L.5.2

RFD 336

Board of Governors of the Federal Reserve System

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

November 17, 1959

The Necessity of Luxuries 6 pages

Reed J. Irvine

NOT FOR PUBLICATION

This Review is intended primarily for internal circulation and should in no case be cited or quoted. It consists of personal and informal contributions by the author, which in many cases represent tentative analyses of the subject considered.

The Necessity of Luxuries

Reed J. Irvine

The leaders of many of the less-developed countries have come to accept the notion that a free market is in fact a luxury that only the rich countries can afford. This attitude most often seems to be based on the fact that under a free market men are permitted to indulge their impulse to consume luxuries. This is considered bad, a fatal obstacle to an increase in national wealth.

This is by no means a new idea. It was widely held in Europe when mercantilist economic thinking was dominant. The absurd lengths to which European governments once went to limit consumption to what was then thought to be in the best interests of the nation would make a schoolboy smile today. However, modern thinking and performance is often only slightly less questionable.

The process of raising living standards has always meant the conversion of luxuries into necessities. One of the classical measures of living standards, the Engel Coefficient, is based on the observed fact that as incomes rise a smaller proportion of income is spent on the basic necessity, food, and more on other things. A rising standard of living means increasing consumption of goods and services in excess of the bare necessities of life. To condemn the free market because it permits this process to take place is paradoxical if higher living standards are an accepted goal.

The egalitarian argument

The condemnation of the free market for permitting consumption of luxuries is based on one of two assumptions. One is that the living standards of everyone should advance equally, that no one should enjoy any luxuries until everyone is assured enjoyment of the necessities. This egalitarian argument is noble but impractical, as the communists themselves have discovered. Economic progress depends heavily on incentives. Material incentives in the form of higher income, and hence greater consuming power, have been found essential to get men to work up to their mental and physical capacities in both communist and non-communist countries. Obviously if different levels of income are permitted, some individuals will be able to consume what others cannot afford. In other words, they will be able to enjoy luxuries. To condemn this as immoral is inconsistent with the principle that differential incomes are a necessary incentive.

The savings argument

The second assumption behind the paradoxical attack on the free market is that it is good for the long run welfare of the population if consumption is restrained and savings increased. This is valid if the individual can be made to see this and be persuaded to save voluntarily. The country will gain capital to help its further advance, and the individual's incentive to produce will not have been weakened. On the other hand, if the government tries to force him to save when he would prefer not to, it is in effect depriving him of part of the income that was initially given to him as a necessary and desirable incentive. The loss resulting from reducing the incentive may more than offset the gain derived from the addition to savings. Forced saving of this type generally succeeds only for short periods when it can be buttressed by special patriotic appeals, as in wartime.

Governments have devised more subtle techniques for discouraging consumption and increase savings. One of the most common of these is the restriction of the supply of goods and services that the consumer can buy. The theory is that money incomes alone will provide an incentive for harder work and that the absence of goods in the market will induce voluntary saving without reducing the income incentive. This is no doubt true in the short run. People can be induced to save in the expectation that at some future date they will be able to make better use of their money than they can at present. However, this is less likely to be true if the consumers are confronted with an indefinite period of scarcity and if it appears that rising prices will rob their savings of much of their value.

A question arises as to whether the urge to work and save can be maximized more readily by promises that consumer goods will someday be made available or by making the goods immediately available to heighten the incentive. The latter is the practice followed in the U.S. and most other developed countries. It cannot be said that it has resulted in an unsatisfactory level of saving in these countries. Enforced austerity, on the other hand, does not appear to have had any great success in increasing the rate of saving where it has been tried for long periods. British productivity teams that visited the U.S. in the postwar period were struck by the incentive to harder work provided by the ready availability of a wide variety of consumer goods in this country. They urged that their own government consider the advisability of moderating austerity to achieve the same results in Britain. There is little doubt that goods in the shop, whether they be bicycles or automobiles, are a more powerful incentive to work and save than a vague promise that such goods will some day be available at an unspecified price. The scarcity of material incentives in the form of goods available for purchase is one reason for low productivity in many Asian countries. In an agricultural economy that is not highly monetized, incentives in the form of goods that meet more than the subsistence needs of the peasants are especially important as a spur to greater effort. It has been noted many times in such countries that where attractive consumer goods are not available, increased earnings resulting from higher prices or wages often result in less work being done.

