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Taxes and the Structure of Production

Abstract – In Austrian theory, the business cycle is caused by expansive monetary policy, which artificially lowers the interest rate below equilibrium rates, necessarily lengthening the structure of production. Can tax alterations also cause an Austrian business cycle? Only if they affect time preference rates, the determinant of the shape of the Hayekian triangle. It is the contention of this paper that changes in taxes possibly can (but need not) impact time preference rates. Thus there may be a causal relation between fiscal policy and the business cycle, but this is not a necessary connection, as there is between monetary policy and the business cycle. This is contentious, since some Austrians argue that there is a praxeological link between tax policy and time preference rates.

Key words – Structure of production, Hayekian triangle, taxes, roundaboutness, time preference

JEL classifications – E2, E3, E4, E6, H2

1. – *Introduction*

The objective of this paper is to explore, from an Austrian economic perspective, the nexus between the structure of production and taxes. There are numerous Austrian studies of taxation [ROTHBARD, 1970, 1977] but these do not focus on the implications for the structure of production. Similarly, works on taxes by non-Austrians are abundant[1], but these do not even address the implications for the structure of production[2], albeit they do not address specifically the topic we wish to investigate.

Austrians have frequently focused on the structure of production and the concept of roundaboutness [BÖHM-BAWERK, 1959; HAYEK, 1932, 1975;

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[1] See for example Browning [1979], Browning and Johnson [1984], Buchanan [1984], Buchanan and Brennan [1980], Due [1963], Feldstein [1980], Musgrave and Musgrave [1959], Shoup [1969]. For an Austrian critique of some of these neoclassical perspectives, see Block [1989, 1992, 1993].

[2] Indeed, this is probably as good a short hand definition of the praxeological school as one is likely to obtain.

ROTHBARD, 1970, chs. 6 and 7; 1975; VON MISES, 1966, chs. 18-20], but their analyses have always been directed to the problems of the business cycle, or inflation, not taxes. The original aspect of this paper, thus, is to directly probe the relationship between taxes, on the one hand, and the structure of production, on the other [MACHLUP, 1935; KALDOR, 1932][3].

2. – *Theoretical background*

2.1 – Time preference rates

It shall be our contention that taxes affect the structure of production, or the shape of the investment triangle (see Appendix 1) insofar, and to the degree, that they impact on time preference rates. If taxes did not alter the rate of preference of present over future, then, according to the view espoused here, they would leave unchanged the structure of production. The reason for taking this stance is obvious; since the rate of time preference in an economy is the sole determinant of the shape of the triangle [ROTHBARD, 1970] it is inconceivable that any tax could alter the latter without doing so to the former as well.

This, however, brings us to an immediate problem. For there is no necessary relationship between a tax and time preference. To be sure, taxes, *ceteris paribus*, lower incomes. And income, or wealth, or salary, or take-home pay tends to be inversely related to time preference rates. That is, the richer is a person, the more likely he is to have a low time preference rate, and if a particular person gains wealth, the rate of his preference for present over future is likely to fall. But this need not be the case; for example, a person could become poorer, and yet undergo a decrease in his rate of time preference[4]. Thus, we cannot derive an apodictically certain relationship between the shape of the triangles and the effect of taxes; any association we succeed in uncovering cannot be any stronger than this mere tendency, or correlation; we cannot, in other words, derive any necessary relationship between taxation and the structure of production.

[3] I owe these citations to Richard Ebeling.

[4] There would appear to be only one exception to this general rule. At extremely low levels of wealth, literally at subsistence levels, if a person suffers a loss of income his time preference for the present must rise. And since if he does not survive, he will no longer be part of the economy, we may safely ignore those for whom this is not true. See Rothbard [1970, pp.329,330,380,381].

2.2 – Subsidies

There is also a second difficulty before we even begin. Our analysis shall be incomplete if we ignore the government subsidies which flow from the taxes, and are only made possible by them. If taxes were the sole phenomena to be considered, and we could safely ignore the expenditure side of the equation, our conclusions would be direct and straightforward: taxes lower incomes. A fall in income is (historically, or empirically, or statistically) linked with higher time preference rates; these, in turn, are correlated with a flatter triangle. Hence, taxes flatten triangles, QED.

In what way, however, shall we take account of subsidies? One possibility is to assume that the government budget is balanced, and that taxes thus equal subsidies. If we make the further assumption that each taxpayer is fully compensated by the government subsidies spent in his behalf, we might conclude that fiscal policy has no effect on the triangle; this would be because in the present scenario, any incipient flattening of the production structure due to taxes is exactly counterbalanced by its lengthening, due to offsetting subsidies.

But there are grave difficulties with such a model. First, it would be practically impossible for government to spend the consumers' money in their behalf exactly as they themselves would have, in the absence of the tax and subsidy. But unless this is done, the fiscal process would leave people poorer[5], and thus have a flattening effect on the triangle. Secondly, even if the state could somehow contrive this happy situation, it would still cost more than if government had not engaged in any such policy. Again, we have the same result: the structure of production becomes flatter. But even if government could somehow engineer this outcome, why engage in such a financially meaningless transaction in the first place? It would be null and void[6] in any case.

[5] We know this because otherwise the people could have done this for themselves. Why should they be forced to pay taxes, if they were truly made no worse off? See Rothbard [1977].

[6] See Calhoun [1953, p. 16]. Rothbard [1978, p. 53] states: «Few, comparatively, as they are, the agents and employees of the government constitute that portion of the community who are the exclusive recipients of the proceeds of the taxes. Whatever amount is taken from the community in the form of taxes, if not lost, goes to them in the shape of expenditures or disbursements. The two – disbursement and taxation – constitute the fiscal action of the government. They are correlatives. What the one takes from the community under the name of taxes is transferred to the portion of the community who are the recipients under that of disbursements. But as the recipients constitute only a portion of the community, it follows, taking the two parts of the fiscal process together, that its action must be unequal between the payers of the taxes and the recipients of their proceeds. Nor can it be otherwise; unless what is collected from each individual in the shape of taxes shall be returned to him in that of disbursements, which would make the process *nugatory and absurd* [...]» (emphasis added).