

**Taxation  
Inflation  
and the role of  
Government**

**MILTON  
FRIEDMAN**

**with**

MICHAEL  
PORTER

FRED  
GRUEN

DON  
STAMMER



Occasional Papers 4

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# **Taxation Inflation and the role of Government**



# Taxation inflation and the role of Government

**Milton Friedman**

*The Hoover Institution  
Stanford University*

*with comments by*

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*Bain & Company*

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**Milton Friedman**

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# Preface

The Centre's series of Occasional Papers is designed to bring to the attention of a wider audience, addresses and essays which it is felt may shed some light on important economic and social issues.

This Occasional Paper publishes the edited transcript of an informal afternoon Seminar sponsored by the Centre for Independent Studies and featuring as guest speaker Professor Milton Friedman who visited Australia during April 1981. The CIS was indeed fortunate that Professor Friedman was able to participate in one of its functions for he is a man of international reputation, not only as an economist, but as a tireless supporter of the many aspects of the free society.

The Seminar also heard comments on Professor Friedman's address by Professor Michael Porter, Professor Fred Gruen and Dr Don Stammer and a number of questions from those in the audience. The Seminar was chaired by Professor Ray Ball, Chairman of the Centre's Research Committee.

The ability of Milton Friedman to convey a clearer understanding of many present-day economic issues to audiences of a wide range of understanding, is perhaps second to none. On this occasion Professor Friedman addressed himself to three interrelated issues, namely taxation, inflation and the role of government and drew attention to how the changing pattern of ideas throughout the world affected these issues.

The proper role of government has been one idea which has always occupied the minds of political philosophers. Various shades of opinion have put this role somewhere along a spectrum from totalitarianism to anarchy. However, if the maintenance of a society of free people is the predominant desire then there are very few options. A number of thinkers including John Locke and Adam Smith, determined that for a people to prosper in freedom, their governments must be limited to a small number of specific functions that it seemed only governments could best undertake, and leave the rest to individuals. They arrived at this position not only through philosophical insight, but by a keen observance of several thousand years of human history. The consequences of the ideas of Smith and others were that many nations reversed

their mercantilist economic philosophies, adopted policies of free trade and limited government, and embarked upon a never before seen period of prosperity for all levels of society.

Today it would appear that we have forgotten many of those lessons as we enter upon an era of ever-burgeoning state power. It may also be that today's interventionist-style government is more pervasive than before. Increasingly, governments are taking over activities which were considered solely the domain of individuals. At the same time they have removed from individuals the responsibilities for the consequences of many of their actions. Along with this growth in government functions has come high taxation and high inflation. And why? If the government takes over more functions, then these must be paid for. Taxation increases until resistance is met and then without the necessary revenue, governments must resort to inflation to pay for their schemes - inflation being a hidden form of taxation.

The processes that led to the changes in economic philosophy and government policy both in Adam Smith's time (towards the free market) and in recent history (away from the free market), are crucial to an understanding of the role of government today for, according to Friedman, we are witnessing another change of direction and again, it is a turn away from collectivism, away from centralised control and towards a greater role for individuals and the market. He surveys the changes in public opinion and how this relates to perceptions of what governments should do. People have felt that they are not getting their money's worth for the taxes they pay. The persistence of inflation has led to dissatisfaction from the citizenry and governments now see that inflation must be beaten - it is becoming politically profitable for them to do so. Experiences of the failure of government are a major factor leading once again to a re-evaluation of government's role.

The Centre for Independent Studies is pleased to have sponsored the Seminar and to publish this edited transcript of the proceedings, for it feels that a significant contribution has been made to the debate on economic and social issues in Australia. Nevertheless, the conclusions presented in this publication by the various participants are theirs alone and cannot be considered to be those of the Centre, its Directors, Trustees, Advisers or officers.

**Greg Lindsay**

# Taxation Inflation and the role of Government MILTON FRIEDMAN

I'm very glad to be with you. I think it is a sign of the health of the kind of ideas that the Centre for Independent Studies is promoting that there should be so many of you here. The only other explanation I can find is that they have under-priced it.

Indeed, one of the things that I find is most impressing as I have been following free market ideas over a long time is the extent to which there is a world wide transmission of ideas. Countries have been very successful in inhibiting the flow of goods and services. Protectionism is rife and in not very many places is it more so than Australia. But no country has been able to succeed in keeping out ideas. The result is that, whereas it is sometimes difficult to talk about a world business cycle or a world trend (because that will be different from country to country as they follow their own national policies), there is no difficulty whatsoever in talking about a world climate of opinion and a world trend of ideas. That climate of opinion changes from time to time - very infrequently, very slowly and taking a long period of time to develop, to emerge and to be reversed.

## **Major tides of opinion**

As I look at the areas we are interested in, the areas of the role of government and of economic arrangements, I think we have had two major tides of opinion in the past two centuries. One was set in motion, if you want a convenient date, in 1776 with the publication of Adam Smith's *Wealth of Nations*. That was a tide of opinion going against the mercantilist governments of the time, the centrally controlled welfare states of the 18th century. It was a tide of opinion in favour of a greater degree of free markets, of laissez-faire, of competition. Adam Smith himself, when he wrote his book, thought that it was vain to hope that you

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could ever succeed in achieving free trade. He used a fine expression that it was 'as absurd to expect that an Oceana or Utopia should ever be established'. And yet 70 years later in 1846 you did achieve complete free trade in Great Britain and the tide of opinion (that dominant sentiment for the rest of the 19th Century) was in the direction that Adam Smith had started. That tide of opinion was world wide. It was manifested not only in Great Britain. It was manifested on the continent of Europe; it was manifested in the United States; it was manifested even as far away as Japan where, after the Meiji restoration in 1867, Japan developed along essentially free market, free enterprise lines.

Toward the end of the 19th century, there began to be a change in the tide of opinion. A.V. Dicey, the great British constitutional lawyer, set the turn in opinion as occurring some time around the 1880s or 1890s, when he claimed that British public opinion turned away from belief in laissez-faire and individual freedom and toward a belief in a greater role for government and collectivism. He describes it as an emerging tide of collectivism. As in the case of Adam Smith's time, it took a long time before the change in the tide of opinion came to affect in any very significant way actual policy and behaviour. In Great Britain it was reflected in the pre-World War I movement towards the welfare state, in the introduction of various social insurance measures and the like. It was not fully reflected in the United States in policy until after the New Deal got started in 1933. But again it was world wide. It was reflected in India and the kind of government they adopted after it gained its independence in 1948. It was reflected no less in the success of the communist revolution in Russia, and after World War II in the success of the communist revolution in China. All of these were reflections of that same tide of opinion, of a loss of confidence in markets and individualism and an increase in confidence in collectivism and centralisation.

In my view a new tide of opinion has been turning ever since shortly after World War II and it is a reverse tide, a tide away from centralised control and collectivism, a tide towards a greater role for individuals and for free markets. Again it is world wide. The first manifestation of an actual policy curiously enough came in the Far East. It came in Hong Kong, in Singapore and Taiwan - in that Asian crescent of countries which experienced a drastic change after World War II and which have been the great success stories of economic improvement in the well-being of their people.

The fascinating thing about them is that all of them departed from the earlier pattern. They departed from the pattern that was set by India and by many other countries in their adoption of central planning, and instead they relied primarily on the market and were, as I say, great successes. But that same tide of opinion has been affecting policy in the whole of the rest of the world. We have dramatic examples of it right now. What is happening in Poland could not have happened fifty years ago. The attempts by a country like Hungary to introduce market mechanisms provide another example.

My wife and I spent a number of weeks in September in China and there again, in the attempt to introduce market mechanisms, you can see a reaction against highly centralised control. I stress 'attempt' because I have no great confidence in how far that will be carried or how successful it will be, but it is a dramatic example of the power of ideas and the extent to which they do spread their influence and cannot be contained. That same tide was demonstrated in Great Britain in the election of Margaret Thatcher; in Sweden in the defeat of a Social Democratic government that had been in office for forty years; most recently in the United States in the election of Ronald Reagan as President and in the change in the character of the U.S. Congress, particularly the Senate.

I have the impression that the same tide has not been completely absent from Australia and indeed it is reflected in the number of people who are here today and in the success of the Centre for Independent Studies. It is fascinating to me how small organisations like the CIS, independent of official sponsorship and governmental bodies, have been able to exert a tremendous influence. In Great Britain the Institute of Economic Affairs in London - Ralph Harris' and Arthur Seldon's institute - has had a far greater influence on attitudes and ideas within Britain in the past twenty years, in my opinion, than any of the much better known or much more prestigious institutions of learning. In Canada the Fraser Institute in Vancouver has been playing the same kind of role and it has been having an extraordinarily great influence. I hope your Centre here will have the same kind of influence.

But the title of this session is *Taxation, Inflation and the Role of Government* and you may be wondering what I've been saying has to do with that. I think it is closely related to our subject because it is very easy to see that the trends that I have been talking about have been manifested funda-

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mentally in those areas. They have been fundamentally about the role of government and that has been reflected in turn in the extent of taxation and the emergence of inflation.

