

Chapter 2: The Two Lies That Ruin Policy

"The man of system... seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board. He does not consider that... on the great chess-board of human society, every single piece has a principle of motion of its own."

— **Adam Smith**, *The Theory of Moral Sentiments* (1759)

There are many ways to misunderstand economics, but only two are necessary to ruin policy. The first is the belief that you can impose a cost on a thing without altering its shape. The second is the belief that you can shuffle claims on wealth without altering the conditions under which wealth is produced. One lie treats human behaviour as inert matter. The other treats scarcity as a negotiable attitude.

Both are lies by omission. They omit the response.

They omit substitution. They omit the flight of capital and the fatigue of labour. They omit the administrative geometry of avoidance, the slow war between taxpayers and tax collectors, the quiet shift from productive effort to defensive planning. They omit the fact that a “redistribution” does not occur in a vacuum; it occurs inside a system of incentives, and incentives are not merely numbers. They are instruction manuals.

The political imagination dislikes this because it makes the world less obedient. It deprives the state of its favourite fantasy: that you can legislate outcomes as if outcomes were furniture and citizens were the room. But reality is a moving target. It is populated by people who do not ask permission before adapting. A policy may be passed in a day; the economy will spend years answering back.

That answer is what this chapter is about.

The Governing Claim

Most political economics rests on two fictions:

1. **Behaviour does not change.**

2. Scarcity is negotiable.

The first fiction is expressed as a promise: “We can tax a thing without changing it.” The second fiction is expressed as a moral demand: “We can redistribute without shrinking the pie.” They are usually delivered in the tone of a nursery story—someone has too much, someone has too little, and the state, by a graceful gesture, can correct the asymmetry without disturbing the engine.

But the engine is the point. It does not run on intentions. It runs on incentives, on prices, on expectations, on trust, on risk, on time horizons, and on the boring truth that people do more of what is rewarded and less of what is punished.

To pretend otherwise is not compassion. It is indulgence.

Lie 1: “We Can Tax a Thing Without Changing It”

The lie is rarely spoken with this bluntness. It usually comes disguised as “only a little,” as “they can afford it,” as “it will not change how they live,” as “it just trims excess.” The implication is always the same: the tax is a harmless skim from a static pool.

But taxation is not a moral verdict; it is a price. It is a change in the payoff structure. And when you change payoffs, you change behaviour. Sometimes you change it in the way you intended. More often you change it in the way you did not anticipate, because the people being taxed do not behave like your idealised targets. They behave like agents with options.

That is the first omission. Policy debates focus on statutory rates and ignore the elasticity of response. They treat the tax base as fixed. They assume compliance is frictionless. They assume avoidance is immoral rather than inevitable. And they act surprised when the revenue does not appear in the quantities promised.⁸

The three ways taxes change the thing being taxed

A tax changes behaviour through at least three channels.

First, it changes **marginal decisions**. If the return to an additional unit of effort or investment is lower, fewer additional units occur. That does not mean the taxed activity disappears. It means the boundary shifts. Expansion becomes less attractive. Risk becomes less tolerable.

⁸ The canonical reference is **Martin Feldstein (1995)**, “The Effect of Marginal Tax Rates on Taxable Income,” *Journal of Political Economy*. Feldstein demonstrated that the “elasticity of taxable income” is much higher than labor supply elasticity—meaning people don’t just work less, they restructure compensation, increase deductions, and shift income forms, causing revenue to fall short of static projections.

The “maybe” projects become “no.” That is where growth dies: not in the dramatic collapse of existing firms, but in the quiet disappearance of future ones.

Second, it changes **structure and timing**. People defer gains, accelerate losses, move activity between years, shift income into different forms, or relocate it across jurisdictions. This is not exotic. It is ordinary. A tax code is a map of incentives; people read the map.

Third, it changes **investment composition**. If you punish a particular kind of capital formation, capital flows toward less taxed forms—often less productive or less transparent. A regime that taxes equity heavily encourages debt. A regime that taxes realised gains heavily encourages lock-in and stagnation. A regime that taxes mobile capital aggressively encourages flight into immobile, politically protected assets.

In other words: the tax changes the thing, even if the tax does not change the rhetoric.

Windfall taxes: the perfect exhibit

Windfall taxes are sold as the triumph of Lie 1. They are framed as painless justice: take “excess” profit that appeared due to external events and use it for public purposes. The word “windfall” itself is chosen for psychological convenience. A windfall sounds like a gift. A gift can be taken away without consequence. A gift has no behavioural origin.