Personal preference vs. official taste

Laws that try to prevent the consumption of luxuries may be counter-productive in terms of the effect on savings and output. In any case, it would never be possible to limit consumption in a prospering economy to the bare subsistence level.1/ This means that a government will have to permit some luxuries even though it denies others. This frequently has anomalous results. If bananas are not permitted, more may be spent on sugar. If automobiles are restricted, the money that might have been spent to buy a car may be spent on cabaret entertainment, travel, or extra servants. If a girl can't buy lipstick, she may spend more money on clothing or jewelry. In other words, it is vitually impossible to close off all the possible avenues of luxury expenditure. Some luxuries may be injurious to health or morals and may be curbed on these grounds. Otherwise it is difficult to see why government officials should try to dictate the pattern of luxury consumption. But they do. Bananas are likely to be curbed more than sugar and automobiles more than the employment of personal servants, etc. This means the imposition of some official standard of taste and preferences in areas where the choice of the individual should prevail. In this connection it has been said that the typical official's definition of a luxury is "something that someone else can do without."

1/ Dr. Ma Yen-Chu, a Chinese communist population expert, called attention to the great pressure for raising consumption above subsistence levels in a paper on China's population problem written in 1957. Dr. Ma's paper has since brought the wrath of the communist regime down upon his head, probably because of the following frank discussion of this problem:

> "One of the reasons for the Polish and Hungarian incidents is precisely that the Governments paid attention only to industrialization and not to the needs of the people, changing the people's zeal for industrialization into disappointment in life, and thus causing trouble....Nowadays, peasants always want to keep a little more of the grain they produce, and to catch up gradually with the standard of urban inhabitants in respect of livelihood requirements. They want to have more edible oil, and thus the supply of edible oil is tighter than that of grain. They want to wear more new clothes, and thus cloth is in shortage...and cloth tickets can fetch only half of their denoted quantity. Therefore, while the twelve million newly increased population whom we settle in rural areas every year cannot raise their labor productivity within a short period, they nevertheless try to catch up with urban people in respect to their living requirements."

Quoted by S. Chandrasekhar in "China's Population Problems", Far Eastern Economic Review, June 11, 1959, p. 808.

Imported luxuries

What is even less defensible is the common belief that the luxuries that must be denied the consumer are those that come from foreign countries. The high income receiver is not prevented from buying a domestically made automobile, but he may not be allowed to buy an American car. The Cadillac has become the universal symbol of the evil waste that the operation of an unrestricted free market supposedly visits upon poor countries.

Limiting the availability of luxury goods in general may under some conditions contribute to more austere living and help encourage habits of thrift. Limiting the availability of imported luxuries will have the effect of encouraging the consumption of domestically produced goods and services. In most cases this will hinder rather than help the country's economic enrichment. The reason is that it is almost always more costly in terms of the labor and other resources to produce such goods domestically than it would be to obtain them through international trade. For example, it is obvious that a country with a very limited market for automobiles and a scarcity of capital can produce cars only at a relatively high cost, since this is an industry that is capital intensive and well-suited to mass production techniques. Such a country can take advantage of the low cost of capital in the more advanced countries and the great economies possible through mass production by concentrating on goods more suited to its own potentialities and exchanging these for automobiles produced more efficiently elsewhere. In doing this it can satisfy consumer demand for automobiles, or whatever other product is involved, at less cost than it can by trying to produce the good itself.