### **The role of government**

The whole question has been: What is the appropriate role of government? Is it, as Adam Smith urged, to construct a system of natural liberty in which people are free to pursue their own ends, in which the invisible hand will lead people who seek to pursue only their own interests to promote the social interest? Or is the appropriate role of government, as the Fabian socialists and the other collectivists would tell you, to serve as a benevolent parent to make sure that its wards act in a way which is in their own best interest? Is it to have a very visible hand of government which prevents the invisible hand from carrying out its functions and which guides people in the course of their lives?

The difference between these approaches is not really one of objectives. I don't mean to say that the people who tend to pursue these may not have different objectives. Nor do I mean to say that the one system or another may not give power or may not automatically render power unto people with different objectives. The intellectuals who have largely developed and fostered these ideas have had essentially the same objectives, but they have envisaged different techniques by which those objectives could be carried out. The reaction that has occurred from time to time, the change in tide of opinion and its impact on policy, has not in my opinion come primarily from the success of intellectuals of one kind or another in persuading the people. It has come from the peoples' actual experience with the results of the policies that were adopted.

If you go back to the 19th century, the laissez-faire policies were very successful from the point of view of those who set them up. Britain had an enormous growth in income, prosperity and influence in the latter half of the 19th century when it was following a laissez-faire policy. Japan emerged as a modern nation at the end of the 19th century when it was following essentially the same policy. And so on down the line.

But at the same time that very success rendered some features of the landscape more visible and brought more attention both to their evils and to the possibility of doing something about them. And that in turn, in the natural

human reaction in which people always take good things for granted and always regard them as their due, led them to regard any bad features of the landscape as being a result of malevolent, evil people who seek to harm their fellow man. A natural reaction consequently was the development of the idea that we ought to use the instruments of the State and of Government to improve the lot of the ordinary man and to promote welfare.

Experience has again been producing a turn away from that. Governments have grown and grown. They have expanded their role and, lo and behold, they seem not to have achieved their objectives. The well-meaning objectives of a paternalistic government that will take from some to benefit others, has turned out to produce very disappointing results and for very understandable reasons. And those results have been most manifested in exactly the items that are the topics of this talk.

In the area of taxation, tax burdens have grown. The fraction of people's resources that has been taken over by their governments has become increasingly large and people world wide have felt that they have not been getting their money's worth for the taxes they are paying. People in all countries have felt driven to take whatever measures they can to avoid those taxes - to engage in what is called 'underground activity' - to try to achieve their income in ways that so far as possible escape tax. And of course they have been driven to protest against the size of taxation. The public reaction against taxes has been one of the factors that in turn has given rise to inflation. As government spending has risen, governments everywhere have tried to raise resources to spend, without imposing explicit taxes on their constituents. And one way in which they have been able to do so has been by financing their spending through creation of money. That in turn has given rise to inflation.

Now most people in the world really like inflation, at least when it affects the prices of the things they sell, but they begin to object to it when it affects notably the prices of the things they buy. Sooner or later it does have that unfortunate effect and therefore sooner or later you do get a public protest against the emergence of inflation.

It's fascinating to note that the English constitutional lawyer I spoke of earlier, A.V. Dicey, writing in 1913 in the preface to his book *Law and Public Opinion In the Nineteenth Century*, said that if there ever comes a check to a socialist government it will be because of the reactions of people to

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high taxation. I think that is one of the most brilliant and prescient statements you can possibly imagine - he was 50 years ahead of his time. I think that has been what we have been observing and all over the world therefore, there has been a reaction in an attempt to narrow the role of government, reduce inflation and limit the scope of taxation. Whether that move will succeed or not is an open question. It is a very difficult thing; everybody is interested in reducing taxation, provided the particular benefits he thinks he gets from government are not reduced.

Let me go on by saying a few more specific things about these three topics: taxation, inflation and the role of government.

### **Taxation**

I think there is a great misconception about what taxation is. The true tax on any people is what government spends, plus the additional cost government imposes on the people in the course of getting the funds to spend. Let me elaborate on that in a moment.

We read a lot in the papers about governments having deficits and about the problems of raising enough taxes to pay for spending. Now that's nonsense. Governments never have deficits in any meaningful economic sense. I don't know the figures well enough here for Australia, but if the United States government in the current fiscal year spends \$650 billion and takes in (in what are called taxes) \$600 billion, who do you suppose pays the other \$50 billion? Is there some Santa Claus somewhere who pays that \$50 billion? I don't think even Saudi Arabia is willing to come and give us that much foreign aid. The \$50 billion is paid for by the American people and it is paid for in the form of taxes. But the taxes are hidden. In so far as the \$50 billion is financed by printing money, people are paying for it in the form of the hidden tax of inflation. In so far as it is financed by supposedly borrowing from the public, that is essentially a claim on future wealth and so then it represents a hidden tax on the wealth of the country. In an important sense government budgets are always balanced and the real tax burden on the public is to be measured by what governments spend.

Moreover that's an underestimate of the tax burden on the people because, over and above what governments spend exclusively, there are costs imposed on the public in connection with the collection of those taxes. Those costs



ought to be included in estimating the burden of taxes on the people. If somebody, because it's a way of evading tax, invests his funds in a way that is less remunerative than other investments open to him, tax considerations aside, then he is doing the equivalent of paying taxes. That's a tax burden. Not to mention the more trivial but equally burdensome problem that, as you spend time to fill out your tax returns you are an unpaid clerk for the government. Government spending ought to include the cost of your time filling out the tax return and that ought to be included in both spending and taxation. I once made an estimate in connection with a *Newsweek* column I wrote that the time people spend in the United States in filling out income taxes would provide enough resources to build 50,000 houses a year. And that's an honest-to-God cost. Those are 50,000 houses that the American people are doing without, because people instead are spending their time trying to invent appropriate figures to reduce their tax burden.

In addition to which, in a country like the United States and I am sure in your country, some of our ablest people are devoting their talents to the strictly unproductive activities of finding ways in which people can avoid taxes. The producers of tax shelters are able people. They are pursuing their interests and the interests of their clients, but from a social point of view that's a complete and utter waste and it ought to be included in the tax burden which is borne by the public at large.

Now over and above that you ought also to include in the total burden of taxation, the cost of regulations that are imposed on the public at large. In the United States Murray Weidenbaum, the current chairman of the Council of Economic Advisers, who was head of the Centre for the Study of American Business at Washington University in St. Louis, has made very detailed estimates of the cost of complying with governmental regulation, of filling out those 4,336 forms, of doing things in a different way than you would want to because there is some regulation requiring you to, and so on. His estimate says that the total cost-some years back was well over \$100 billion a year. Well that means that the Federal budget instead of being \$650 billion was really \$750 billion so far as that item was concerned.

In both the United States and in Australia at the moment, recorded government spending - what government spends at the Federal, State and local levels - is somewhere around 38% of the national income. If you could include this

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indirect government spending (the burden on taxpayers of the cost of collecting the taxes, the inefficiencies and distortions and the like) it would be much higher than that. Now from the point of view of people who believe in self government there is nothing wrong with that, provided that people believe they are getting their money's worth. But suppose you went around to the people of this country and said: 'You know, 40% of your income is being spent for you by government. You are working from January 1st to roughly the end of May to pay the cost of government and the rest of the time you are working for yourself. Are you getting your money's worth?' What do you suppose the answer would be? Well there are a few government civil servants who would probably say 'yes', but I doubt very much if there would be many other people who would say 'yes', and I know for the United States there are very few people who would say 'yes'. It is this reaction to the feeling that people are not getting their money's worth which has been at the bottom of the tax revolt that has swept the United States and that has been a large part of the political atmosphere of the past few years.

It is in the self interest, of course, of those of us who get involved in government to make the collection of taxes and the bearing of this burden as painless as possible. One of the most efficient devices which is used for this purpose is to tax in forms which are invisible. Those of us who would like to have the public aware of what is going on ought to be in favour of having taxes as visible as possible. The most invisible taxes we have in various countries, in my country and in yours, are those such as company taxes. One thing we know is that a company can't pay any taxes. Only people can pay taxes. What a company can do is collect taxes. What happens is that a company collects taxes from its stockholders, from its workers and from its customers and turns over the proceeds to the government, but it does so in such a way that the workers and the stockholders and the customers hardly know that they have paid taxes.

That's equally true in the United States, not only with corporate taxes but with many of the other invisible taxes we have. In our various countries we have developed systems for collecting personal direct income taxes at source, so they are taken out of your pay cheque before you get it. I have to confess that I am guilty of having played a part in the United States in designing our system when I was working as an economist at the Treasury Department during the early part of the War and I may say my wife has never forgiven me.

That is another device which has made the burden of taxes less visible. Personally I believe, that in so far as you are going to have taxes, they should be as visible as possible. In my opinion, apart from a few minor exceptions (for example, fees in the form of taxes which are really designed to pay for services - gasoline taxes designed to pay for roadways being one case that comes to mind) the least bad form of taxation is a straight flat rate tax on all spending above a minimum charged on everybody and collected in such a way that people know they are paying it. The second least bad tax is a similar flat rate tax on all income above a minimum. Those seem to me to be the most visible and least bad taxes.