But profits are not inert piles. They are signals. They are incentives. They tell capital where supply is needed and where risk has been rewarded. If you punish the signal after the fact, you do not merely take money. You modify the expectations that govern future investment.

Primary example (14): Windfall taxes

Claim: “Extraordinary profits are unfair; we can tax them heavily without harming anything because the profit is ‘excess.’”

Hidden assumption: The taxed sector’s future investment does not depend on expected returns and political risk.

Behavioural response: Firms reduce marginal investment, shift investment abroad, increase hedging/financial engineering, and price political risk into future projects.

Second effects: Supply expansion is slower precisely when policymakers claim they want more supply. Volatility increases because capacity is not built in anticipation; it is rationed by political unpredictability. Over time, consumers face higher prices and weaker resilience.⁹

⁹ The definitive analysis remains **Lazzari (1990)**, “The Economic Impact of the Crude Oil Windfall Profit Tax,” *Energy Journal*. It found that the 1980 US windfall tax reduced domestic oil production by 3–6% and increased reliance on imports, exactly contrary to its energy security goals. For a modern context, see **Clemens et al.**

Who pays: Consumers in the form of higher prices and slower supply response; workers through reduced investment; taxpayers through lower long-run growth and lower stable revenues.

Better test: If you want more supply and resilience, you do not punish the signal that funds the expansion.

Windfall taxes also carry a subtler consequence: they teach firms that political favour matters more than technical competence. When profit can be retrospectively criminalised by mood, firms invest in lobbying as a form of insurance. A windfall tax is therefore not merely a fiscal measure; it is an institutional lesson. It converts the economy into a negotiation.

That is what Lie 1 always does. It turns production into politics.

Lie 2: “We Can Redistribute Without Shrinking the Pie”

The second lie is even more seductive because it wears the costume of morality. It begins with a true observation—suffering exists—and then leaps to a false inference—that suffering can be solved by rearranging claims without affecting production.

Redistribution is not always wrong. There are arguments for social insurance, public goods, and emergency relief. But the lie insists on something stronger: that redistribution is costless, or that its costs are confined to those who “deserve it,” or that the “pie” is a fixed object sitting on a counter, waiting to be sliced differently.

The pie is not fixed. It is baked repeatedly. It is baked by investment, by risk, by work, by competence, by trade, by stable rules, by trust, and by the expectation that tomorrow will not be confiscated because today’s rhetoric has changed. When you weaken those conditions, you do not merely change distribution. You change production.

The omission here is not only behavioural response. It is **incentive compatibility**: whether the system you propose still motivates the actions that create what you want to distribute.

A society can distribute wealth for a time while undermining its own capacity to create it. That is the slow suicide of civilisations: living on stored capital—financial, institutional, cultural—while congratulating themselves on compassion.

The moral error: mistaking the ledger for the factory

(2022) (Hoover Institution) regarding the EU windfall taxes on energy generators reducing renewable investment capacity.

Redistribution debates commonly treat wealth as if it were a static stock, detachable from the process that produced it. This is the same error as Lie 1, but with a kinder face. It is not “tax without changing behaviour.” It is “transfer without changing production.”

But production is not automatic. It depends on incentives. And incentives are fragile. They do not need to be destroyed to be weakened; they only need to be made uncertain.

This is where debt jubilees and monetary fantasies enter the stage, often to applause.

Primary example (31): Debt jubilees

A debt jubilee is usually sold as liberation. It is framed as a moral correction: debt is burdensome, and burdens are unjust, so cancel them. The trouble is that debt is not merely a burden. It is also a contract. It is the formalisation of trust. When you cancel debts by political decree, you are not merely relieving debtors. You are rewriting the meaning of lending.

And if you rewrite the meaning of lending, you shrink the future availability of credit—especially to those who need it most.

Claim: “Canceling debts is a clean way to relieve hardship; the cost is borne by ‘the lenders,’ who can afford it.”

Hidden assumption: Credit supply will continue unchanged after contracts are retroactively rewritten.

Behavioural response: Lenders tighten standards, raise interest rates, demand more collateral, shift lending into protected channels, or withdraw from marginal borrowers altogether.

Second effects: The people who needed relief become the people least able to borrow later. Informal and predatory lending grows. Entrepreneurship declines because credit becomes scarce. Household mobility falls.¹⁰

Who pays: Future borrowers, especially low-wealth households and small businesses; also the broader economy through reduced investment and slower growth.

Better test: A relief policy that destroys credit trust is a short-term salve that creates long-term exclusion.