The idea that it is more outrageous to spend foreign exchange for luxuries than to spend domestic currency has grown up because of the prevalence of exchange rates that have overvalued domestic currencies in the postwar period. This has led people in many countries, including some economists, to believe that foreign money is necessarily always intrinsically more valuable than domestic currency. This is why it is felt that it is so wrong to use foreign exchange to buy baubles, even though buying baubles may not in itself be thought wrong. Where a currency is not overvalued and can be freely exchanged for any foreign money, as in the U.S., Canada and nearly all European and Latin American countries, people are less likely to be confused on this score. No one would dream of arguing that the U.S. should "save" the millions of dollars in foreign exchange that it spends on coffee by banning imports and starting coffee plantations in Texas. Any one can see that the money "saved" on imports of coffee would be more than offset by the higher cost of producing coffee domestically. Obviously dollars spent in Texas are just as valuable as dollars spent in Brazil and should be used with equal care. This means that neither dollars nor any other currency should be used to buy domestically produced luxuries if the goods may be obtained at lower cost elsewhere.

The illusion that the reverse is true can only be corrected by getting rid of the overvalued exchange rates and getting governments out of the business of rationing foreign exchange. When a currency is properly valued, foreign exchange can safely be made freely available to all who want to buy it, and nothing is gained economically by attempting to ration it. When this is done, the market mechanism can do a far better job of pointing out what goods should be produced domestically, what should be exported and what should be imported than can any collection of "experts." Bureaucrats assigned this task generally know very little about either production or markets. They work with the additional handicap of distorted exchange rates and restrictions on trade which make it virtually impossible to properly assess many of the factors that have to be considered in trying to decide what production is economic and what is not.

Taxes and tourism

It may be that there are political reasons for wanting to curb conspicuous luxury consumption. Where markets are imperfect and elements of monopoly are strong the disparity of income may be far greater than can be justified by any reasonable requirement for incentives. This can lead to charges of unfair distribution and injustice that may reflect badly on the free market. Progressive income taxes should serve to limit these disparities, but where tax systems are weak income taxes may not work too well. Luxury excise taxes would be justified under such conditions. However, it is clear that such taxes should apply equally to domestic and imported goods and services. Some differences in the taxes levied on different commodities may be justified to secure the effect of imposing heavier taxes on the very rich. For example, diamonds might be taxes at a higher rate than face powder.

However, it would be well to exercise caution in this type of discrimination. Luxuries have varying degrees of utility in contributing to economic efficiency and growth. In less developed countries, automobiles are characteristically purchased by the rich, but they also perform an extremely valuable function in speeding local transport and are an aid to efficiency. Alcoholic beverages may be bad for the health, but their absence may render an area less attractive to free spending tourists, as India has discovered. The prosperity of Hong Kong in the postwar period owes much to the fact that it has refrained from taxing luxuries. As a result, it has acquired a world-wide reputation as a good place to shop and has earned millions of dollars selling other countries' luxuries to tourists. On the other hand, nearby countries with high import duties and austerity measures attract few tourists. Those who do visit such countries are generally appalled by the high prices and keep their purses tightly buttoned.

The conditions that make a country unattractive to tourists also make it less attractive as a place of residence. Very often the wealthy citizens of such countries contrive to spend as much time as possible abroad, where they can enjoy luxuries at less cost than they can at home. This not only defeats the purpose of the curbs on luxury consumption, but such individuals are very likely to save less and invest less in their own countries than they would if they were full time residents. They must usually take some of their capital out of the country to provide themselves while abroad with a source of income unhampered by exchange controls.

It is interesting in this connection to note that the Philippines, one of the Asian countries that makes luxuries particularly expensive by restricting imports and imposing heavy taxes, spends over ten times as much on foreign travel each year on a per capita basis as does Japan. Much of this is spent in nearby Hong Kong, which is known as Manila's "suburban shopping center." Philippine earnings from foreign travel, on the other hand, are pitifully small. It would be erroneous to conclude that the availability of luxury goods is the only determinant of whether a country earns more from tourism than it spends, but there is little doubt that this is an important factor.

Austerity is admirable, and the defense of luxurious living is seldom popular. Certainly thrift and diligence are to be encouraged for the good of the nation as well as the individual. But paradoxical as it may seem, the hope of greater enjoyment of luxury and leisure is one of the chief incentives to thrift and diligence. To maximize individual economic effort luxuries are necessities.