### **Inflation**

As I said, what is true about taxation has been true of inflation. It too, in my opinion, reflects a response to the growth of government and to the expansion of the role of government. Inflation is a monetary phenomenon which is produced by a more rapid increase in the quantity of money than output. Under modern circumstances (this was not true many years ago) it is everywhere produced by government.

Your government at the moment has a target of inflation for the next year of about 9%. Now I doubt very much that any of you have heard a major leader of your government get up and proclaim that the government's target for inflation next year is 9%. Maybe I'm wrong and yet when the government announces that its target for monetary growth is 9-11%, that's equivalent to saying its target for inflation is somewhere around 9%.

Inflation has been resorted to again in considerable measure as a way of making less visible the level of taxation to which the public is subjected, because that again tends to be in the form of a hidden tax. Here again there is a widespread attempt around many countries in the world to reduce the level of inflation and almost all of them have come to recognise that that involves reducing the rate of monetary growth. But objectives are one thing and achievements are another. The record is not yet in as to whether any of the governments will be able to achieve their objectives. That's a slight exaggeration: there are some records in, for Japan has done very well over the past eight years.

There is not very much more to say about inflation except to say that it has in fact been accompanied over

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recent years by slow growth and we have had the phenomenon of stagflation - inflation accompanied by slow growth - and that higher and higher inflation has gone hand in hand in country after country with higher and higher rates of unemployment. This is something which many people at one time thought was a paradox, but it is not a paradox. The fact is, in my opinion, that both inflation and slow growth have been the common consequence of the expansion of government. In its growth and expansion, government has on the one hand promoted inflation and on the other hand has promoted inefficiency and rigidity, and in the process of promoting that inefficiency and rigidity there has been a tendency towards slower growth.

### **Current tide of opinion**

I think we are at the moment living in a very exciting time, because it is only, as I said at the very outset, about once every 100 years that you come to the stage where there is a real possibility of a decided change in the direction of governmental economic and social policies. We are, I believe, at one of those turning points now. It is by no means certain that it will be a successful turning point. The consequences if it is not, I fear - the consequences of continuing on the path of bigger and bigger government or more and more taxation or more and more intervention - will be that there does ultimately come a point beyond which a country will degenerate into a completely collectivist state. There are very few examples in history of collectivist states that have peacefully converted to democratic free societies and as a consequence I think a great deal is riding on whether we can achieve this kind of a transition. It is riding on whether we can reverse the course, on whether we can move toward a lower level of government, a lower level of spending, and a lower level of taxation and intervention.

### **Current public opinion in United States**

I am at present reasonably optimistic that we in the United States have a fair chance of success in that direction. We have a public opinion at the moment which is very favourable to a move to lower government spending, taxation and intervention. We have a President who is determined to achieve such a change and who has proclaimed a policy which would be effective to it. The members of Congress and our

elected officials have been listening to the voice of the people and have been discovering that it may be politically profitable for a change to move in that direction. But all that having been said, it is still very much of an open question, because history suggests that it is much easier to avoid going in the wrong direction in the first place, than it is to reverse course once you have gone that way. You tend to build up all sorts of vested interests and all sorts of restrictions to movement.

### **Prospects for Australia**

Australia has been very fortunate over a long period of time in that it has not fallen prey to those excesses. I am always fascinated by an example that goes back a long time and with which I will close. Back in the 1920s and 1930s, students of economic development and economic history used to compare Australia and Argentina. Now I know that Argentina being in South America is not in the front of your consciousness in Australia, but it is a very interesting comparison. The two countries used to be compared because they had a great deal in common. They were both countries of almost entirely European settlement. As you know, many of the South American countries have very large admixtures of native indians, but Argentina was almost entirely settled by Europeans as was Australia. Both were countries with rather spectacular natural resources of a similar kind, much land, great opportunities for agriculture and particularly for animal husbandry, for beef and for sheep. Both were countries that had been progressing rather well and rather rapidly. And when people would talk about which of the newer countries had the greatest chance to emerge and become productive and affluent, they would tend to lump Australia and Argentina together.

If you look at the history of the two countries since then, their courses have diverged very much. What produced that divergence? There was nothing that happened to the natural resources of Argentina. There was nothing that happened to the quality of its people. What did happen was a political change: the emergence of Mr Peron and the Peronist movement of a collectivist socialist society; a rigidified society which stopped that Argentinian growth and development largely in its tracks after the artificial stimulus of wartime boom had disappeared, and which led to a real catastrophe, an experience from which it is only now trying

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very hard and not very successfully to recoup. Australia was very fortunate in this respect in that it managed to avoid that kind of development. You retained your democratic, largely market-capitalist system, though it was filled with all sorts of protection and all sorts of rigidities and yet with enough flexibility and fluidity so that you were able to continue on an upward path. But if Australia were to go the way of Argentina in its political system it would go the way of Argentina in its economic system. That only illustrates how much is at stake in your capacity to control your destinies, to turn things around and to start putting a greater degree of freedom into your polity.

# Commentary

## Michael Porter

It is a very great privilege to follow Milton Friedman. First of all I should like to deny the rumour that my mother's maiden name is Dix and that her first name is Dorothy; because I certainly agree with most of what Milton Friedman has said here and on other occasions. I view my role here as agent provocateur.

I would like to talk briefly about two markets which are thoroughly distorted in Australia; markets which do not immediately come to mind, but which are very much behind the current inflationary problems and which are generating considerable social waste in our society.

These are the market for knowledge and the market for sickness. Both are heavily regulated and growing rapidly and both account for sharply increasing percentages of government expenditure. The distortions in the tertiary education component of the knowledge market make even the textiles industry look good. Yet to date most criticism of economic policy in Australia has been in relation to manufacturing industries such as textiles, leaving education largely alone.

Professor Friedman mentioned that while it is easy for governments to restrict the flow of commodities, it is less easy to restrict the flow of ideas. Regrettably we Australians have come up with numerous restrictions in the market for knowledge. In primary and secondary schools, we have a degree of competition, with private schools acting as a safety valve (but if you choose to go to a private school you have to pay twice, both taxes and fees, with some offset via per capita grants to private schools). There is a system of largely tenured teachers in the state system, with very limited capacity of students to move between schools and a bureaucratic incapacity to sack incompetent teachers. Right now of course, with declining student numbers, it is politically difficult to reform the school system, given the government induced over-supply of teachers. Instead of

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experimenting with schemes such as vouchers and private supplementation schemes, which might create greater choice in schools, the current preoccupation of governments of differing political persuasions is to pour more money into the system rather than risk a restructuring. I would very much like to draw Milton Friedman out on the subject of education, schools and vouchers.

Coming to tertiary education the rot really sets in. Whereas students can opt out of the state school system into a private school there are no such options in the tertiary sector unless students are inclined to stay home and read or go overseas. It is not difficult to document the extent to which students are misdirected by the rules of our tertiary system. We are told by our great mineral companies, for example, that they are seriously short of skilled labour and yet students are pouring into universities in ever increasing numbers. We have a situation within tertiary education which might be called 'the battle for the mediocre mind', because every tertiary institution expects that it can increase its income by attracting students away from other institutions. This battle is rarely fought out on educational criteria, given that the universities believe they have a monopoly of those with exceptionally high ability, and consequently attempts to expand budgets often lead to a lowering of standards. Such social inefficiency should hardly surprise Buchanan and Devletoglou who once asked, 'What would you expect of an industry that gave its product away and offered the workers life-time tenure?'

The other rapidly growing area of State and Federal government expenditures occurs in the market for sickness. I use the word sickness rather than health given that doctors' incomes increase with the extent of our sickness rather than our health. The current health mess could be reduced by a competitive market for 'sickness services' in which doctors adopted an essentially 'Chinese' formula - that is a fixed fee per annum for preventative and other health care with the bulk of marginal costs of medical care borne by the doctor. In this situation both patients and doctors would have a vested interest in efficient allocation of health resources. In contrast, in our current situation the government-induced insurance arrangements encourage persons to make additional use of medical and hospital care at virtually no marginal cost, and doctors are encouraged to prescribe and operate with the highest frequency their consciences allow. Just as the mismatch in the education market is to be expected given the



incentive structure, so too should we expect the extraordinary growth rates in medical and health expenditures given the nature of our medical incentive 'system'.

Professor Friedman briefly endorsed a flat tax and I would like to add that as far as I know, there is no serious evidence for the proposition that introduction of a flat tax would lower total tax receipts. Indeed the evidence points the other way, but it is very difficult to disentangle. It would appear that after standardising for the growth of wage salaries and supplements in Australia, tax receipts paid by PAYE taxpayers appear to be **negatively** associated with marginal tax rates. Unfortunately, there are some problems of interpretation here because this apparent decline of the tax take also correlates with the growth of the number of working women. One of the reasons for the decline in tax take is that a wife who chooses to work ten or twenty hours may get the lot tax free, whereas her husband may face a penal rate of taxation should he choose to work overtime. For this reason and others related to the disincentive effect of high marginal rates of taxation, Australian evidence may well turn out to confirm Laffer's wishbone.