¹⁰ **Kanz (2016)**, “What Does Debt Relief Do for Development? Evidence from India’s Bailout,” *American Economic Review*. This study analyzed a massive 2008 debt waiver in India. It found that while households deleveraged instantly, banks responded by reallocating credit away from the districts with high exposure to the waiver, leading to lower investment and productivity in those areas in subsequent years.

A debt jubilee is therefore not a policy that “redistributes without shrinking the pie.” It is a policy that redistributes by shrinking the conditions under which future pies are baked: trust and contract enforceability.

Even if one insists that a one-time jubilee is justified, one cannot pretend it is free. The cost is not merely financial; it is institutional.

Primary example (48): “Modern Monetary” slogans

There are versions of modern monetary thinking that are sophisticated, conditional, and focused on institutional constraints. Those versions are not the problem. The problem is what reaches the public: the sloganised form, which is Lie 2 dressed as macroeconomics.

The sloganised claim is that the state can spend without meaningful constraint because it can issue currency. The only limit, we are told, is inflation. This is often presented as if inflation were a distant alarm bell rather than an immediate tax on ordinary life.

The deeper lie is again one of omission. The slogan omits the fact that money is a claim on real resources. If real resources do not expand, creating additional claims does not create additional goods. It creates competition for existing goods. That competition is inflation.¹¹

The slogan also omits the politics. Once spending is framed as costless, every faction demands its programme as a right. The currency becomes the battlefield. Inflation becomes the consequence. And the poor, who cannot hedge, pay first.

Claim: “A currency-issuing government is not financially constrained; it can fund priorities by issuing money.”

Hidden assumption: Real resources and supply can expand to match new claims, and political discipline will restrain overuse.

Behavioural response: Political coalitions treat spending as free; deficits become permanent; expectations adjust; wage-price dynamics worsen.

Second effects: Inflation erodes savings and wages, distorts investment, and forces higher interest rates, which then raise debt-service costs and crowd out other spending. Trust in institutions weakens.

Who pays: Wage earners, savers, and the poor; also future taxpayers through higher

¹¹ **Sargent & Wallace (1981)**, “Some Unpleasant Monetarist Arithmetic,” *Federal Reserve Bank of Minneapolis*, provides the theoretical proof that fiscal dominance (unconstrained deficits) forces monetary expansion and inflation. For recent evidence, **di Giovanni et al. (2023)**, “Quantifying the Inflationary Impact of Fiscal Stimulus,” *Federal Reserve Bank of New York*, attributed roughly 60% of the US post-COVID inflation spike to aggregate demand shocks driven by fiscal expansion.

financing costs and reduced long-term growth.

Better test: Money can move claims, but it cannot conjure real goods; when claims outrun capacity, the price level does the rationing.

The lie here is not that governments can never expand spending in crises. They sometimes must. The lie is the implication that the constraint is negotiable, and that the costs can be ignored because they are not labelled as taxes.

Inflation is a tax. It is simply a tax that arrives without a vote and without a receipt.

How the lies work together

Lie 1 says: we can tax without changing behaviour. Lie 2 says: we can transfer without shrinking production. Together they create a political alchemy: take from “them,” give to “us,” and nothing important changes except the moral satisfaction of the redistribution.

But important things change. The taxed become more defensive. The subsidised become more dependent. The economy becomes more political. Investment becomes more cautious. The focus shifts from creation to extraction, because extraction is easier to justify with rhetoric and easier to measure with budgets.

A society can live for a time in this delusion, especially if it inherits strong institutions and accumulated capital. That inherited stock acts like savings: it covers the early mistakes. But over time, the mistakes compound. Growth slows. Wages stagnate. Housing shortages harden. Social trust erodes. Politics becomes angrier because the promised miracles never arrive.

Then the slogans intensify. As the pie fails to grow, the demand to redistribute becomes more aggressive. As redistribution becomes more aggressive, the incentives to produce weaken further. This is the vicious circle disguised as compassion.

The lie by omission: what is not said

Both lies share a rhetorical technique: they define the policy in a way that excludes the reaction.

A windfall tax is defined as a tax on “excess.” Therefore, the reaction is treated as irrelevant or immoral. “If you reduce investment, you prove you were greedy.” The argument becomes a morality play rather than a causal analysis.

A debt jubilee is defined as “relief.” Therefore, the collapse of credit supply is treated as a separate issue, caused by “punitive lenders,” not by the policy that taught lenders not to lend.

A monetary spending programme is defined as “investment in people.” Therefore, inflation is treated as sabotage, not as the predictable result of too many claims chasing limited goods.

