is this: every economist of all stripes, no matter what their school of thought, modern economists accept the findings of the marginalist revolution, which is that the value that people place upon goods in an action is subjective to the person.

And it follows from this that subjective value cannot be compared interpersonally. If it can't be compared interpersonally, then it can't be the foundation for efficient allocation of resources in and of itself, because you can't compare the subjective value one group of

people would get from using resources one way with the subjective value that a different group would get from getting a different product with those resources. And so that problem needs to be solved somehow, and Mises of course famously solved this by showing how market exchange transforms our preferences, our subjective rank orders of things into money prices, which are cardinal numbers, and now we can do computations and we can make decisions about resource use through economic calculation of profit and loss.

But the mainstream doesn't fully accept this, because what they want to do is apply mathematical reasoning to all economic theory, and in order to do this, they have to have a mathematical representation of subjective utility rankings, and so that's the famous Debreu demonstration in the 1950s that representation theorems — so you can have a preference ranking, as long as it's of all possible goods, and that's where the bundle of goods come from. You have this economic agent who can rank all the different possible bundles of goods, just preferring one to another. Of course, in order to make the function continuous, you also have to allow the agent to say one bundle is the same as another in utility. And from that, you can generate a cardinal number utility function. But the utility function would not be continuous if you didn't have the notion of indifference, and it can't be constructed at all if you don't start with bundles of goods, an agent ranking bundles of goods.

WOODS: So the Austrian take on this involves a number of critiques of the problems with indifference curves, but let's just focus on how does the Austrian think of the acting person and the choices that he faces? They certainly don't think of him as a "economic agent." And secondly, I don't think they think of him in these hypothetical situations where he's presented with this infinite possible array of bundles of goods. They think of him as an actual person at a discreet moment making choices related to discreet resources in particular situations.

HERBENER: Yeah, that's exactly right. So this is Rothbard's idea, what he calls demonstrated preference. So the conception is we have an actual person in actual circumstances with ends that this person has formulated and access to means that the person believes would be suitable to the attainment of an end. And in those circumstances, given the alternative available to the person, the person simply rank orders the subjective values as he or she perceives it of the different alternatives, whether to buy this pair of shoes or that pair of shoes or whether as man entrepreneur to locate your factory in this place with a given cost structure in that location or in a different place in the world where the cost structure is configured in a different way.

WOODS: And just to make sure people don't get the wrong idea, the key I want to leave people with is not simply that the Austrians have some little insight in this case or here and there where we differ from the mainstream, but rather that, thanks to Mises, we've constructed a complete and free-standing alternative to the entire edifice of mainstream economics based on this insight.

HERBENER: Yeah, so that's exactly right. That's really the bottom line to it all, that we start with this basic conception, this realistic conception of the human person, and Mises being the first step and then many other authors after him building on this, the entire panoply of economic explanation of the world. I mean, just think for example of the application of Mises' business cycle theory and how superior it has been to mainstream analysis of cycles. So it isn't just that we have a little niggling complaint about how they do things; it's we have an entire systematic approach that we think is more robust than theirs.

WOODS: So what's the next step for people? They should read your article, which I'll link to at TomWoods.com/1118. They should join LibertyClassroom.com, where they can learn step by step from the beginning Austrian economics from you. In fact, my favorite part of that is I solicited from that a course no one, no one anywhere in the world has created. Namely, Jeff went through an extremely popular mainstream economics textbook used in colleges all over America and did an Austrian critique of every single chapter. He did that for LibertyClassroom.com. That's just amazing that you did that. I'm still not fully out of your debt for having done that.

HERBENER: [laughing]

WOODS: You're going to want to do — because then you'll be able to — you say to yourself, "Man, I wish I knew this stuff inside and out like this Herbener." Yeah, well, you will if you go through and do all this stuff. And then if you are a student, of course, you should apply — because there's probably still a little time, you should apply for Mises University, where you can get an intensive study of Austrian economics for a week this summer, so go over to Mises.org/events and find Mises University and apply for that. And then you've got plenty of reading ahead of you. I've got a place online called LearnAustrianEconomics.com that gives you a recommended program of self-education. So I was about to ask you what people should do next, and then I answered my own question, Jeff.

HERBENER: [laughing] Exactly. You have a better answer, so there you go.

WOODS: All right, good. And there's plenty of Herbener material in everything I just said. All right, thanks, Jeff, and I am very much looking forward to seeing you this summer at that Mises University program.

HERBENER: Oh, me too, Tom. It'll be great.