Monetary issues didn't loom large in Professor Friedman's discussion, so I would like to ask a few questions. It would seem to me that in Australia, persons in positions of power in the Reserve Bank and the Treasury have been persuaded by the ideas of Milton Friedman, and this is a situation which has been noted in other countries. The real question, however, relates to the political viability of policies such as those advocated by Friedman. We come, then, to the question of whether it is possible in a democracy to impose the sort of monetary discipline which can both cure inflation and lay the basis for freedom and prosperity.

The bulk of the evidence in Australia regarding the linkage between money, output and prices, is very much along the lines that Professor Friedman has argued for many years. We find a very strong and sustained connection between money and prices with an elasticity of about one. We also find that a monetary crunch can very rapidly reduce output, maybe within six months. We also find that monetary expansion can have a weak positive effect on output in the short-run, but it then tends to wash out over the next year or so. Like most other countries we fail to have much evidence on the relationship between monetary restriction, particularly sustained monetary restriction, and a reduction in the rate of inflation, for the simple reason that

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most political processes have made it impossible to sustain sharp reductions in monetary growth.

This then leads me to the basic question of what sort of countries find it possible to adopt Friedman-type policies? Is there not evidence that such policies are easier to adopt in countries with less respect for democratic processes?

One final question; in an ideal world - and maybe we can move to this promised land with the release and implementation of the Campbell Committee's report - what regulations and constraints ought to be retained? Should we have a Federal Deposit Insurance Corporation; should there be prudential controls? What is the sort of minimal structure Professor Friedman would recommend. In nineteenth century Australia, our financial sector was heavily specialised in wool, gold and other minerals, and this dependence created pressure for heavy controls, given the volatility of the primary sector. But given our more diversified economy and greater international integration, and given the capacity of our central bank to constrain monetary growth, fears regarding financial instability would now seem to have a weaker foundation. What minimal financial structure is appropriate for Australia?

# Commentary

Fred Gruen

I feel a bit like a Christian among the libertarian lions. Although I'm not a Christian, I do feel somewhat isolated among these libertarian lions. Also as a former pupil of Milton Friedman's, I have a very healthy respect of his ability as a debater. I thought the most sensible thing was not to tackle him head on, on economics, but perhaps to start on the cognate discipline of economic history where he might be more vulnerable. Although after I wrote that I realised he was the author of *A Monetary History of the United States* and really I'm not quite sure I'm going to get very far that way either.

Let me first of all challenge the view of the golden economic age before World War I, when government kept to essentials and economically the western world was, if not prosperous, at least dynamic and becoming more prosperous all the time. Now if one compares productivity growth rates per man hour in the western world, there is little doubt that the most dynamic period in western economic performance was not the 19th century but the 20 years from 1950 to 1970. There are no doubt many reasons why we have had this very good performance from 1950 to 1970. I would imagine for instance that trade liberalisation in Europe has been one of the major factors, but I think we have to realise that this period coincided with a very rapid growth of government. It has also been argued that the lack of social tension at that time was partly the result of the growth of world wide social security provision. I want to quote what Angus Maddison said on that subject relatively recently.\* He examined why the performance of the west declined in the 1970s and he compares this with the 50s and the 60s. He says the climate

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\* 'Western Economic Performance in the 1970s' in *Banca Nazionale del Lavoro*, September 1980. pp. 258-259.

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of wage bargaining in the 50s and 60s was rather mild. By pre-war standards there was a very low level of social tension. Several reasons contributed to this: the unprecedented increases in real income, the effect of east-west tension in consolidating western societies internally, the community feelings promoted by wide social security provisions and income transfers. The climate can best be recalled by citing some of the social critics of that epoch whose judgements now seem so inappropriate. In books published at that time, Crossland, Galbraith, Bell and Myrdal, all proclaimed the unimportance of distributive issues, the increasing internal harmony of western societies, a rise of legitimate meritocratic elites etc. The welfare state was in its hey-day. There was no New Left, no neo-Marxist renaissance. Hayek was quiescent on current issues and Harold Macmillan said 'we never had it so good' and what's more he was believed.

Now everyone believes that government has become too big. For instance John Kenneth Galbraith said two months ago\* that expenditure on social welfare has been undertaken without careful judgement of need or cost, that the quality of public administration has been seriously deficient and that macroeconomic management no longer works. If John Kenneth Galbraith and Milton Friedman agree, far be it from me to argue with both of them. However, there is really no evidence that the growth of big government has led to all the evils Professor Friedman says it has led to. To the best of my knowledge there is no serious historical, econometric or statistical study showing that big government has led to inflation, that big government has led to poor economic performance, and when I say that I'm thinking of the type of study that Friedman and Schwartz produced on the monetary history of the United States. The reason for there being no such study is not that it hasn't been tried. Alan Peacock for instance attempted that sort of a study and had to give up.

So what do we have to rely on when we denounce big government? We have to rely on casual empiricism for showing the economic ill-effects of big government. Now the basic trouble with casual empiricism is that the two opposing sides can rely on different bits of casual evidence. For every businessman who regards England as an example par excellence of how big government has ruined the country,

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\* *New York Review of Books*, 22 January 1981, p. 33.

there is a do-gooder who will point out that Germany and Sweden have welfare systems which cost proportionately more than Britain's and do more good in terms of alleviating poverty and suffering. So I would argue that we can't really get very far that way either, because we all pick the bits of casual evidence which suit our particular wishes. So my first major question to Professor Friedman is: Just what evidence does he rely on when he warns us that government has grown so big it is threatening our living standards, our economic well being and our future economic dynamism?

Secondly, suppose that we reduce the level of government. I might add that, contrary to popular myths, that means at least as much that we need to reduce the level of State governments in Australia, since these have grown much faster over the last three decades than the federal government, but that's not a beef I have with our honoured guest. Suppose we reduce both the level of government expenditure and the amount of government regulation. What guarantee have we or even what likelihood is there that private economic agents will compete vigorously and become sufficiently flexible to take advantage of the changing economic opportunities offering? I would argue that all the Australian evidence suggests that there would be in-club settlements of economic disagreements between rivals, rather than all-out economic and price competition. It is difficult to think of any economic activity in Australia that is not subject to regulation, either by government or by industry. If government gets out of the regulating business, private self regulation takes over.

Professor Friedman, you say on page two of your book "Tax Limitation, Inflation and the Role of Government," that:

one meaning that is often attached to free enterprise is the meaning that enterprises shall be free to do what they want. That is not the meaning that has historically been attached to free enterprise. What we really mean by free enterprise is the freedom of individuals to set up enterprises.

By that standard there is practically no free enterprise in this country. Even when there is no government regulation or even when there was no government regulation, you couldn't become a stockbroker in this country before there was government regulation and you couldn't undercut existing

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\* Published by the Fisher Institute in Dallas, Texas.

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stockbrokers. You couldn't start a newspaper as someone tried in Melbourne because you couldn't get your newspapers distributed. We used to have a Trade Practices Act under which business agreements in restraint of competition had to be registered. Before the repeal of that particular Act in 1974, 14,403 examinable business agreements were registered under the Act. I would argue that in small economies such as Australia, economic rivalries are generally settled in-club. Full-blown economic and especially price competition is rare outside certain areas such as food and clothing. In other words, I believe that especially in small democratic countries, private interest groups will take over regulatory functions and prevent economic change which is inimical to them and thus rob us of the economic dynamism of earlier years. Or to put it another way I think there is merit in Mancur Olsen's thesis of the gradual senescence of western democratic countries because private pressure groups are acquiring a veto power preventing change.

I think it is significant that the countries in this part of the world which meet with greatest approval from Professor Friedman are Taiwan, Hong Kong and Singapore. These are all countries which are governed without the sort of competition for votes from rival political parties which normally characterise democratic societies and which enables private interests to exercise their veto power.

# Commentary

## Don Stammer

As the only person at the table who is not a professor of economics, I proposed to talk today about the economics of education. But Michael Porter has handled that topic very well. A simple observation is that the financial system, which has already been freed up to a certain extent, is currently being reviewed by the Campbell Committee and the expectation is that it will be freed up even further. Many of us look forward to a similar committee of inquiry into the barriers to competition and efficiency in the education system.

I would like to make one other small observation before I ask three questions. The small observation is that in the first half of his talk Professor Friedman did not mention the word 'money'. I wondered how I would hang my question, carefully prepared last night, if his talk didn't mention money at all. But for those who keep such statistics, the word 'money' was mentioned five times in the second part of Professor Friedman's talk.

Professor Friedman is well known for his observation that substantial inflation is always and everywhere a monetary phenomenon. My question to him is: Why has money got so badly out of control? I suspect some of the reasons lie with governments seeking to solve in the wrong way the problem of unemployment. I suspect that part of the reason is governments meeting pressures on them for an expansion of the government sector while not increasing the level of taxation. Professor Friedman has written extensively about these two influences. But there is, I think, a further explanation as to why money has got out of control: the monetary authorities have been accommodating and validating the inflationary wage settlements reached by trade unions and employers. If that factor is important, much of the disagreement among economists on the cause of inflation is misplaced. If we can agree that rapid growth in the money supply reflects the authorities' validating the actions of monopolies, much of the conflict among

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economists may be put aside to allow more effort to be spent on considering cures for inflation.