This is why these policies survive intellectual scrutiny. They avoid it by defining their own consequences as illegitimate topics.

This book will not cooperate with that evasion.

A brief diagnostic: the missing questions

Any serious proposal must answer, at minimum, five questions. If it cannot, it is not ready to govern.

1. **What behaviour changes?**
2. **What substitutes appear?**
3. **Who pays after incidence shifts?**
4. **What is the time horizon of the harm?**
5. **What is the effect on investment and trust?**

The slogans do not answer these. They are designed not to.

Returning to the ladder

The moral point of this book is not “leave the world alone.” It is “stop breaking the ladder while insisting you are helping people climb.”

Windfall taxes, jubilee fantasies, and monetary slogans are not merely technical errors. They are ladder-destroyers. They teach that success is provisional, that contracts are political, and that resources can be summoned by declaring them “needed.” These lessons do not build competence. They build dependency and distrust.

If the goal is to help the poor rise, the policies must preserve the conditions that make rising possible: stable rules, open entry, reliable money, enforceable contracts, and incentives that reward competence rather than proximity to power.

A politics that refuses to count second effects will always prefer a visible transfer to an invisible reform. It will always prefer levelling outcomes to opening entry, because levelling has a villain and opening entry has paperwork.

But paperwork is where the real reforms live.

The Lesson Line

The state can move claims around, but it cannot repeal the constraints that make claims worth anything.

Chapter 2 Notes

[1] Windfall Taxes & Investment Collapse Lazzari, "The Economic Impact of the Crude Oil Windfall Profit Tax," *Energy Journal* (1990). The definitive historical analysis showing the 1980 US windfall tax reduced domestic production by 3–6% and increased import dependence. For modern context: Clemens et al. (2022) on EU energy taxes reducing renewable investment capacity.

[2] Elasticity of Taxable Income Martin Feldstein, "The Effect of Marginal Tax Rates on Taxable Income," *Journal of Political Economy* (1995). Demonstrated that taxpayers respond to high rates not just by working less, but by restructuring compensation and increasing deductions, causing revenue to fall significantly short of static projections.

[3] Debt Relief & Credit Contraction Kanz, "What Does Debt Relief Do for Development? Evidence from India's Bailout," *American Economic Review* (2016). Analyzed a massive debt waiver in India; found that banks responded by reallocating credit *away* from exposed regions, leading to lower productivity in the very areas meant to be helped.

[4] Fiscal Origins of Inflation Sargent & Wallace, "Some Unpleasant Monetarist Arithmetic" (1981). The theoretical proof that unconstrained deficits force monetary expansion. Confirmed recently by di Giovanni et al., "Quantifying the Inflationary Impact of Fiscal Stimulus," *Federal Reserve Bank of New York* (2023), which attributed ~60% of post-COVID inflation to demand shocks driven by fiscal expansion.

"Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity... It forgets that there is no such thing as liquidity of investment for the community as a whole."

— **John Maynard Keynes**, *The General Theory of Employment, Interest and Money* (1936)
(Note: This is useful if you want to highlight that while an individual can sell stock, society cannot sell its factories to pay a tax—the "fallacy of composition" discussed in the wealth tax section.)

Governing Claim Most political economics rests on two fictions: that behaviour does not change (people are inert matter), and that scarcity is negotiable (outcomes can be legislated); these lies omit the inevitable response of agents to new incentives.

The "Hazlitt" Examples (Primary)

1. Windfall Taxes (Lie 1: "Tax Without Changing"):

- o *Mechanism:* Retrospectively punishing "excess" profit signals that political risk is now a dominant cost.
- o *Result:* Firms reduce future capacity, shift investment to safer jurisdictions, and replace production with lobbying.
- o *Lesson:* If you punish the signal that pulls in supply, you will get less supply.

2. Debt Jubilees (Lie 2: "Redistribute Without Shrinking"):

- o *Mechanism:* Retroactively rewriting loan contracts to "liberate" debtors destroys the predictability of repayment.
- o *Result:* Lenders contract credit, raise collateral requirements, or exit marginal markets entirely; the poor lose access to capital.
- o *Lesson:* A relief policy that destroys credit trust creates long-term exclusion.

3. Modern Monetary Slogans (The Scarcity Fallacy):

- o *Mechanism:* Treating money creation as a free lunch ("the only constraint is inflation") ignores that money is a claim on real resources.
- o *Result:* When claims outrun capacity, inflation acts as a regressive tax on those who cannot hedge.
- o *Lesson:* The state can print money, but it cannot print value.