My second question relates to the welfare costs of inflation. In 1973 as a research economist in the Reserve Bank, I was asked to write a paper on the welfare costs of inflation. I went to the Bank's library and borrowed a large number of articles carrying that title; many of the articles were from the University of Chicago. Most of the articles were concerned with a thing called the 'welfare triangle' which, when I got to understand it, was that inflation mattered because interest is not paid on money; therefore there is a distortion to portfolios at a time of inflation. Well since 1973 there has been a horrible increase in prices: in Australia the price level has doubled since 1974 and obviously we have learnt the hard way on the welfare costs of inflation. Indeed, in the light of this experience, the earlier analyses now seem like considering the problem of wear and tear on the fiddle while Rome burned. The important costs of inflation are uncertainty and the shortening of business and household horizons and the enormous distortion done to relative price signals. At a time of rapid growth in prices, people just can't see or respond to movements in relative prices. I ask Professor Friedman, have I been too harsh on how economists a few years ago assessed the welfare costs of inflation? As part of that, does he think that our kind of economy can live with another decade or so of inflation?

Finally, we often see reference in the press to the development, particularly in the U.S., of the branch of (or development in) economics called 'supply side' economics. Emphasis on the supply side sounds very familiar to an Australian economist. Around 1974 we had a sizeable jolt to real wages in this country and as a result, at least in my view, unemployment rose sharply. We didn't call this supply side economics, but of course that is a title under which this unhappy experience of rising unemployment could be considered. But 'supply side' economics is also given a more specific meaning. As I understand much of supply side economics now, it runs in terms of the following: If the government cuts taxes in advance of a cut in government spending, the boost to initiatives and the boost to economic activity will be such that output will expand, employment will expand, and the government may well end up with a smaller deficit than at the outset. I wonder if this line of argument is not getting very close to the suggestion that there is, after all, such a thing as a free lunch?



# Response

## **Milton Friedman**

Unfortunately, I'm told I only have two hours.

I am shaken a bit by the discovery that John Kenneth Galbraith is agreeing with me and I rather doubt that's true. As a matter of fact I rather think that Ken has been making a career of going around and giving talks explaining how wrong I am and how I am responsible for 150% inflation in Israel because I spent a week there in 1977. Or about how I am responsible for the serious problems of Thatcher's government because I once had dinner with Mrs Thatcher.

But at any rate Professor Gruen has raised some very real and significant problems. Empirical evidence is hard to read and it is not one way. He is certainly quite right that the period to 1950 to 1970 was a period of very rapid and dynamic growth and he is right in asking for an explanation of that and of how I reconcile that with the growth in the size of the government in that period. My own view of that is very straight forward. I think in the first place that the rapid growth of government in that case was largely a consequence rather than a cause of the rapid growth of the economy. What happened in many of these countries during that period was that you were having a rapid growth in national income, output and employment and you were therefore able to afford to waste more of your substance on governmental activities than otherwise you would have been able to. As that dynamic expansion came to a slow down - for some reasons which were internal and some which were external and I'll come back to those - the luxury was no longer so easily affordable and the problems raised by the expansion of government spending had been coming home to roost in every one of the countries in question. Sweden is in very deep trouble right now. Germany has experienced difficulties. There is not one of the countries that you have spoken of that has escaped those difficulties.

Now why was there such rapid growth in 1950-1970?

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For one thing we have had something which we have observed over and over again and that Alfred Marshall in fact referred to at one point many, many years ago in some of his testimony. This was a phenomenon that a society which suffered a very great catastrophe was able to rebound from that and improve its lot much more rapidly than you might have expected. He was referring to the extent to which countries recovered immediately after war, and that the damage was done to physical things, leaving intact the knowledge, the understanding and so on. You have observed over and over again that any country which has gone through a great catastrophe and gets a period of stability of whatever kind, experiences for a while a very rapid rate of growth. That was true in China after the communists took over for they were able to eliminate the high inflation that had been raging and have a fairly stable inflationary course. It has been happening again in China after the Cultural Revolution ended in 1976. I don't believe that that means you can look forward to a long continued period of rapid growth in China. But I think in considerable part that what we were observing immediately after the War was a rebound from the enormous catastrophe of World War II.

I think a secondary favourable factor was that monetary collapses were avoided. There was no monetary disaster in the 20 years from 1950-70 that was comparable to the monetary disaster of the Great Depression, so that you had relatively stable monetary conditions under which you were able to bring to fruition many of the technological and scientific developments of the prior 40 or 50 years. Obviously time is limited and I'm only trying to suggest that this is an interpretation of that era.

But I go back to my belief that in certain respects the age before 1914 was a golden age. In my country, the United States, it was an age in which millions and millions of people from all over the world - poor people, my parents and the parents of many of my fellow citizens - were able to move from conditions of extreme poverty and come into the United States freely. There were no immigration restrictions. Anybody could come in. They were able to build a much better life for themselves and for their families without any welfare agencies, without any departments of social security, without any minimum wages, without any of the other apparatus which we now think is so essential. It was a period in which, despite the pressures raised by the enormous inflow of immigrants, you were able to get very rapidly rising living

standards. Now it's not a very different story I suspect from what you could tell for Australia at around the same period. The period 1846-1914 in Great Britain was one of great progress and rapid growth. I think those were golden ages. I'm prepared to attribute that golden age to the efficacy of a free enterprise system and of market arrangements.

Professor Gruen raised the question of my citing Hong Kong, Taiwan and Singapore and that these are countries where people do not have the effective vote. That is right in the case of Hong Kong and less so in the case of Singapore or Taiwan. You do have something of a benevolent dictatorship in Singapore, but you also have something of an operative democracy. You do have less than completely free government in Taiwan, but still you do have a considerable element of democracy as well. Associated with that was the question that Michael Porter raised as to whether any countries had been able to succeed in holding down the rate of monetary growth and whether there were political obstacles to doing so. Well, in the first place the cases we were citing earlier of the United States and Great Britain in the 19th Century, were cases of countries which progressed very rapidly under free enterprise systems and under circumstances where people did have the vote and where you had democracies. Moreover I am enormously impressed by this issue - people have always said that if you give people the vote, the have-nots will vote to take away the goods from the haves, but I think that is fundamentally wrong as shown by evidence. The drive and the pressure from these governmental regulations have not come from that source. They have come from the ideas of intellectuals.

In the United States we have a highly graduated income tax, not because the populace at large wants it or directly has expressed a desire for it. On the contrary we have had over the course of the past eight or ten years a whole series of referenda in individual states on the question of whether the state income taxes should be made more graduated. In every single case the public-at-large has voted it down. They voted down the graduated income tax in Connecticut. They voted down the increased graduation in Massachusetts, in the state of Washington and in several other cases. Similarly I don't really believe it is correct to say we had social security in the United States because there was a great public demand for it. On the contrary, the people who were interested in it had to engage in a sales campaign which Madison Avenue would have been proud of in

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order to get the people to swallow social security. They had to present misleading advertising, telling the public it was an insurance program, and so on. So I do not really believe that it is a fact of experience that democracies are incapable of exercising this kind of self restraint. I think it is an attempt to blame somebody else for our own sins.

Japan is the best example I know of a major country that has exercised effective monetary discipline and has stuck to it long enough to bring down inflation. Japan in 1973 had an inflation rate of 25%. It shifted monetary policy and reduced the rate of monetary growth from 25% to something like 10 or 12% a year. It kept it there for the next five years. The rate of inflation came down to under 5%. I think that is a very good and successful example.

The most dramatic example on another level was the case of Chile in the last 5 years where you started with an inflation rate of 700% a year, and where you did have a very deliberate policy of reducing government spending and the rate of monetary growth. After two or three years the inflation rate came way down and it has continued to come down. It is now in the range of somewhere like 20-25% a year, which for South American standards is very good. On the other side of that picture, after an initial period of readjustment, Chile has been having a very rapidly increasing economic growth rate. However, that doesn't really meet your point because it is another one of these countries which is not a democracy and where you have not had to count the votes. That is a serious defect of that particular example. It shows the economic principles involved but it doesn't meet Professor Gruen's political argument, though of course Japan does.

Let me jump to another couple of items. On the education side I do want to say (after all I'm a guest in your country so let me be generous to you) that you are better off in this case than we are at the elementary and secondary level. Not at the tertiary level. But as I understand it you do have a partial voucher system now in which the Commonwealth government gives per capita grants to schools in the private sector, according to the number of their students. So I am going back home to take Australia as an example of the point that it is feasible to have a voucher scheme.

I may tell you that another respect in which you are more advanced than we are (and less regulatory) is in your financial institutions. You don't have anything like the severe restrictions on interest rates which your banks can pay

on savings deposits as we do. You do have restrictions on the lending rates and you do have them on demand deposits, but not on savings deposits.

But in the education system - I haven't talked about that because I have written about that extensively for anybody to read - I strongly support the views of Michael Porter that it is a disgrace and a scandal. Parents ought to be free to choose where their children go to school. There ought to be more competition in schools, but the biggest scandal of all is in tertiary education. Professor Porter was stressing that scandal from the point of view of poor education, but I would like to stress it from the point of view of one of the most scandalous redistributive financial schemes in existence. I do not know of any other government program which so clearly taxes low income people to benefit high income people. You impose taxes on people who do not go to colleges and universities in order to provide free benefits to those who do go to college and universities, and the first class of people on the average are very much less well off than the second class of people. As I say I have written about that extensively and I'm not really going into it now only to agree with Professor Porter and that it is the same in both our countries.

In respect to some of Don Stammer's questions, I do not agree that money has gone out of control because the authorities have accommodated the inflationary settlements between employers and unions. I think one can establish a theoretical case where that could be a fact but as I have examined the empirical evidence I do not believe it conforms to it. I don't believe it to be a valid interpretation of inflation, so I resist the olive branch you offer.

On the welfare cost of inflation you are entirely justified in your criticism. I think those earlier articles, of which I authored at least one, were seriously deficient in restricting themselves primarily to the welfare effects of anticipated inflation and not allowing as fully as we might for the other costs. I think that defect has been rectified in much that I and others have written since, and I think there is a much wider recognition of the problems that you were raising than there was at the time. Maybe if you read the literature now you wouldn't be quite as disappointed.

On supply side economics, I agree with Don Stammer that the only thing new about supply side economics is the name. It is simply good economics if it's properly done. I wrote an article in *Newsweek* a few years ago on the Kemp-

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Roth tax bill which I entitled 'Kemp-Roth Free Lunch' and in which I said that while I was in favour of the tax bill, because I'm in favour of cutting tax at any time for any excuse, I could not accept the arguments that were given in support of it. I did not believe you could justify the view that an across-the-board cut in taxes without a cut in spending would have the effects described. I think there are many specific cuts in taxes which would increase revenue. Michael Porter referred to some of those when he referred to the graduated rates on the income tax but I think that is a very different thing. They increase revenue not so much because they induce people to work harder and be more enterprising, but because they simply shift effort from creating tax shelters to engaging in productive activity.

I apologise for taking more time than I should have in answering these questions, but you should really blame the panel because they raised some very good questions.

**Ray Pelham Thorman:** Does Professor Friedman see the self equilibrating nature of the market economy depending on the existence of perfect or near perfect competition? If so does he see the market economy remaining competitive without the need for legislative sanctions against non-competitive behaviour by businesses? Would he see the Australian Trade Practices Act or the equivalent U.S. anti-trust legislation as legitimate interventions by government in the market place, bearing in mind of course, his favourite scholar Adam Smith's well quoted aphorism about the propensity of businessmen to conspire together.

**Milton Friedman:** Number one, I do not regard the self equilibrating nature of an economy as depending on perfect or near perfect competition. We have to distinguish between the theoretical constructs and what we observe, and I wouldn't know perfect competition if I found it, but I do know how to write about it. More seriously I think the equilibrating nature is present with business as it is.

Number two, I am strongly in favour of as competitive a market system as possible. I have long concluded that the most effective single measure any government can take to promote such competition is not to have a stronger anti-trust division or a stronger trade practices act but to have complete free trade. In this country, for example, the removal of tariff protection would do much more to promote competition than would an anti-trust act.

In the United States you have to distinguish two components of the anti-trust laws. The original Sherman Act, which made agreements in restraint on trade unenforceable in the courts, was I think a very desirable measure in promoting competition. Almost all of the later additions to the anti-trust laws have in fact been pro-monopoly laws. There have been laws to protect one sector

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of the industry or another and I think those are ill-advised.

**Peter Brun:** You commented on the failure of governments to control their money supplies. To what extent is this because they have not really equipped themselves with the power to do so rather than the failure of will?

**Friedman:** That is a very good question, and the problem with answering it is what the word 'they' means. Let me illustrate very specifically. In the United States, part of our failure has been because the Federal Reserve system has been unwilling to alter its operating procedures in such a way as to be able to control the money supply effectively. That has not been because it doesn't have the power to do so - it does have the power to do so and therefore if you say 'they', being Congress not willing to give them the power then the answer is 'no'. If you say 'they', being the Federal Reserve, the answer to your question is 'yes'. But I think if the public at large had the will, if the government had the will, they would over-rule the bureaucratic unwillingness of such organisations as the Federal Reserve system to change its procedures in such a way as to enable it to control the money supply.

**Brun:** In other words the governments are lacking the will.

**Friedman:** Governments don't have any will. Only people have will. The public at large, the voters, have said to the governments they don't want them to control inflation and so the governments haven't controlled inflation. I believe in democracy and I believe that the people rule in a democracy, a little slowly, a little erratically, but sooner or later they do so.

Now as an empiricist I would be inclined to say that in modern western countries, inflation has to reach something in the neighbourhood of 20-30% before it reaches a level at which the costs you were referring to are sufficiently great to establish a will. The only exception to that is in those countries which have experienced a real hyper-inflation and there the will exists from the beginning. Germany has done well, not because it has better instruments of monetary control than other countries, but because it went through a hyper-inflation after World War I and after World War II and therefore it is politically unprofitable to produce inflation. In Japan they had to get up to 25% before they had the political will to do it. Great Britain had to get up to 20-25%



before it did. Maybe I'm duly optimistic in supposing that the United States will have the will before it gets up to 20 or 25%.

But I think it's a mistake to talk in terms of government this and government that. There is no government - there are only people in government who are operating an instrument in which the ultimate authority is exercised by the public at large. I think it's a tendency to shift the blame when instead of saying, 'we are to blame', we say 'it's that awful government that's to blame.'

**Frank Ash:** Concerning your views on the golden economic age, pre 1914, I'm interested in the difficulty of cross-cultural comparisons, because there was a completely different culture then. How can we be sure that the laissez-faire ideas that worked then will work now when we have a very much greater real wealth.

**Friedman:** I don't believe you will find levels of real wealth are important in that regard (and after all that's an empirical question). We have a good deal of empirical evidence on it because the countries which have engaged in laissez-faire policies have had very different levels of real wealth at different times. The real wealth of the U.S. in 1860 was very different from what it was in 1900. Britain in 1846 was different from Britain in 1900. I think the question you asked is one which is researchable. I'm not saying I've done the research in full - I am now giving you some casual reactions to the kind of evidence that I think is available, but it seems to me that we have countries at very different levels of economic well-being, of economic wealth, and what we have observed is that regardless of those levels the countries that have embarked on centralised control have not done very well and the countries that have embarked on a market system have in the main done better. A country like India was certainly no better off on the average than a country like Hong Kong or Singapore at the end of World War II, or than Japan was in 1867. And yet India did very very badly with centralised control and a collectivist welfare state approach while Japan in 1867 and Hong Kong in the 1950s did very well with the free market approach.

Ash: I agree with you completely, but the point I was getting at was that all those countries you mentioned started off from a much lower wealth, either measured per capita or

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measured on a gross physical scale, they had much less to work with than we have now.

**Friedman:** You are asking an impossible question, because if I'm right the only way to get to our scale is by having that free market system to begin with and if you don't have it then you have a low level of wealth. Take the modern world and look at countries like the United States and Japan in the period after World War II (Japan had a lower wealth but Japan has done very well). These are mixed systems, they aren't as clean cases as the 19th century cases but yet they are predominantly free market countries.. So now are you asking, is there some high income country which has been able to achieve dynamism in growth by some other means? Or is your proposition the Spenglerian proposition that we have an inevitable cycle of rise and decline and what we are facing now is the decline of the west. We may be, but I'm not clear which is your proposition.

Ash: My proposition was just to get your ideas on why markets will work when we are now at a high level of growth. Can you give us some reason why, if we keep this free market idea, we can go still higher when we have only just seen the free market idea working on the lower wealth levels?

**Friedman:** We haven't only seen them working on the lower ones. If you look at any one of these high income countries and ask what sectors of the economy have been most dynamic and have been most productive, they have been the free market sectors.

**Sidney Gilchrist:** My question to Professor Friedman concerns taxation which is an incentive. First may I congratulate and support him in his condemnation of currency debasement and tariffs, although I would like to have heard him a bit stronger in condemning income tax, sales taxes and similar taxes which are deterrent fines on economic transactions. It is economic transactions upon which our prosperity depends. So my question is why not use taxation which is incentive. Should not the main action of a wise government (or perhaps I should say now a wise people) which is seeking to achieve prosperity for all in a free enterprise system, be to steadily reduce income tax and sales tax and similar taxes on transactions and instead to gradually

increase site value taxation? Has not site value taxation been shown to be entirely practical? Is it not an incentive to the reasonably full and efficient use of all sites and resources and is it not an incentive to economic activity? Is it not a tax which does not fall on transaction nor on investment improvement capital?

**Friedman:** My fellow countryman Henry George was a great man. He wrote a major book. There is much truth in it, but it is possible to carry good ideas too far. I am in favour of a greater use of property tax, land value taxation, but I believe that people like yourself grossly overstate either the possibilities or the merits thereof because of not distinguishing between the theoretical attributes which would determine the land which is relevant to such consideration and the actual attributes which such land and other things have.

For example, the crucial feature of land value taxation is that you have a resource which is perfectly inelastic in supply and whose use will not be determined by the income which people get from using it. Now some land qualifies for that but a great deal of land does not qualify in those terms and a great deal of what is not land does qualify. I rather suspect Frank Sinatra's peculiar voice is just as inelastic in supply and in the kind of use that will be made of it, as is any piece of land in Australia and therefore there would be as little effect on incentive of taxing away the site value of Sinatra's curious voice, as there would be taxing away the site value of a piece of land. Now I'm only illustrating this to show the direction in which I would attempt to give you a full answer and to say, you and I can go a long way in the desirability of eliminating many kinds of taxes and giving an important role to site value. But the same logic will lead us to use other kinds of taxation as well and will lead us to refrain from carrying site value taxation to its full conceivable possible extent.

I hope you will pardon the dogmatic character of my statement, but it is based on the fact that I've heard this argument so very many times that I have developed a dogmatic answer to it. I must say that I admire the Henry Georgites. They and I are together on almost everything except how far we want to carry the good argument.

**Alan Searle:** I have a very brief question. The voucher system seems an excellent idea in relation to schooling. Is there any investigation into the possibility of using this

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system in the field of hospital care? If not, what do you think of the idea?

**Friedrnan:** I think there has been a good deal of investigation, a good deal of talk in the United States about using the voucher in the area of hospital care. As opposed to alternative methods of subsidising medical care I think it makes a great deal of sense, but on the whole I think the problems of medical sickness regulation and hospital care that Michael Porter was talking about go much farther than could be cured simply by a voucher scheme. I think the problems there go much deeper and farther afield and I think there you do need a very different kind of solution.

**Mr Plowman:** I'd like to ask Professor Porter is not the way to achieve minimum levels of government to introduce wherever possible (and I stress wherever possible) a user pays policy?

**Michael Porter:** My answer may be interesting but Professor Friedman's might be valuable.

**Friedrnan:** I won't charge any extra for it.

**Porter:** He's the scarce resource, but my answer is 'yes' we should have many more examples of user pay principles and while I think there has been an attempt to move in that direction, it seems very difficult to get politicians to act.

**Tony Dirnrnitt:** Professor Friedman, you speak with excellence on defending free enterprise, yet when it comes to the government monopoly on the control of the money supply you seem to use this as a specific example where it might not work. Have you considered some form of competition amongst suppliers of money or if not, at least allowing individuals and business firms to accept different forms of exchange instead of money?

**Friedrnan:** I'm entirely in favour of free competition so far as individuals and business firms are concerned. I do not believe a government ought to try to enforce any kind of monopoly on money. So there is no problem there at all. The place where we might come to some disagreement is on the conclusion which we might reach about the consequences of even a very vigorous attempt to promote competition in

the provision of money. I believe that unless government money is very badly mismanaged it will almost surely end up being accepted because of the great external advantage of having a single money. But maybe I'm wrong, and I don't want to assert that it is necessarily true and I have certainly always believed and do believe people should be free to use any kind of thing they want to in their transactions. Certainly they ought to be free to use foreign currencies. They ought to be free to use American Express Travellers Cheques or any other kind of travellers cheques. As a matter of fact the American Express Cheque is the only form of money in the United States that can be issued without any legal reserve requirements or any other legal regulation. And it has been a very successful form of private enterprise money. So I don't really think there is any difference between us on this issue at all.

**P. P. McGuinness:** If I may Mr Chairman, I'd like to ask Professor Friedman a very simple question. When discussing education he seems to be saying that the poor should not subsidise the education of the rich. Why not, is he a socialist?

**Friedman:** I don't think the rich should subsidise the education of the poor either. I think that people should be in a position where they are able to get the education they are willing to pay for and I'm all in favour of (as you know from my writings) arrangements which would enable people who cannot pay for it currently, to get the resources to get an education and schooling, provided that they will commit themselves to paying it back later or undertaking obligations later of an equity kind as a result of their having got the assistance.

My main point is a very different one and it's really not to make a debating point. But it always seems to me rather hypocritical of very many people who profess to be egalitarians to argue as they do for the kind of system of financing higher education that we do. Many of my intellectual confreres in the United States and many of yours here will profess to be egalitarians. If they are serious in their egalitarian professions they ought to be in the forefront of ending the kind of situation we have in university education. Now I'm not sure whether that is responsive to your question or not - perhaps not?

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**McGuinness:** I'm simply asking why you think anybody should be egalitarian?

**Friedman:** I'm not asking that anybody should be egalitarian.

**McGuinness:** That's implicit in almost all your arguments. You are arguing for equality of treatment, you are arguing for equality of opportunity, you are arguing for equality of contribution.

**Friedman:** I am arguing for equality of opportunity, I am not arguing for equality of results. And I'm not asking anybody else to be an egalitarian. Egalitarianism has different meanings. I personally have as my basic value human freedom and the important component of that is that individuals should be free to develop and exercise and take advantage of the qualities they have in accordance with their own values and that nobody has a right to force anybody to do anything else. I think when some people take money away from other people to help still third parties - it is not humanity and it is not compassion and it is not egalitarianism. It's a naked exercise of force.

**McGuinness:** So in fact you are a kind of socialist, or perhaps a Christian.

**Friedman:** I am neither one. I can assure you that I was born of Jewish parentage and that I have never converted, but I guess that does make me a Christian along with Jesus Christ.

**Alan Dawson:** How important Professor Friedman is a widespread public understanding of basic economic concepts to the maintenance of the market economy and what might be done to improve the level of economic understanding? I suppose that implicit in my question is the assumption that economists can agree on some basic concepts.

**Friedman:** Well, I'm not sure I'm able to answer your question on that. I do not believe a widespread understanding of basic economic principles or analysis is really necessary for appropriate economic policy. At any rate we have had good economic policies in various countries of the world at times when there has been very little such understanding on the part of the great public. I think what is much more

important is that the public have a set of values which is conducive to permitting a large degree of freedom and individual opportunity and a minimum of attempts at the use of force. I am very much struck by the historical observation that these seem to be very rare and that it seems to be very hard to develop. Such values have existed only over a small part of the surface of the earth. Many countries have tried to adopt such governments, for example many South American countries adopted the American Constitution word for word, but it hasn't had the same effect in those countries, and only a very few countries seem to have the kind of culture that is conducive to a free society. So I really don't know how to answer the second half of your question.

**Greg Story:** My question is for Professor Friedman on the flat rate of tax. The opponents of a flat rate of tax in Australia have told us that the loss to government revenue would be in a massive range, from some \$4 to \$7 billion per year. The advocates of the flat rate have never successfully refuted those figures. That loss to revenue would further be compounded if we adopted your alternatives of taxing spending or lowering the flat rate to 16 or 17%. Could Professor Friedman tackle the political question of the restraint on lowering government spending and tell us how to implement a flat rate of tax.

**Friedman:** In talking about the technical problem of a flat rate of tax, I think one ought to hold constant the revenue that the tax is designed to raise. Permit me to discuss this in the American context (I have a little difficulty because I don't know numerical parameters of the Australian situation). In the United States we have a graduated personal income tax which has rates running from 14% to 70%. We have a much more complex structure than yours - with many more brackets. It is possible to calculate arithmetically what flat rate would be necessary to raise identically the same revenue if you left the exemptions exactly where they are (the zero tax amount where it is) and if you simply kept the law the same except that you eliminated various of the kinds of deductions that are designated as loop-holes, so that you taxed on the gross rather than the net. It turns out that the arithmetical answer is that a tax rate of something like 18% would yield the same revenue as our present system of tax rates running

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from 14% up to a rate of 70%.

Now that's arithmetic. I think it would be a far better tax system. Very few people would pay more and almost everybody would pay less. Moreover in the United States I have made the estimate that a much simpler tax reform, would almost certainly yield more revenue than the present system does, namely keeping the tax law exactly as it is with all the loop-holes and everything else the same, except that you take every tax rate above 25% and reduce it to 25% so that the maximum tax rate is 25% and in the American context that system comes closer to approximating a flat system. It would eliminate a large part of the wedge between the cost of the tax systems to the taxpayer and the receipts which the government gets from the taxpayer. Now in the Australian context I simply don't know enough about your numerical values to tell you what flat rate would be necessary, but it is clear that there exists an arithmetical flat rate which would yield the same revenue as the present tax depending on the parameters that you feed into it. I suspect that either Don Stammer or Mike Porter can answer this better than I can as to what those numbers and parameters are.

**Michael Porter:** In 1975 the Priorities Review Staff with the assistance of the Tax Commissioner used the Bureau of Statistics data collected for the Inquiry on Poverty to calculate what flat tax rate was required to pay for the existing welfare structure, (e.g. to pay everybody basically the pension rate and other benefits, including recent Whitlam schemes). It was assumed that workers would, since many of the Whitlam schemes were just taking shape, continue to work the same hours. Given these assumptions the flat (marginal) tax rate came out at 43%.

There are a number of reasons for querying the applicability of that figure, but when the sum was done it was rather higher than expected (this was done of course when the Whitlam government was in full flight - or thought it was in full flight). That year, health, education and welfare expenditures were growing at the rate of 50% per annum.

**Friedman:** If that number were 43%, I think you would agree immediately that a lower number would clearly give you the same revenue, because that is an arithmetic number and it doesn't take into account the extent to which expensive tax shelters would be eliminated leading to more taxable income



reported.

In the United States, so far as the spending part of it is concerned, that raises the required tax rate very little, because spending amounts to something like 90-93% of total income and therefore on a spending tax you would have to have a 21-22% rate instead of an 18% rate.

**Porter:** I left out one major point. The calculation I referred to was a negative income tax calculation and the constant marginal rate which came out of that calculation was 43. The average rate paid by some people was going to be far less. 43% was not an average rate.

**Morton Bagley:** I am a surveyor and am glad that our tapes and chains don't alter their length like the value of money does. What I wanted to ask was, is there a limit that occurs after which further taxation brings in less revenue rather than more? Have we reached it or where is it?

**Friedman:** Of course there is a limit. We all know that 100% tax would bring in zero revenue so there must be a limit. This is the famous Laffer curve - zero tax brings in zero revenue and 100% tax brings in zero revenue. So there must be a turning point in between.

First of all I don't believe that the question can be answered in that way because I believe that the crucial consideration of where the turning point is depends on the structure and character of taxes. I think there are many many different turning points for many many different taxes. With respect to if you could really have a site value tax, a true honest-to-God Henry George site value tax, there would be no turning point. But you can't do it because you can not define the original and indestructible value of the soil (in David Ricardo's language). With respect to personal income taxes I have no doubt that in the United States we are way past the turning point in respect to the upper rates. But that doesn't mean we have passed the turning point with respect to the lower rates. You see what I am trying to say: I don't think your question admits of a very simple answer in that case.

In another context, one of your fellow countrymen, Colin Clark, estimated many many years ago that 25% was the highest fraction of a nation's income that could be taken in taxes without generating a process that would produce inflation. That was hooted down at the time but history

suggests that it wasn't such a bad conjecture. It might have been that 25% was a little low, but you don't have to go much higher before there's a good deal of empirical support for his proposition.

**Bob McGregor:** I am totally in favour of free competition at every level and like you I believe tariffs play a major role in protecting or insulating certain sectors of business from both internal and external competition to the detriment of most Australians. However, I believe exchange controls, perfected by the Nazis and embraced by the Australian government in the early 40s as a temporary measure, still restrict personal freedom in Australia today, as they restrict individuals doing what they want to do with their money. I ask the question: Is there any argument in favour of exchange controls and, if not, should they be abolished in Australia immediately as Margaret Thatcher did?

**Friedman:** I think there is no argument whatsoever. I have never been able to find an argument for exchange controls that would hold water. I agree with you, they should be abolished immediately. I believe it is true for Australia, I believe it was true in the United States and I was delighted when we abolished them. We did have a measure of exchange control in the United States some years back and I felt one of the best things Margaret Thatcher did when she came into office was to abolish exchange controls.

**Chris Anderson:** My question concerns the incentive people have to change the system and specifically how to reduce resistance by bureaucratic and other vested interests to change. For instance, I believe that in Australia a civil servant is paid more as the number of people who work for him increases, whereas to reduce government spending the reverse needs to be true. My question is: Is Professor Friedman aware of any ideas which address this problem?

**Friedman:** It has been suggested that the easiest way to be sure of getting rid of inflation would be to index all legislative and bureaucratic salaries inversely to inflation. I am sure that would work very promptly and very efficiently, but I am also sure that this is a wholly idealistic, utopian dream. I think you have raised a very important question. The only direction in which I can see to move is through some process of trying to institutionalise an overall limit on total

government spending, rather than changes in the bureaucratic rules. One possibility would be to eliminate the civil service system and have a complete spoils system.\* I think that has much to be said for it, but I don't think again it is within the realm of political or practical feasibility. The only proposition in the United States at any rate which I think might be within the realm of political feasibility is a movement that I among others have been trying to push, for getting an amendment to the Federal Constitution which would limit spending by requiring in the ordinary case, that government spending could not go up by a greater percentage than income went up and in order for that to be exceeded, you had to have the two-thirds vote of each house of Congress plus a few other measures. That's about the only device I really have been able to think of. I think the question you've raised is one which deserves a good deal more attention and it would be very nice if we could get some good inventions along this line.

**Richard Giles:** Professor Friedman, in view of your seeming hesitations about site value taxation, do you not think that what people will pay for access to a site constitutes a way of establishing this site value taxation?

**Friedman:** Well that depends on what you mean by paying access to a site and by what you mean by site value taxation. Just as you are not in favour of taxing the value of buildings, much land is also created and produced. Northwestern University in Evanston, a northern part of my former city of Chicago, is built entirely on land which was reclaimed from the ocean at a cost. Now I cannot see any justification for site value taxation of that land once it's been produced. The same thing goes with a great deal of the additional value of the land. So when you ask what access they will pay for, are you going to say what they will pay for it in its original form when it's newly discovered? If so then you have no more site value taxation - government sells the land off and it has that money.

**Giles:** Aren't we talking about sites and not simply land and the indestructible powers of the land? Aren't we talking

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\* Editor's note: In the United States, a spoils system means the practice of the distribution of public offices etc. among the supporters of the successful political party.

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about sites and therefore talking about the presence of the community around that site?

**Friedman:** Where did the community come from? There was no community, there were no Northwestern buildings out in that lake. In the early days, you could have offered up for bids the right to fill in that lake. The site value of that would have brought zero.

**Giles:** In which case the rent for that particular site would be nothing.

**Friedman:** Well would you allow that to be determined once and for all? If you do then you would never have anything like the right amount of money because you would have had to sell off all the land. We did that in the United States. We did exactly that. What happened was that most of the land in the United States was sold off to the public and it was sold off at a price that was not too far away from the market price that people were willing to pay for the privilege of developing that site. For example, take all of Iowa, Kansas - all of the rich farm land - it was all sold off by public sale. You had site value taxation in that sense. There is nothing more left.

**Giles:** I didn't intend it to be sold, but it be bid for and leased for a shorter period.

**Friedman:** It doesn't matter. For every indefinite lease there is a present capital value and it is equivalent to selling it. There is no difference between a sale and a lease.

**Giles:** I didn't say indefinite lease, I said a short lease.

**Friedman:** Well then if you make a very short lease nobody will develop it. If you make it for a very long lease then the present value is going to be the same. It really doesn't matter. You know, economics is economics, and the discounted value of an income stream has a certain capital value.

**Giles:** Do you say then, there is an optimal period of lease?

**Friedman:** I say the appropriate way to handle public land is to sell it off at auction. Let me give you a different

example. The right to have a television station is a very valuable right. In my country and in your country that right is given away supposedly for nothing. I say supposedly for nothing because I believe there are expensive efforts made to get the right assigned to one. Well now, what is the right way to distribute that publicly owned property? The right way to distribute, it in my view, is to auction it off. And that is the economic equivalent of what you are calling site value taxation.

**Giles:** I accept your answer, thank you.

**Dick Tanner:** At the risk of being accused of making a personal statement from the floor, I should like to give Professor Friedman some figures in the Australian context on the taxation figures which a previous questioner, Mr Story, has raised. What we have at the moment is a threshold in Australia of \$4,041 and the effect of this is to create an enormous income base on which no tax is collected. The reason for that is it supposedly looks after the lower income earner. In fact it doesn't do anything of the sort. It provides a basis for income splitting as mentioned by Professor Porter. The figures on the flat rate of tax if we were to move in that direction, are that we could raise the same amount of revenue in Australia with a flat rate of tax of some 20.9% which would thereby raise \$12.2 billion out of an income base of \$58 billion (from the latest available figure provided in the last budget papers). But the effect of the raising threshold over the last five years can be seen if we go back five years to the figures then. You could have raised the same amount of revenue as assessed five years ago when the threshold was only \$1,041, with a flat rate of tax of 17.5%. I think this gives the basis for Mr Story's comments that the amount of revenue lost, if we move to a flat rate of tax situation, is nothing like that which has been mooted by our politicians. In fact, there is a leak from Treasury which I think should go down as the leak of the decade, that if in fact we could move to a flat rate of tax there would be an extra \$5 billion worth of revenue derived from taxing the additional income that would be disclosed.

**Friedman:** In your estimate are you assuming that that base \$4,041 is subject to the flat rate of tax?

**Tanner:** Yes

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**Friedman:** Well then it seems to me you really have to separate two aspects of this. It may be desirable or undesirable to change the method of taxation to have either a lower threshold or to have a system on a per capita basis so that income splitting doesn't lead to the results you are speaking of. That may be desirable or undesirable, but that is a separate issue from the issue of given whatever tax base you have, the taxes imposed on it should be levied at a flat rate or a graduated rate. In the calculations I was giving I was throughout not changing the zero tax amount. I was not changing (for the United States) the tax deductible amount.

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# Taxation inflation and the role of Government

## MILTON FRIEDMAN

with

MICHAEL  
PORTER

FRED  
GRUEN

DON  
STAMMER

Milton Friedman is one of the most authoritative and independent figures in the fields of economics and political philosophy today. His research and published works have established him as the leading monetary economist of his time and his uncompromising advocacy of the many aspects of a free society and the free market have led to a re-examination of ideas and policies on the part of many people and governments.

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